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EXECUTIVE SUMMARY

Determining an optimal level of debt can be likened to the quest for the Holy Grail, for both companies and for the academic world. Within the current context of reduced profitability levels and the scarcity of financial resources which have led to the consequent reduction in self-financing, family businesses in search of growth are facing a structural issue following on from the financial crisis and the introduction of new prudential regulation (Basel III): determining whether the intrinsic characteristics of family businesses justify a level of debt below that of non-family businesses.

To address this problem, it is necessary to revisit modern financial theory by considering two additional dimensions: the desire to perpetuate the family business and to maintain its control. The traditional criterion used when choosing financial structure, based on the risk-reward ratio, is thus relegated as the two-fold condition of sustainability and control takes priority in all decisions.

This four-dimensional approach changes a company’s criteria for choosing its modes of financing and also impacts agency costs and the management of information asymmetry, which thus challenges the traditional order of prioritisation for non-family businesses (self-financing, debt and then equity).

The double constraint of perpetuating a company and maintaining control over it translates into a very strong aversion toward the risk of failure. As such, when self-financing is not sufficient, capital injections from within the family are preferred in order to not dilute family control. If such a family capital increase is not possible, then recourse to debt is considered (in ascending order of disclosure of information – bank loans, private placements, and then bond debt). Capital increases, hybrid financing or a public listing are considered as a last resort, with the fear of dilution sometimes superseding any objective reference.

In the face of restrictive bank lending, sometimes for regulatory reasons (Basel III), new modes of financing should be developed specifically for family businesses in order to integrate this two-fold obligation of perpetuity and control. Such financing could include hybrid financing of quasi-equity without the opening-up of capital (OBSARs for example – bonds with redeemable equity warrants) or the issuance of pooled bonds.

In the new economic context of historically low interest rates, where some family businesses finance themselves (by issuing bonds or private placements) at costs of lower than 1% per annum over a 5-7 year period, the paradigm of financial distress is likely to be less restrictive. We can therefore ask ourselves if family businesses were sufficiently integrated into this new environment. In other words, have they taken on sufficient amounts of debt?
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INTRODUCTION
INTRODUCTION

For many decades now, for both companies and for the academic world, determining the optimal level of debt can be likened to the quest for the Holy Grail. The financial and the economic crises which have been ongoing since 2008 have brought this subject back into the spotlight, given the increasing scarcity of financial resources and the reduced profitability levels of companies, which consequently reduce self-financing.

Within this context, many family businesses, in the quest for growth, have found themselves facing a structural problem and asking the following question: Do the intrinsic characteristics of family businesses justify debt levels that are structurally lower than those of their non-family counterparts? Within the current context of historically low interest rates, are family businesses taking on sufficient debt? Are the classic paradigms on funding structure not more fragile inside this new interest rate environment?

Is there a legitimate explanation for why family businesses will inevitably resort to using less debt and are thus compelled to look to other types of resources to finance their internal and/or external growth? We are often asked this question by CFOs and CEOs of large family businesses and, with this Position Paper, we will provide some answers.

To do this, in Section I, we put forward a family business definition which we deem to be the most relevant to our problem of choosing a funding structure and we study the two intrinsic characteristics that would seemingly justify the need for family firms to have a lower debt level compared to non-family businesses: the two-fold desire to perpetuate the family business and to maintain control.

In Section II, we will focus on the criteria that take precedence when companies choose what type of funding structure to adopt. Specifically, we will present the principal theories of financial leverage (net debt / shareholders’ equity) in order to identify the factors likely to push family businesses to take on less debt, particularly when compared to non-family firms. We will conclude this second section by taking the view of CFOs, in order to put these various theories into perspective.

In Section III, using the analysis of the two-fold constraint of aiming to perpetuate the family business and maintain control (Section I) and based on the study of theories behind the criteria considered when choosing a funding structure (Section II), we shall highlight the elements that best explain the funding structure of family businesses.1 We study the capital asset pricing model (CAPM) on the basis of four-dimensions (as opposed to the two-dimensional mean-variance model conventionally used within modern financial theory), in order to justify the financial leverage and debt level undertaken by family businesses. We put these choices into perspective inside a universe where agency costs and information asymmetry are present.

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1 - The Capital Asset Pricing Model – This model, introduced by Treynor (1961, 1962) and Sharpe (1964) who relied on Markowitz’s (1952) work on diversification and modern portfolio theory, estimates the expected market rate of return on the basis of systematic risk.
I. WHAT PARTICULAR FAMILY FIRM CHARACTERISTICS ARE LIKELY TO IMPACT FUNDING STRUCTURE?
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Family businesses have substantial weight in the global economy, accounting for one-third of the companies in the S&P 500 Index (Anderson et al., 2003) and 60% of all listed and unlisted European companies (European Commission, 2009). According to Marie-Hélène Boidin Dubrule of the Auchan Group (Journal du Net, 26 July 2006),

Furthermore, we have chosen to maintain property holdings within some of the shopping centres we manage via our subsidiary, Immochan. Many of our competitors have preferred to divest core assets in order to rapidly free up cash. We issue bonds which we have no difficulty in placing, we borrow from banks and we practise self-financing.

Within the context of the funding structure problem faced by family businesses, these remarks illustrate two specific factors likely to affect key investment and financing decisions, particularly through intrinsic management of exposure to risk. These two factors are summed up by the two-fold desire to perpetuate the family business and to maintain control.

