



## INSIDERS OWNERSHIP AND GENERATIONAL PHASE IN SMEs FAMILY FIRMS<sup>1</sup>

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### ABSTRACT

This paper provides new evidence on the way in which ownership influences firm value. We analyze the effect of the insider ownership on firm performance in family SMEs, highlighting the generational effect using data on 336 non-listed Spanish SME family firms. For this purpose we have distinguished between first, second and subsequent generation family firms. The empirical evidence obtained support the monitoring and also the expropriation effects. Our results support the convergence of interest and entrenchment hypothesis on the relationship between firm performance and insider ownership in family firms. The profitability of family firms grows with low and high levels of insider ownership and falls in the intermediate levels.

**Key words:** insider ownership, non-listed firms, family firms, generation

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## 1. INTRODUCCIÓN

The relevant literature suggests that ownership structure is one of the main corporate governance mechanisms influencing the scope of a firm's agency cost. Berle and Means (1932) suggest that ownership concentration should have a positive effect on performance because it alleviates the conflict of interests between owners and managers. In this sense, concentrated ownership structures leave aside the classic agency problem between managers and shareholders, but lead to a conflict between majority and minority shareholders (Shleifer and Vishny, 1997, La Porta et al., 2000).

In this context, this study focuses on non-listed SME family firms with concentrated ownership structures whose principal shareholders are, in many cases, families. Most studies focus on listed firms, so we considered it is very important to focus on non-listed SME firms to fill this gap. It is interesting to check whether the results obtained on the behavior of internal control mechanisms of non-listed firms, could be compared with findings from numerous studies investigating listed firms.

Our results support the convergence of interest and entrenchment hypothesis on the relationship between firm profitability and insider ownership in family firms. The profitability of family firms grows with low and high levels of insider ownership and falls in the intermediate levels.

This study seeks to make a new contribution with a highly representative sample of non-listed Spanish SME family firms. The limitations identifying non-listed family firms imply that the detailed analysis of the information in databases and the survey are the only ways to do so. This paper uses a combination of these two forms to categorize family firms.

The aim of the paper is to examine the effect of ownership structure of non-listed SME family firms on firm performance, using the insider ownership as corporate governance mechanisms. Besides, verifying whether the generational phase generates a different behavior in the action of these mechanisms.

Our results support the convergence of interest and entrenchment hypothesis on the relationship between firm performance and insider ownership in family firms. The performance of family firms grows with low and high levels of insider ownership and falls in the intermediate levels. Results depend on which generation runs the firm. For first generation family firms the results support the convergence of interest and entrenchment hypothesis, but when second and subsequent generations run the firm there is no significant relationship between the two variables.

The rest of the article is organized as follows. Section 2 contains a review of the literature regarding the ownership structure as a control mechanism, and presents the hypothesis and models. Section 3 sets out the data and procedures for analysis used in undertaking this empirical study. The main results of the investigation are presented in Sections 4. Finally, Section 5 sets out the principal conclusions, and the paper ends with a list of bibliographical references.

## 2. THEORETICAL BASE

Ownership structure and its impact on firm behavior is one of the most debated issues in literature today (McConaughy et al., 1998; Ang et al., 2000; Anderson and Reeb, 2003a,b; Maury, 2006; Villalonga and Amit,

2006; Bennedsen et al., 2007; Miller et al., 2007; Eddleston et al., 2008). Most researchers use agency theory to explain the influence of ownership structure on firm performance (Anderson and Reeb, 2003a,b; Villalonga and Amit, 2006). Agency theory treats the company as a nexus of contracts through which various participants transact with each other (Jensen and Meckling 1976). Agents are opportunistic and are strongly motivated to take profit from the information asymmetry between them and their principals. This theory asserts that management and ownership pursue different interests, where top managers may be more interested in their own personal welfare than that of shareholders (Jensen and Meckling 1976).

Non-listed companies are characterized by concentrated ownership and the main agency problem is between the majority and minority shareholders. The origin of conflicts in concentrated ownership firms can be found in the tendency of majority shareholders to use their power to gain benefits that harm the private wealth of minority shareholders (La Porta et al., 1999; Francis et al., 2005). A greater concentration of voting rights can therefore lead to greater incentives for controlling shareholders to obtain private benefits. This trend may be exacerbated in the case of family firms because those benefits remain in the controlling family, whereas in non-family firms they are distributed among a large number of shareholders (Villalonga and Amit, 2006).

