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Capital Markets and Family Business: Some Surprising Results

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A recent study by Citigroup, titled "Growing the Family Business," reports that publicly-held family-controlled firms generated higher financial returns than their non-family counterparts. The study observed 1,000 publicly traded firms worldwide where a founding family member is in management and the founding family controls at least 20 percent of the stock.

Conventional wisdom has long held that family firms are not a good investment due to the dynamics of family ownership, including succession planning, managing divergent interests of family members and balancing the interests of public equity markets with family owner expectations. These dynamics are expected to cause lower financial performance. Results showed annualized returns for 5 years of more than 20 percent for family-controlled firms, compared to 14 percent for all public companies over the same period. And, family firms have outperformed non-family firms in 11 of the past 12 years.

At the same time, the valuation discount of family firms is disappearing. Past research has shown that family-controlled enterprises trade at a discount to their non-family peers. The assumption is that investors discount family firms due to the family dynamics described above. The Citigroup study shows that the discount has been diminishing. In 2002, PE multiple for family firms was 15.5 vs. 17.1 for non-family public firms. By 2006, the gap had narrowed to 19.9 for family firms and 20.3 for non-family.

The study also looks at behavior of family firms to determine what drives superior performance. They find the family firms that invest more in capital expenditures and those that pursue acquisitions show higher returns than those that do not. Even so, family businesses lag non-family in their capital expenditures and acquisition activity. These results support common wisdom that family businesses tend to be more conservative than their non-family counterparts.

This wisdom is also supported by the fact that family businesses in the study retained more capital than non-family businesses. Over the period of study, capital distributions of family businesses held steady around 50 percent, almost equally split between share buy-backs and dividends, which was slightly lower than non-family companies, which averaged in the mid-60 percentages. It is interesting to note that poorly performing family firms distributed a much higher percentage of their capital than high performers.

The study goes on to suggest that one way to balance the need for capital to fund acquisitions and capital expenditures with the desire to retain cash within the business is to turn to the public markets. The study shows that raising money from capital markets (either debt or equity) leads to increased revenue and earnings growth for family firms that have pursued this strategy.

If growth is the only goal, then raising outside capital may be the solution. This viewpoint fails to acknowledge, however, that unlike other public companies, growth may be one of many goals a family business seeks to achieve. What makes many family firms unique is that many do not focus on economic return as the sole measure of success. Other measures include the ability to retain the business within the family for generations to come, the ability to focus on the needs of multiple stakeholders — including employees, community and owners — and the ability to run the business in a manner consistent with the family's values.

When family businesses turn to the public markets for capital, they may see several benefits – an opportunity to monetize the investment of family members, an opportunity for some family members to exit if desired, and an opportunity to pursue a more aggressive growth plan. However, these benefits must be balanced with the potential downside. They will now be subject to a set of owners whose objectives may be very different than their own. They will be subject to market expectations for growth. To the extent that they can ignore these growth expectations and invest the money as they see fit, taking a part of the business public but retaining control may create the best of both worlds. This strategy gives all investors, both family and non-family the opportunity to benefit from a long-time horizon and more conservative management of resources.

Of course, there is a reason for the saying "You can't have your cake and eat it too." This situation requires that non-family investors value the family owner's decision to ignore the focus on short-term returns. And, just as non-family investors must be willing to make some concessions, so must family owners. The financial markets will expect qualified management to make economically rational decisions. For example, keeping an underperforming plant open to retain employment in a community may not be viewed as a wise decision.

Family businesses must take all these considerations into account when determining whether or not the opportunities presented by public capital are worth the cost. The answer of whether or not the balance will favor going public versus staying private differs from business to business and family to family. But it is one that should be studied carefully. The families that make the wisest decisions are those that study their options —going public or staying private — and understand the pros and cons of each option in the context of their unique family and business situation.

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The Family Business Advisor