But first, we must define what exactly a family business is.

I.1. WHAT DEFINITION SHALL WE APPLY TO A FAMILY BUSINESS IN ORDER TO STUDY ITS FINANCIAL STRUCTURE?

Academic literature offers a wide range of definitions of what a family business is, depending on desired objectives. Shanker and Astrachan (1996) identify 34 definitions.

The European Commission (2009) considers a company a family business if:

- The majority of the voting rights are held by the founder of the company or by a physical person who has acquired the share capital, or by their
spouses, parents, children or descendants;
• The majority of the voting rights can be direct or indirect;
• At least one family representative is involved in management or in a supervisory body;
• Listed companies fall within the definition of a family business if the person who founded or acquired the company (or their relatives or descendants) holds 25% of the voting rights.

Our objective is not to identify all existing definitions of a family business. We shall retain that of Churchill and Hatten (1987), which is most in line with our questions on funding structure: "Any business, listed or not, whose family members have a direct or indirect interest in company, both in terms of ownership rights with regard to profits and in terms of validating strategic direction and control." We will revisit this crucial concept of control in Section I.3.

With the definition of a family business thus established, we now turn to the two-fold desire to perpetuate its heritage and to maintain control.

I.2. THE CONTINUITY OF THE COMPANY: A MAJOR CONSTRAINT WHEN CHOOSING FUNDING STRUCTURE

The continuity of the company is a priority for family businesses because it fulfils an objective inscribed in their DNA: the transmission of family assets to future generations.3

This trans-generational dimension of continuity encourages:
• A considerable extension to deadlines for decision-making;
• The development of specific values (such as involvement, the sharing of culture, a long-term vision, trust, reputation) and the intangible assets associated with these values;4
• An increase in the idiosyncratic risk of companies, due to the impossibility of diversifying their heritage and the desire to pass the business on to future generations;
• A better allocation of capital, in the sense that increasing the decision-making time frame permits the transfer of resources, which would otherwise have been consumed in the short term and not invested in wealth-creating projects (Harvey, 1999).

All of these characteristics, which are conditional upon the objective of continuity of the company, generate a number of impacts on the investment and financing policy of family businesses, particularly when it comes to managing problems of adverse selection and moral hazard, funding structure, the cost of debt (Anderson et al., 2003c) and the cost of equity (Ali et al., 2007), as we shall see in Section II.5

When analysing the constraint of continuity that businesses face within the context of investment and funding policy choices, academic works have traditionally approached the issue by considering the following two questions:
• Are investments made in all sectors of activity or only in those with the lowest levels of risk?
• Does the choice of funding structure reflect a particular approach to financial risk management?

Regarding the first issue, many authors (Anderson et al., 2003b; Maury, 2006) show that family businesses are present in most sectors (including those which are highly-capital intensive such as metallurgy and textiles, even if gradual investment

3 - Many academic works have addressed this issue, in particular, we refer readers to Gallo and Vilaseca (1996), Harvey (1999) and Amit et al. (2008).

4 - See, for example, Kaye (1991), Habbershon et al. (2003) and Gallo et al. (2004).

5 - When considering a new borrower, a lender is subject to two types of risk: (i) adverse selection risk (i.e. the risk linked to the inability to determine ex ante the borrower’s creditworthiness); and (ii) the risk of moral hazard (i.e. the risk that, after the granting of credit, the borrower adopts opportunistic behaviour towards the lender).
withdrawal can be explained by the crises experienced within these two sectors, as is the case with non-family companies.

Additionally, the operational risk associated with family businesses does not seem to be fundamentally different from that of other companies as pointed out by Sraer and Thesmar (2007) through their analysis of the volatility of financial returns (i.e. Return on Equity). However, even if the debate still seems totally open, many authors believe that the more pronounced risk aversion of family businesses translates into better business oversight and thus better operational performance.

More specifically, some authors (Fama and Jensen, 1983, 1983; Ang et al., 2000) feel that these levels of operational performance can be attributed to the fact that family ownership automatically aligns the interests of management and the providers of capital given that they are one and the same, or at least partly. This alignment is sometimes reinforced by the presence of a founder CEO, one of his or her direct descendants or someone affiliated with the family (Anderson et al., 2003a; La Porta et al., 1999; Maury, 2006), or by an employee shareholding scheme, which could be potentially boosted with a portion of remuneration offered as equity- or share-based compensation options.

According to other authors (Allouche et al., 2007; Sraer and Thesmar, 2007), this superior performance is related to the quality of the relationships that family businesses have forged with stakeholders: these companies are often considered among their ‘favourites’ by consumers, and are also seen to be more service-oriented, more aware of corporate social responsibility, equipped with a better social policy, better job protection, etc.

The controversy surrounding the relationship between family businesses and performance resulted in more detailed background studies. So, Anderson and Raja (2003a) and Maury (2006) show that performance, both in terms of return on assets (RoA) as well as in terms of Tobin’s Q, is an increasing function of the percentage of capital held by the family up until a family control threshold of 30%, beyond which it decreases. Holderness and Sheehan (1988) even found that companies with very high levels of family control showed inferior performance to those with more diffuse shareholding structures.

The explanation lies in the theory of family entrenchment, according to which CEOs have a tendency to develop strategies with a view to preserving their status within the company. Entrenching themselves also allows CEOs to increase their managerial latitude by using various manoeuvres (manipulation of information, investment decisions, control over resources, etc.) and by appropriating company income at the expense of shareholders and organisational efficiency.