In the context of family firms with high ownership concentration, the agency problem seems less important, given that the controlling shareholders have sufficient incentives, power and information to control top managers (Jensen and Meckling 1976).

Founding families represent a special type of shareholders in firms. Anderson et al. (2003a) say that founding families differ from other shareholders in two main aspects: the interest of the family in the long-term survival of the company, and the concern of the family for the reputation of the company and the family itself. This may suggest that the aim of these companies is not to maximize shareholder value, but to maximize the value of the firm when the two are in conflict. Families have concerns and interests of their own, such as stability and capital preservation, which may not align with the interests of other investors of the firm. The strong alignment of interests between owners and managers reduces agency costs arising from the need to establish mechanisms for the supervision of the management team (García and García 2010). Fama and Jensen (1983) contend that family management is especially efficient.

Focusing on the relevant literature, it should be noted that various studies that have considered the ownership structure as an internal control mechanism, have analyzed three distinct aspects: the ownership concentration (Demsetz and Lehn, 1985; Shleifer and Vishny, 1986; McConnell and Servaes, 1990; Leech and Leahy, 1991; Morck et al., 2000), insider ownership (Stulz, 1988; Morck, et al., 1988; McConnell and Servaes, 1990; Faccio and Lasfar, 1999), and the identity of the owner (Galve and Salas, 1992; Pedersen and Thomsen, 1997).

In this study we discuss one of these three areas: insider ownership, and look at its validity as internal control mechanisms for non-listed family firms, following the principles of agency theory. In this regard, we need to fill the gap and check whether ownership structure acts as an internal control mechanism in non-listed SME firms.

Jensen and Meckling (1976) and Fama and Jensen (1983) argue that insider ownership can cause two types of fully differentiated behavior: convergence of interests with shareholders and the entrenchment effect. Jensen and Meckling (1976) assert that as insider ownership grows, the tendency of owners to consume company resources decreases, and therefore their interests and those of shareholders are aligned. In this way, conflicts between

owners and managers tend to disappear, and the hypothesis of convergence of interests prevails. However, they also argue that the natural tendency of managers is to use company resources in their own interests, which may conflict with those of external shareholders. These authors note that with increasing insider ownership, conflicts of interest between shareholders and managers disappear because their interests tend to converge.

However, Demsetz (1983) and Fama and Jensen (1983) argue that significant percentages of insider ownership generate compensation costs. They argue that even when the levels of insider ownership are low, market discipline may induce managers to seek to maximize value, despite scant personal incentives to do so. Conversely, when insiders hold a percentage of the capital of the company that is large enough to give them voting power or influence, they can achieve their own objectives other than the maximization of value without compromising either their jobs or their salaries.

These arguments show an entrenchment effect on the part of insiders, which means that too high a percentage of insider ownership has a negative impact on business performance. The entrenchment effect is based on the idea that concentrated ownership creates incentives for the controlling shareholder to expropriate wealth from minority shareholders (Fama and Jensen, 1983; Morck et al., 1988; Shleifer and Vishny, 1997). If family members occupy important positions both in management and on the board of directors, worse governance mechanisms may result, since the supervisory body may not operate efficiently.

Moreover, information asymmetry between the founding family and other shareholders can increase the entrenchment effect due to a lower flow of information and less transparency, all leading to a loss of performance (Wang, 2006). Faccio et al. (2001) suggest that founding families have strong incentives to expropriate wealth from minority shareholders, and note that such incentives are greatest when the influence of the family extends beyond their ownership rights. Families can exercise control or influence in two ways: through the position of chief executive or through a disproportionate representation on the board of directors. Consequently, expropriation by families is expected to be greater when the board's family control exceeds family rights, or when a family member is the chief executive officer.

The existence of these two widely different effects suggests a nonlinear relationship between insider ownership and the value of the firm (Wruck, 1989; McConnell and Servaes, 1990; Hermalin and Weisbach, 1991; Cho, 1998; Gedajlovic Shapiro, 1998). So, in our first hypothesis we propose that the relationship between the insider ownership and firm performance is nonlinear in non-listed family SMEs. More specifically, an inverted U-shaped relationship.