It also appears that the CEO’s character and/or the presence (or absence) of the founder are determining factors when it comes to the performance of family businesses. According to Anderson and Reeb (2003a), family involvement in the operations of the business is a guarantee...
of better profitability. They observe that the operational performance of a company whose CEO is the founder, is higher than when he or she is another family member, which itself is higher than when the CEO does not belong to the family at all. On the other hand, when these authors consider Tobin’s Q, that is the market’s perception and valuation of future growth prospects, they highlight the following:
- Businesses whose CEO is the founder have the highest valuations;
- Those whose CEO does not belong to the family register a better Tobin’s Q than those registered by non-family businesses;
- On the other hand, those whose CEO is a heir do not distinguish themselves from non-family businesses. The explanation put forward for this is that those in the latter category do not necessarily have an entrepreneurial spirit and are focused on the objective of continuity.

It would thus appear that, in general, family businesses have not opted for the solution of reducing risk via their business activity.

What about the second option offered through management of the funding structure?

A number of empirical studies show that family businesses have lower debt levels than non-family businesses. This choice is usually justified by the desire to reduce the risk associated with the significant and non-diversifiable investment of a family fortune, which should consequently perpetuate the family business. In fact, we will see in Section II that a significant level of financial leverage leads to a higher probability of default.

I.3. MAINTAINING CONTROL OF THE COMPANY: A MAJOR CONSTRAINT WHEN CHOOSING A FUNDING STRUCTURE

Control is naturally intrinsic to the definition of a family business set out in Section I.1. and it relates to the issue of independence, as well as that of how to ensure the continuity of the company.

The notion of control is therefore crucial here because it corresponds to the ability to build and implement the financial and operational policy of the entity in question. This control can be obtained by virtue of where capital is located, by legal construction, by the use of specific financing assets or by representing the interests of the family (or families) within the controlling or managerial branches of the business. These different elements are not mutually exclusive.

This notion of control is thus wider than that adopted by the international accounting standard, IFRS 10, applicable from 1 January 2013 according to the IASB. For the record, until then, the IAS 27 standard defined control as being the power to define operational and financial policies in order to obtain the benefits of one’s business activity. It related to the model of traditional control which involves holding the majority of the voting rights of the consolidated entity. Now, under IFRS 10, an investor does not control an entity if the following three conditions are not “cumulatively” fulfilled:
- The investor has power over the entity;
- The investor has exposure or rights to variable returns from its involvement with the entity;
- The investor has the ability to exert power over the entity to affect the amount of its returns (the relationship between power and variable returns).

The rights to be taken into account when assessing power include current and potential voting rights, understandings with other investors such as voting agreements, the right to appoint or remove the leaders of the entity, and the contractual right to manage activities. Unlike US GAAP standards, control is actually explicitly recognised by IFRS 10: “An investor exercises power if, even with less than a majority of the voting rights, it has the ability in practice to unilaterally direct relevant activities.”

The question of control is at the heart of family governance issues (the distribution of shareholder, managerial and control powers). As we will cover in the following sections, it is as much about the power to oversee management decisions in order to keep them in line with shareholders’ interests as it is about ownership, which raises the issue of financial independence. Section III will show that this desire for continuous control of the business leads to the CAPM (the classic model for determining funding structure) being called into question, and it results in a funding structure different to those of non-family businesses.
II. ACCORDING TO WHAT CRITERIA ARE FUNDING STRUCTURES DEFINED?
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Companies meet their financial needs, either by reinvesting their profits (self-financing) or by seeking out external funding sources (equity, debt, or a mixture of the two known as hybrid capital). This leads us to define the criteria according to which companies choose their funding structure, including their debt levels and their leverage ratios (calculated as net debt divided by shareholders’ equity).

Our objective, however, is not to carry out a comprehensive literature review of the numerous academic models which look at funding structures and financial leverage, but only to cover the main criteria of choice, in order to subsequently analyse the extent to which family businesses may interfere in the determination of the debt levels. In other words, we shall look at what factors lead family businesses to hold lower levels of debt (and thus lower leverage ratios) than non-family businesses.

As mentioned in the introduction, for many decades now, for both companies and for the academic world, determining the optimal level of debt can be likened to the quest for the Holy Grail. A number of theories have thus emerged and here we revisit those that principally underlie this sentiment, in order to see to what possible solutions they might provide for our problem of lower debt levels within family businesses. We will therefore successively present:

- The Modigliani-Miller Theorem (1958, 1963);
- The Signalling Theory (Ross, 1977) and Information Asymmetry;
- The Trade-Off Theory (Kraus and Litzenberger, 1973);
- The Pecking Order Theory (Myers and Majluf, 1984); and
- The Market Timing Theory (Baker and Wurgler, 2002).

We will conclude this second section by taking the view of CFOs, in order to put these various theories into perspective.

II.1. BEFORE 1958, THE OPTIMAL DEBT LEVEL WAS THAT WHICH MINIMISED THE COST OF RESOURCES

Prior to the first formalisation of liability structures carried out by the 1958 Modigliani-Miller Theorem, the optimal debt level was defined as that which minimised the cost of resources – otherwise known as the weighted average cost of capital (or WACC).