*H<sub>1</sub>: There will be an inverted-U-shaped relationship between insider ownership and firm performance in non-listed family firms.*

Although we have proposed an inverted-U-shaped relationship between insider ownership and firm performance in non-listed family firms, following Morck et al. (1988) and De Miguel et al. (2004), in the next hypothesis we analyze the existence of a convergence of interest effect after the inverted-U-shaped. Until a level of insider ownership, the entrenchment effect can be predominant, but the increase of the insider ownership from this level will impact positively in firm performance, which might reflect a pure convergence of interest effect (Morck et al, 1988). Firm performance increases at low and high level of insider ownership, as a result of the convergence of interest effect, and decreases at intermediate level of insider ownership, as a consequence of managerial

entrenchment. De Miguel et al. (2004) found a significant cubic relationship between insider ownership and firm profitability for Spanish listed companies. These results can be interpreted as consistent with both convergence of interests and the entrenchment hypothesis.

As the result of the above mentioned, we proposed the second hypothesis.

*H<sub>2</sub>: There will be a cubic relationship between insider ownership and firm performance in non-listed family firms*

The generational phase can be linked with the effect of insider ownership on firm performance. In first generation family firms there is an alignment of interests between principal and agent, which ensures that management does not expropriate the wealth of shareholders. Reductions in agency costs may be achieved by entirely eliminating the separation between owners and management. In such cases, the interests of principal and agent are aligned and it is assured that the management will not expropriate the shareholders' wealth (Miller and Le-Breton Miller 2006).

Because the family property is shared by an increasingly large number of family members priorities and problems change (Gersick et al. 1997) and conflicts may start to arise when the interests of the family members are not aligned, and the agency relations between the various participants in the firm are conducted on the basis of economic and non-economic preferences (Chrisman et al, 2005; Sharma et al., 2007). When more family members are active in the firm, the likelihood of opposite opinions and objectives increases. Families age and a new generation takes over the key management positions in the firm, the risk of intra-family conflict augments (Schulze et al. 2003). Davis and Harveston (1999, 2001) found more conflicts as subsequent generations run the firm. Consequently, in subsequent generations, there is no necessarily a convergence of interests between different family branches, which leads to increased agency costs.

Schulze et al. (2003) argued that these conflicts are especially likely to occur when the distribution of ownership is balanced between competing blocks, as often occurs as later generations enter the business. Such exploitation may be more common where rival ownership blocs among family factions have different interests and roles (e.g., extracting dividends vs. growing the business), and where there has been a turbulent family history (Miller et al., 2005). Another potential problem as the generations progress, is the growing demand for dividends from a greater number of family members who no longer directly work for the business.

However, following Morck and Yeung (2003) entrepreneurial spirit and talent are not necessarily inherited by ensuing generations of a controlling family, it is much easier for succeeding generations to use their wealth and influence to obtain competitive advantages through political rent seeking rather than through innovation and entrepreneurship (Christman et al., 2005).

As the result of the above mentioned, the generational phase will influence on the effect of insider ownership on firm performance, the insider ownership percentage in which begins the entrenchment effect, cut-off point, decreases over generations:

*H<sub>3</sub>: The turning point of insider ownership decreases over generations.*

### **3. EMPIRICAL RESEARCH: METHOD, DATA AND ANALYSIS**

#### **3.1. – POPULATION AND SAMPLE**

We conducted this study on Spanish firms included in the SABI (Iberian Balance Sheet Analysis System) database for 2006 (the latest year for which full data are available). We imposed certain restrictions on this group of companies in order to reach a representative set of the population. First, we eliminated companies affected by special situations such as insolvency, winding-up, liquidation or zero activity. Second, restrictions concerning the legal form of companies were imposed: we focused on limited companies and private limited companies as they have a legal obligation to establish boards of directors. Third, we eliminated listed companies. Fourth, we studied only Spanish firms with more than 50 employees, i.e. companies large enough for us to ensure the existence of a suitable management team and a controlling board to monitor their performance. Finally, companies were required to have provided financial information in 2006.

There is no official database of family firms, so there is no way to directly identify family firms. Also, the lack of an agreed definition of family firm leads to the use of samples of convenience, or to firms being identified as family firms after the sample is preselected (Daily and Dollinger, 1993; Schulze et al. 2001, 2003; Chua et al., 2003). Given these limitations, the detailed analysis of the information in databases and the survey are the only way to identify family and non-family non-listed firms. This study has chosen a combination of these two methods of identification.

In this study, family firm means a firm who meets two conditions: a) a substantial common stock held by the founder or family members that allow them to exercise control over the firm, and also b) participate actively in monitoring it. As per Voordeckers et al. (2007), we established 50% as the minimum percentage of a firm's equity considered as a controlling interest. To find compliance with these two conditions, we conducted an exhaustive review of shareholding structures (percentage of common stock) and composition (name and surnames of shareholders), and also examined the composition of the board of directors of each of the 2958 selected companies in the database.

Accordingly, we classified a firm as a family firm if main shareholder is a person or a family with a minimum of 50% of firm equity and there are family relationships between this shareholder and directors, based on coincidence of surnames. The composition of the management was also reviewed in search of family relationships between shareholders and managers.

### **3.2.- DATA**

Data were collected by means of telephone interviews, a method that ensures a high response rate, and financial reporting information was obtained from the SABI database. To guarantee the highest possible number of replies, managers were made aware of the study in advance by means of a letter indicating the purpose and importance of the research. In cases where they were reluctant to reply or made excuses, a date and time were arranged in advance for the telephone interview. The final response rate was approximately 22.50%, and the interviewees were persons responsible of management at the firms (financial managers in 56.48% of the cases, the chief executive officer in 31.06%, the president in 1.54% of the cases, and others in 10.92%). The questionnaire collects information on the variables required for the study that could not be obtained from the SABI database and that it was considered would be captured more reliably through a survey. In particular, information regarding the ownership structure, the composition of the board of directors and company management.

**TABLE. 1** – Definition and calculation of variables

<b>PANEL A</b>
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<b>VARIABLES OBTAINED FROM THE QUESTIONNAIRE</b>	
<b>VARIABLE</b>	<b>DEFINITION</b>
Generation managing the firm (GEN1)	Dummy variable that takes the value of 1 if the firm is headed by the first generation and 0 otherwise.
Generation managing the firm (GEN2)	Dummy variable that takes the value of 1 if the firm is headed by the second generation and 0 otherwise.
Generation managing the firm (GEN3)	Dummy variable that takes the value of 1 if the firm is headed by the third and subsequent generations and 0 otherwise.
Insider ownership (INSOWN)	Percentage of ownership of insider directors and chief executive officer in family firms
Board of Director's composition (OUTSIDERS)	Percentage of external directors on the total number of directors
<b>PANEL B</b>	
<b>VARIABLES OBTAINED FROM FINANCIAL STATEMENTS</b>	
Firm performance, measured by firm profitability (ROA)	EBIT / TA, where EBIT = earnings + financial expenses + tax benefit, and TA = Total Assets
Growth opportunity (GROWTHOP)	$Sales_0 / Sales_{-1}$
Debt (LEV)	Total Debt / Total Assets.
Firm's size (SIZE)	Ln Total Assets.
Firm's age (AGE)	Ln number of years since the establishment of the company.
SECT	Dummy variables to control for sector

### 3.3.- SUMMARY STATISTICS

Table 2 presents descriptive statistics for the variables in the analysis. We show mean values for family firms in the sample. It should be noted that the average of insider ownership stake in family firms is 50%. Nevertheless, as different generations join the firm, this ownership stake is diluted significantly. This dilution of ownership makes different conflicts to appear. It is therefore necessary to determine the possible effect of the insider ownership on firm performance due to the different behavior they can have. In relation to control variables, it can be highlighted the high proportion of outsiders on the board, taking, possibly, a control role. It is also noteworthy that family firms have an average age of 40 years, suggesting that our firms are well established.