Specifically, this optimal the debt level which minimised the cost of capital corresponded to the inflection point of two opposing phenomena:

- With debt coming at a cheaper cost than equity (given that creditors have priority over shareholders in the event of a business declaring bankruptcy), any rise in debt results in a decrease of the weighted average cost of capital. Equity, which is an expensive resource, is replaced by the relatively inexpensive resource that is debt.
- Conversely, an increase in the debt level translates into a higher leverage ratio. Debt represents a fixed cost and as such, causes an increase in the volatility of net income. This results in an increase in the cost of debt and, by extension, the cost of equity (with shareholder risk increasing...
in line with net income volatility, they demand a higher level of return). In the end, the cost of capital increases and thus cancels out all or part of the gain related to the cost of debt, which is lower than that of equity.

Beyond this point of inflection (the optimum level of debt), the cost of risk linked to the increased level of debt no longer offsets the lower cost of debt, so the cost of capital (equity and debt) increases.

II.2. THE MODIGLIANI-MILLER THEOREM (1958) AND DEBT-GENERATED TAX SAVINGS

The Modigliani-Miller Theorem (1958) is one of the fundamental theorems of modern corporate finance. This contribution led to them winning the Nobel Prize in Economics in 1985 and 1990, respectively. They were the first to propose a formal approach to structuring liabilities.

The theorem shows that in a universe free of taxes and transaction costs, a company’s value depends only on the value of its assets. It is thus completely independent of funding structure, which itself, has no impact on the cost of capital. In this universe (i.e. in the absence of fiscal distortions), there is no optimal funding structure and the cost of capital is constant regardless of the company’s level of debt. The value of an economic asset is independent of how it is financed as "the shapes and number of the pieces do not affect the size of the pizza", as Miller stated upon receiving the Nobel Prize in 1990.

Although this theory unsettled beliefs about optimal funding structure, it has the drawback of being unrealistic, as it is based on a world with no tax. Additionally, in 1963, Modigliani and Miller adapted this theory, by integrating the notion of corporate taxation. They demonstrate the economic asset value of a debt-holding company is equal to the economic asset value of a company holding no debt, plus the present value of tax savings linked to the tax deductibility of debt interest.

Naturally, the tax advantage of debt can exist only if the company can actually benefit from the deductibility of the interest expense (recipient company). A number of empirical academic studies are referenced to explain that tax savings contribute to the definition of the financial structure, showing that the leverage ratio is a positive function of taxable income, of profitability and of the tax expense.11

However, in practice, it should be noted that interest expenses account for less than a third of most companies’ operating income, and they therefore resort to using less debt than interest deductibility, as Modigliani and Miller suggested. So, why do companies hold such low levels of debt?

The explanation lies in the fact that this analysis has not included all the costs incurred by the use of debt, which are taken into account in the choice of the funding structure. These include the costs of bankruptcy, conflicts of interest between shareholders and managers, between shareholders and lenders, and the cost of information asymmetry between managers and investors. That is what we explore in the following sections through the use of different theories, including Signalling Theory, Trade-Off Theory, Pecking Order Theory and Market Timing Theory.

II.3. SIGNALLING THEORY (ROSS, 1977) AND INFORMATION ASYMMETRY

Although Modigliani and Miller are largely credited with being the first to propose a formal approach to the structuring of liabilities, a number of academic works have called into question their benchmark work, which relied information symmetry and the identification of the interests of the different stakeholders in the company (executives, shareholders and lenders).

Ross (1977) was the first to formalise the idea of a signal in order to bring information symmetry into question. This approach is based on the fact that management is privy to more information than the providers of funds, particularly with regard to forecasts of the company’s future cash flows.

According to Ross, the issuance of debt is a positive signal for investors. It is effectively unlikely for a CEO to take on company debt in order to finance a very risky and low yielding project, because it would increase the company’s exposure to the risk of failure, which could result in the loss of his/her status and position. Therefore, there is no incentive in sending out a misleading message. So, according to Ross, given that debt increases the risk of bankruptcy, a company that takes on debt is essentially signalling that it is expecting significant positive future cash flows.

On the other hand, CEOs acting in the interests of the shareholders generally do not issue shares when they think their share price is undervalued. Consequently, the issuance of new shares is thus interpreted as bearer of bad signals regarding the company’s future prospects of cash flow generation, since it means that the share price is overvalued. Asquith and Mullins (1986) and Korajczyk et al. (1991) illustrate these points in their work by highlighting negative abnormal returns around the capital increase announcement dates. So, any change in the financial structure is sending a signal to the markets.

What lessons can Ross’s Signalling Theory teach when it comes to the financial structure of family businesses?

For strategic reasons related to perpetuating their heritage, family businesses are often known to safeguard a “secret” and maintain a level of informational asymmetry toward third parties to the company, in terms of variables considered to be strategic for the company or the family. For example, Brau and Fawcett (2006) show that resorting to a stock exchange listing is, outside of the consideration of diluting control, usually not considered if it requires communicating too much information to competitors and if it can be avoided.

It is interesting to note the results of Ginglinger and L’Her (2002), who observe that the effect of a share buyback announcement is, on average, positive and more significant when there is a major shareholder other than a family and, on the other hand, it is generally negative when the major shareholder is a family member. In the latter case, the buyback and cancellation of company shares is interpreted as a further entrenchment of the family’s hold.