**TABLE. 2.-** Descriptive statistics of sample firms: Mean values for variable measures

	<b>Family Firms</b>		
Number of observations	<b>336</b>		
	<b>1<sup>st</sup> Gen</b>	<b>2<sup>nd</sup> Gen</b>	<b>3<sup>rd</sup> Gen</b>
	109	155	72
Insider ownership (%)	50.17		
	<b>1<sup>st</sup> Gen</b>	<b>2<sup>nd</sup> Gen</b>	<b>3<sup>rd</sup> Gen</b>
	58.52	50.62	40.23

<i>Control variables</i>	
Board of Director's composition (Outsiders %)	37.48
Return on Assets (%)	6.42
Growth opportunity ( $Sales_0/Sales_{-1}$ )	1.14
Leverage (Total Debt / Total Assets)	61.98
Firm's size (Total Assets)	27309.48
Firm's age (years)	40

Source: Data of ownership structure, board of directors and management from the survey, and financial information from SABI.

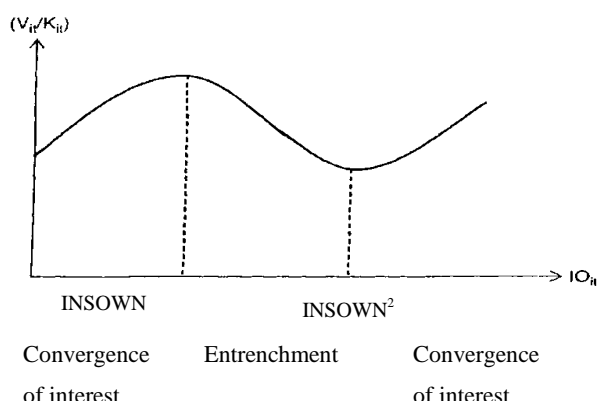
#### 4. RESULTS

In this section we present the results of our models with special attention to the impact of insider ownership in firm performance. This impact is examined through an OLS regression. Our study conducts further tests to examine the possibility of nonlinearity between firm performance and the insider ownership. So an inverted-U-shaped relationship is expected.

In our first regression we examined the influence of insider ownership on firm performance without considering the generation running the firm (Table 3, column I). The results were expected. The coefficient on the insider ownership variables is positive ( $\beta_1 = 0.067$ ), and a negative coefficient for its square ( $\beta_2 = -0.056$ ). These results confirm our hypothesis one, the inverted-U-shaped relationship between insider ownership and firm performance in non-listed family firms. This result demonstrates the existence of an optimal level of insider ownership in these firms, which stands at around 54.14%. The firm performance increases with a higher proportion of insider ownership, convergence of interests, and from this level, the firm performance decrease, entrenchment. Firm value should rise with increased insider ownership because managers are more attentive to shareholder value when themselves are shareholders (Jensen and Meckling, 1976), but when ownership is already substantial, further insider equity ownership is associated with reduced shareholder value.

Taking into account the results of our analysis (Table 3, column II),  $B_2$  and  $B_4$  are positive and the one on  $B_3$  is negative, which supports the cubic specification for the value proposed by hypothesis 2. We can see that in family firms there is evidence of a significant cubic relationship between insider ownership and firm profitability. In this sense, the results are consistent with those of Morck et al. (1988) and De Miguel et al. (2004) for listed companies. These authors show a positive coefficient in the case of insider ownership and its cube, and a negative coefficient for the square of insider ownership. The firm performance increases with relatively high and low levels of insider ownership and falls at intermediate levels. These results can be interpreted as consistent with both convergence of interests and the entrenchment hypothesis. Thus, for low levels of ownership, the interests of insiders tend to converge with those of shareholders, resulting in a positive effect on performance. However, as insider ownership grows, the entrenchment hypothesis begins to gain strength, so that insiders use their greater power in the company for their own benefit, without looking to maximize the value of the firm. Profitability tends to fall in this case. Despite this, there comes a time when the insiders' level of ownership is so high that they again become concerned for the welfare of all shareholders, which makes profitability grow again.





**Figure 2** .Relation between insider ownership and firm profitability

The next step is to calculate the two cut-off points. According to De Miguel et al (2004), they can be calculated by differentiating profit from insider ownership. Equating the partial derivative to zero, the cut-off points are:

$$\text{INSOWN}/\text{INSOWN}^2 = -2\beta_1 \pm \sqrt{4\beta_2 - 12\beta_1\beta_3} / 6\beta_3$$

Once the cut-off points are calculated, we note that if insider ownership is between 0 and 35%, increases in ownership will result in higher firm profitability. The reason lies in the greater incentives for insiders to maximize profitability, as their equity holding grows. On the other hand, if insider ownership is between 35% and 70%, the performance of firms falls when their percentage of ownership increases. Therefore, the entrenchment hypothesis prevails in this case, since most insiders are looking out for their own welfare rather than that of everyone. Finally, for percentages of insider ownership above 70%, the convergence of interest hypothesis appears to prevail again. These results are entirely consistent with those obtained by De Miguel et al. (2004), who analyze a sample of listed Spanish companies, without differentiating whether or not they are family-owned.