Thus, Ross’s Signalling Theory seems ill-suited for explaining the funding structure choices of family businesses.
II.4. THE TRADE-OFF THEORY (KRAUS AND LITZENBERGER, 1973) BETWEEN INTEREST TAX DEDUCTIBILITY, FINANCIAL DISTRESS COSTS AND AGENCY COSTS

As mentioned in the previous section, we note that the companies use less debt than interest deductibility, as highlighted by Modigliani and Miller (1958, 1963) suggested. The explanation of this discrepancy lies in the absence of debt-incurred costs being taken into account, and this is what the Trade-Off theory proposes to examine.

Specifically, an increasing debt level increases the probability of failure. When a company is no longer able to honour its obligations, it can find itself in a situation of financial distress, which translates into direct costs (lawyers, redundancies, etc.) and indirect costs (loss of customers, termination of contracts with suppliers, resignations and employee de-motivation, forced assets sales, etc.). So, the choice of the financial structure must take into account a comparison of the benefits of the interest tax deductibility and the disadvantages brought on by the costs of financial distress.

The effect of this analysis varies according to the type of assets owned, which is not uniform across family businesses as we shall see. Essentially, companies with tangible realisable assets will be more inclined to use debt than those with mostly intangible assets.

Beyond the costs of financial distress, many authors have also shown that the choice of the funding structure is also based on agency costs.12 These latter costs arise from potential conflicts of interest that may exist between the various stakeholders (shareholders, creditors, decision-making executives, etc.) who have different, and sometimes divergent, objectives and access to information. Let us cite some examples:

- Shareholders may prefer to keep a company alive even if its valuation would be higher if dissolved, because the bulk of the freed-up capital would primarily be returned to creditors;
- Due to personal objectives, some executives are tempted to increase the size of the company, and they do so to the detriment of profitability and thus to shareholders’ interests;
- The fact that a CEO, who does not fully own the company, does not receive all of the profits but bears all the business risk, is likely to affect the company’s strategy. Such CEOs will generally tend to minimise debt levels, which put the company and thus themselves personally at risk (given that the company is their source of income) and even, as a precaution, they tend to increase liquidity levels (dormant shareholders assets) rather than invest in risky projects.

These conflicts of interest are likely to lead to opportunistic behaviour which, in order to be reduced or avoided, generate agency costs (monitoring costs for the principal and “clearance” costs for the agent) that correspond to the establishment of a network of contractual relations (the implementation of procedures for control, auditing, share options, annual reports, etc.).

Under these conditions, debt serves as a shareholder tool that can be used to apply pressure on non-shareholder CEOs, because it obliges them to generate substantial cash flows to repay the debt and associated costs, with the threat of failure and their resulting downfall (the CEO’s loss of salary and status). It is interesting to note that the financial structure has an impact

on investment policies, insofar as this structure is reflected in the limitations and incentives of managers and executives.

So, according to the Trade-Off theory, financial structure is based on marginal arbitration of the costs and benefits (costs of financial distress and agency costs; tax and agency benefits) of each funding resource.

What lessons can the Trade-Off theory teach when it comes to the financial structure of family businesses?

The analysis of the family business financial structure according to the Trade-Off theory seems relevant, because these businesses are naturally subject to financial distress and agency costs, which may sometimes be different from those of non-family businesses, particularly depending on whether the chief executive is a family member or not. Additionally, this analysis on the marginal arbitration of family business costs and benefits must necessarily be conducted by integrating the two-fold constraint of perpetuating the family’s heritage within the company whilst also maintaining control, as we will see in Section III.

II.5. THE PECKING ORDER THEORY ACCORDING TO INFORMATION ASYMMETRY COSTS

The work of Myers and Majluf (1984) goes further than that of Ross (1977), by stating in their Pecking Order Theory that companies prioritise their sources of funding based on increasing costs of information asymmetry:

- The preferred form of financing should be the internal funds, essentially the reinvestment of profits (self-financing), for which the cost of information asymmetry is zero and if necessary, paid for using cash. Companies should therefore adapt their dividend payments according to their investment objectives;
- Next in line is debt, the different kinds of which are themselves prioritised depending on the cost of information asymmetry. So, within the universe of debt, bank debt would naturally be given priority, then bond debt, and finally hybrid debt such as convertible bonds, which could potentially give access to the markets;
- Lastly, companies would issue equity, for which the cost of information asymmetry is naturally the highest given the informational requirement to be met in order to access these types of financial markets.

What lessons can Pecking Order Theory teach when it comes to the financial structure of family businesses?

In Section III, we will see that empirical studies on family business show that they also apply a pecking order to their financing, but the two-fold constraint of continuity of the business and maintaining control preserve their independence and their risk management practices. So, whilst the top-ranked resource is still self-financing, equity comes second provided that it is sourced from within the family, or that it is possible to preserve independence. As for debt, given the increased risk of financial distress it generates, it is chosen as a last resort.

After the loosening of Modigliani and Miller’s hypotheses, which allowed for taxation, the costs of agency failure, and the pecking order of financing to be taken into account, the work of Becker and Wurgler (2002) led to the emergence of a new theoretical framework known as the “Market Timing Theory” or “net asset value arbitrage”.

It assumes that companies choose their financial structure by taking advantage of the inefficiency and the segmentation of real financial markets. According to this theory, CEOs are better off issuing shares when the equity markets have experienced a period of strong performance and company valuations are high. Conversely, these same executives are better off issuing debt when share valuations are weak.

Thus, according to the Market Timing Theory, the analysis and justification of the corporate financial structure is supposedly linked the historical market values of the company. Becker and Wurgler (2002) note that 70% of the current financial structures can be explained by decisions taken more than 10 years ago, and therefore relative to share valuations at the time. They show that companies with little debt are those that conducted capital increases when their relative valuations (measured by the market value of equity / book value of equity) were high and vice versa.

What lessons can the Market Timing Theory teach when it comes to the financial structure of family businesses?

In Section III, we will see that the weight of the two-fold constraint of perpetuity and maintaining control of the company is dominant and that the Market Timing Theory barely seems to apply to family businesses.

II.7. THE CFO VIEWPOINT: PRIORITY GIVEN TO FINANCIAL FLEXIBILITY

In the preceding six sections, we have seen that there is an abundance of academic literature on the question of determining financial structures. Many authors have tested the hypotheses of Pecking Order Theory against those of Trade-Off Theory and Market Timing Theory, as well as the relevance of certain variables such as the tax and financial distress.13

In practice, what is the point of view of CEOs and CFOs?

Some authors (Graham and Harvey, 2001; Brounen, Jong and Koedijk, 2004; Bancel and Mittoo, 2005) conducted surveys with American and European CEOs and CFOs in order to analyse the criteria for choosing financial structures. Even if they state the objective of reaching a roughly defined target debt ratio, financial flexibility (having financing capacity to seize an investment opportunity or to deal with a crisis) is the most important criterion. The other criteria mentioned included the impact on the financial rating, the characteristics of the sector (operational leverage, maturity, competition, etc.), the stance of shareholders with regard to the choice of funding, the timing in relation to the appetite of the markets and the financial structure of competitors.

A widely-held view shared by practitioners and academics alike is that companies try to maintain their capital structure around an interval or a target level considered to be satisfactory or optimal. Any deviation from this target triggers rebalancing, either through equity (share issuances, buybacks) or through debt (issuances, redemptions), naturally prioritising the latter adjustment. For example, Graham and Harvey (2001) indicate that 71% of CFOs in their sample mention having a defined leverage ratio within the target range, and that even 10% of them speak of a «strict» target ratio.

Although proponents of Market Timing Theory object to this vision of dynamic management of the funding structure, a trend seems to be forming, as shown in the works of Korajczyk and Levy (2003) and Levy and Hennessy (2007). They show that companies generally have structured funding targets, but that the presence of friction (the Trade-Off theory) and market opportunities (the Market Timing Theory) produce deviations that can generally be temporary, depending on the characteristics of the sector of activity and on the funding structures of direct competitors.

For family businesses, we observe that these deviations from a target leverage ratio are more moderate than those of non-family businesses. When it comes to debt, the constraint of maintaining the continuity of the company leads to a reduction in the volatility of debt levels, notably upwards, which occurs in order to preserve financial autonomy and the minimisation of the risk of failure. As for equity, the constraint of maintaining control translates into a desire to not dilute control.

This second section has allowed us to highlight the characteristics of different available theories on the choice companies have when it comes to determining their financing structure. As we presented them, we laid the groundwork for interpreting the impact that specific family business features may have when applied to these theories, particularly the two-fold constraint of perpetuating the family business and maintaining control. In Section III, we shall therefore show how family businesses have brought modern financial theory into question and, in doing so, how they justify a different financial structure to non-family businesses.
III. DO THE INTRINSIC CHARACTERISTICS OF FAMILY BUSINESSES CALL INTO QUESTION THE USE OF MODERN FINANCIAL THEORY?
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From the analysis of the double constraint of maintaining continuity and control, which characterise family businesses, (Section I) and on the basis of the criteria used to choose financial structure (shown using the different fundamental theories in Section II), we are able to provide justifications for the lower debt levels of family businesses compared to their non-family counterparts.

In the first sub-section we consider an extension of modern portfolio theory’s two-dimensional (mean-variance) CAPM to a four-dimensional model, which goes beyond these two criteria to integrate the double constraint of perpetuating the family business and maintaining control. The prioritisation of this two-fold criterion in the decision-making process alone justifies the fact that family businesses have lower levels of leverage.

To deepen this analysis, in the second sub-section we shall put the two constraints of family firm sustainability into perspective within a universe where the agency costs and information asymmetry are present. We consequently see that observations and models which offer an explanation for the determination of financing structures are, in general, no longer entirely valid for family businesses (or not at all in some cases).

III.1. THE INTRINSIC CHARACTERISTICS OF FAMILY BUSINESSES REQUIRE US TO CONSIDER A FOUR-DIMENSIONAL, RATHER THAN A TWO-DIMENSIONAL CAPM...

Choosing a mode of financing is based on the principles of modern financial theory and, in particular, on the capital asset pricing model (CAPM).

Without reintroducing the theoretical formulation of this model, we should remember that its objective is to value assets in a balanced market. It is based on the assumption that only market risk, known as non-diversifiable risk, is rewarded by investors. Therefore, the investor’s required rate of return is equal to the risk-free rate of money plus a risk premium, which is based on the expected market rate of return and on the idiosyncratic (non-diversifiable) risk of the asset. The latter corresponds to the volatility of the concerned asset’s rate of return in relation to the market. In other words, it measures the elasticity of a security’s share price against the market’s representative index.

According to the CAPM, the return of an asset (or of a portfolio – a linear and weighted combination of assets) is a random variable that has a mean (related to return) and variance (related to risk). Based on this model, it is assumed that the goal of any company’s is to maximise the market value of its shares, based on a risk-return criterion, which also allows the entity to define an appropriate
financial structure and a corresponding leverage ratio.