In order to fulfill the following objectives of the research we compare the behavior of family firms as subsequent generations run the firm and we can see different results (column III and IV). The Hypothesis 2 predicted that the turning point of insider ownership decreases over generations. We analyze if there are significant differences in the optimal insiders ownership proportion of this group of companies based on their generational stage, we included three variables interactively to indicate which generation is running the firm (first generation, second generation and third and subsequent generations). To corroborate the relationships suggested by this model of interactive effects, we conducted another analysis (not reported) in which the sample was divided into first, second and subsequent generation family firms. The results are similar.

For first generation family firms the results are the expected. The coefficient is positive and significant ( $\beta_2 = 0.247$ , column III) and its square is negative and significant ( $\beta_5 = -0.222$ , column III), so the results exhibit an inverted-U-shaped relationship because the coefficients  $\beta_3$  and  $\beta_4$  are significantly positive and negative, respectively. This result demonstrates the existence of an optimal level of insider ownership in these firms, which stands at around 54.3%. Nevertheless, for second and subsequent generation family firms, the coefficients are not significant. The results exhibit no relation between the proportion of insider ownership and firm performance when second and subsequent generations run the firm.

Finally, we analyzed whether there is evidence of a significant cubic relationship between insider ownership and firm performance, considering the generation running the firm. The results shown in Table 3 (column IV),

confirmed that there is a cubic relationship between insider ownership and profitability in family firms managed by the first generation. Therefore, it seems that the high concentration of insider ownership found in family firms managed by the first generation leads to the entrenchment of family insiders when a certain level of ownership is reached and when the insiders' level of ownership is so high that they again become concerned for the welfare of all shareholders, which makes profitability grow again. But there is therefore no cubic relationship between insider ownership and firm performance for second and subsequent generation family firms.

**TABLE 3.** - Relationship between insider ownership and firm profitability

	ROA			
	I	II	III	IV
Constant	-0.020	-0.035	-0.022	-0.027
INSOWN	0.067*	0.256***		
INSOWN <sup>2</sup>	-0.056*	-0.602**		
INSOWN <sup>3</sup>		0.365**		
INSOWN*GEN1			0.247***	0.522***
INSOWN*GEN2			0.017	-0.005
INSOWN*GEN3			0.023	0.067
NSOWN <sup>2</sup> *GEN1			-0.222***	-1.034**
INSOWN <sup>2</sup> *GEN2			-0.009	0.066
INSOWN <sup>2</sup> *GEN3			-0.024	-0.156
INSOWN <sup>3</sup> *GEN1				0.547**
INSOWN <sup>3</sup> *GEN2				-0.053
INSOWN <sup>3</sup> *GEN3				0.091
OUTSIDERS	-0.010	-0.007	-0.006	-0.005
GROWTHOP	-0.001	-0.001	-0.216**	-0.206**
LEV	-0.098***	-0.097***	-0.105***	-0.107***
SIZE	0.008**	0.008**	0.009**	0.009**
AGE	0.004	0.005	0.003	0.004
R <sup>2</sup>	0.12	0.12	0.13	0.13

\*\*\*, \*\* and \* indicate significance at 1%, 5% and 10% respectively.

## 5. CONCLUSIONS AND POLICY IMPLICATIONS

Our results support the convergence of interest and entrenchment hypothesis on the relationship between firm profitability and insider ownership in family firms. The profitability of family firms grows with low and high levels of insider ownership and falls in the intermediate levels.

The rules governing the treatment of minority shareholders in a weaker system of legal protection as in Spain can justify the wealth expropriation in Spanish non-listed family firms with a high level of ownership concentration. Similarly, the family nature of insiders could also give them more power, which makes more incentives for families to expropriate wealth from minority shareholders, when the influence of the family extends beyond their ownership rights. This effect is stronger in family firms managed by the first generation.

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