However, the intrinsic characteristics of family businesses are likely to call the two dimensions (risk and return) of this approach into question because family firms require two further dimensions to be taken into account – namely the continuity of the business and the maintenance of control. This means that a four-dimensional CAPM ought to be considered. This four-dimensional approach therefore modifies the criteria for choosing a means of financing and justifies the notion that family businesses might have a different funding structure to companies that do not possess these family characteristics.

The objective of family businesses can be, as with all companies, to maximise the market value of its shares, based on a risk-return criterion. However, as soon as the objectives of sustainability and control of a company are called into question, this double constraint takes priority over the risk-return ratio. The objective of return in relation to the risks undertaken thus takes a back seat, which is not the case for non-family businesses. This behaviour is key for shareholders, because decisions taken by family businesses may be contrary to the interests of its shareholders (arbitration between perpetuity and profitability).

Thus, analysing the decisions of family businesses according to a four-dimensional CAPM model shows that they will tend to opt for strategic investments which, above all, do not endanger the perpetuity or control of the company. Therefore, in reference to our section on the Trade-Off theory, agency costs and conflicts of interest, they choose less risky investment projects, or they even underinvest. For example, Westhead et al. (2001) observed in the United Kingdom that some family businesses preferred to limit the exercise of options rather than open up their capital. This can thus result in projects with a positive net present value being abandoned, if future cash flows and funding are likely to endanger compliance with the two-fold objective of sustainability and control (Fama and Jensen, 1983a, 1983b).

In addition, the fact that financial distress is often associated with a change in control imposed by the external providers of funds (Gilson, 1989, 1990) also makes family businesses act more prudently than their non-family counterparts with regard to financial policy. This behaviour can be detrimental to minority shareholders. As demonstrated by the DuPont Model, financial profitability (RoE) is in fact a positive function of the leverage ratio, and the sustainable growth rate is weaker the lower the leverage ratio and the more cautious the investment policy.

With reference to Pecking Order Theory, family businesses will tend to minimise their debt (which increases the risk of failure), in favour of boosting liquidity through what shareholders would consider dormant assets (in order to maintain control). The prioritised form of funding is thus internal funds, essentially the reinvestment of profits, thereby meeting the previously stated two-fold constraint. The build-up of cash to ensure a degree of financial flexibility reduces the likelihood of financial distress.

Beyond self-financing and within the context of analysing the financing policies of family business according to a four-dimensional CAPM model,
what should these companies prioritise: debt or equity?

The answer to this question is not trivial. Debt involves no dilution of control and thus seems to perfectly meet the requirements of perpetuating control. In addition, it reduces the likelihood of a hostile takeover bid (Stulz, 1988; Harris and Raviv, 1990, 1991). However, as we showed previously, due to its leverage effect, debt is likely to endanger the requirement of perpetuating the family business. Within the new context of historically low interest rates where some family businesses are financing themselves (with bonds or private placements) at costs of lower than 1% per annum over a 5-7 year period, the financial distress paradigm is probably less constraining. We can therefore ask ourselves if family businesses have sufficiently integrated into this new environment. In other words, have they taken on sufficient amounts of debt?

Conversely, a capital increase does not increase the company’s risk of failure (so it is favourable to the goal of sustaining the firm’s future), but it is likely to dilute control. Some authors (Denis and Denis, 1994; Cronqvist and Nilsson, 2005) show that family businesses tend to have several classes of shares, in order to limit the dilution of control. However, the use of preference shares is generally frowned upon by markets, where this can be seen as a signal of executives entrenching themselves into the company. A number of studies (Jarrell and Poulsen, 1988; Ang and Megginson, 1989) have noted negative abnormal returns upon announcements of these types of shares being issued.

In the end, the choice of the financing policy between debt and equity seems relatively ambiguous, except in the case where a family business can raise capital whilst ensuring the family retains control of the company. In such a case, this mode of financing is preferred over debt. On the other hand, the use of financing instruments that dilute control are only considered as a last resort. These include common shares or hybrid assets, which have a dilutive effect on voting rights as they potentially grant access to capital. Belletante and Paranque (1998) thus highlight the reluctance of managers of listed SMEs to engage in dilutive capital increases, as the “fear of dilution” trumps “any objective reference”.

To complete this analysis, in the next sub-section, we shall go beyond the four-dimensional CAPM model and integrate some notions from the theories outlined in Section II, particularly those relating to agency costs and information asymmetry.

III.2. THE INTRINSIC CHARACTERISTICS OF FAMILY BUSINESSES REQUIRE US TO CONSIDER AGENCY COSTS AND THE INFORMATION ASYMMETRY IMPACTED BY THE STATUS OF FAMILY BUSINESSES

Beyond the four-dimensional CAPM model, the specific features of family businesses have an impact on agency costs and the management of information asymmetry, when compared to non-family businesses. This is likely to change their financing structure, particularly when it comes to debt. To illustrate the complexity of these links, we propose to study:

- The agency conflict between shareholders and executives of by looking at the issue of financial
flexibility for a family business;
• The negative impacts that family business specificities have on agency costs by looking at the culture of secrecy, the potential expropriation of a part of profits for the benefit of the family, the choice of CEO; and
• The positive impacts that family business specificities have on agency costs by looking at family-lender relationships.

The agency conflict between shareholders and executives via the issue of financial flexibility for a family business

Ferreira and Vilela (2004) highlight the large levels of cash held on the balance sheets of European companies (approximately 15% of the book value of the assets). However, we saw in Section II that agency conflicts between shareholders and executives led to the latter boosting their cash positions in order to have more discretionary power over their company’s investment policy (Jensen, 1986).

With this liquid resource at their disposal, executives are in effect able to operate independently from capital markets. They do not have to divulge any information about the company nor about growth forecasts, and thus escape external monitoring from the markets. This is all the more important for businesses with no investment opportunities – those with diffuse shareholding structures with little statutory protection. In fact, Dittmar et al. (2003), Ferreira and Vilela (2004) and Güney et al. (2003) show that in countries that offer little protection for minority shareholders, companies hold up to two times more cash than those in countries with more protective minority rights.

To remedy this opportunistic behaviour, Jensen (1986, 1989) recommends that cash be externalised, notably through debt. In other words, companies with potentially major shareholder-CEO agency conflicts should have a high leverage ratio.

Companies may also justify their high cash levels using either the Trade-Off theory or the Pecking Order Theory. The optimal level of cash is determined by arbitrating between the marginal cost (the opportunity cost of holding these highly liquid assets with very low returns) and the marginal benefit of holding cash (with financial flexibility reducing the probability of a liquidity crisis, allowing companies to avoid delaying, or even abandoning, new investment opportunities when funding constraints are saturated).

Within the specific context of family businesses, we previously saw that it is necessary to distinguish whether the CEO is a family member or not, and whether he or she is the founder or not. Morck et al. (2000) show that if the founder is present in the company, cash has a role in financing of growth projects, whilst in the opposite case, it must first of all be used to reduce exposure to risk. Faccio et al. (2001), Holderness et al. (1999) and Shleifer and Vishny (1997) also show that this cash can satisfy the requirement of not being returned to the markets so as not to reveal information when investments are about to be made, rather than being at the centre of agency conflicts between minority and majority shareholders.

In light of this analysis, it is reasonable to conclude that holding significant levels of a company’s (particularly a family company’s) liquid assets, is dictated more by a concern for financial flexibility
and by a principle of precaution than it is by other considerations.

**The negative impacts that family business specificities have on agency costs**

To illustrate the negative impacts that specific features of family businesses may have, we have chosen three examples: (i) the culture of secrecy; (ii) the potential expropriation of a part of profits for the benefit of the family; and (iii) the choice of CEO.

For strategic reasons related to perpetuating their heritage, family businesses are often known to safeguard a “secret” and maintain a level of informational asymmetry toward third parties to the company, in terms of variables considered to be strategic for the company or the family (for instance, the leading player in the global production of yeast, Lesaffre, reports according IFRS standards but only communicates its turnover). In this context, it is easy to understand, independently of a possible dilution of control, that a stock exchange listing is not contemplated by many family groups unless they are obliged to, as in their eyes doing so would require transmitting too much information to the markets and to competitors in particular (Brau and Fawcett, 2006). Similarly, informational asymmetry is a key element of the debt financing structure of family businesses, namely in terms of the maturity of the debt, in terms of the fixed-rate and variable-rate arbitration and in terms of the interest rate hedging strategy.

However, it should be noted that the quality of accounting and financial information of listed family businesses is generally better than that of their non-family counterparts (Ali et al., 2006; Tong, 2007), for reasons of reputation, growth and sustaining the family’s heritage and control, but also due to the need of families to monitor non-family executives. Communication on governance is, however, generally more opaque.

Another source of increased agency costs is linked to the conflict of interest between family shareholders and minority shareholders. As mentioned earlier, share price maximisation – a major concern for minority shareholders, takes a back seat as soon as the double constraint of sustainability is threatened. Aware of the potential expropriation of a portion of profits for the benefit of the family, minority shareholders are in a position to increase their cost of equity requirement. Furthermore, the objective of maintaining control is generally perceived negatively by minority shareholders, because the likelihood of a takeover bid is low.

The last example we shall illustrate is the choice of CEO. Minority shareholders are aware that, in order to protect their interests, some companies pick a CEO from within the family. Choosing from within the family alone excludes CEOs who are potentially more competent, but not family members. This observation corresponds to the previously mentioned theory about entrenching the family and the expropriation of minority shareholders. Numerous studies show that businesses with a founding family member, but not the founder, as CEO, have lower Tobin’s Q and profitability (as measured by RoA – Return on Assets) when the CEO is not part of the family. Moreover, some families, aware of this lack of efficiency, attempt to reproduce a competitive market of potential leaders within the family, focusing primarily on the entrepreneurial qualities of the candidates.

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The positive impacts that family business specificities have on agency costs

Certain intrinsic family businesses characteristics can reduce agency costs. For example, the requirement to perpetuate the existence of the company is likely to act as a guarantee for lenders against the moral risk of asset substitution, which should ultimately reduce the debt spread.\textsuperscript{15} So, although giving priority to development of the family business at the expense of the share valuation is likely to increase the risk premium demanded by non-family shareholders (a rise in family-minority shareholder agency costs), this prioritisation reduces family-lender agency costs, because it is likely to reduce the probability of bankruptcy and consequently the exposure to lenders’ risks.

Another source of reduced agency costs is linked to the informational asymmetry stemming from reputation and trust. We previously highlighted the issue of the culture of secrecy, but another component of informational asymmetry is reputation and trust. A number of works highlight the importance of confidence in financial relationships between companies and the different stakeholders, particularly the providers of capital (Arrow, 1974; La Porta et al., 1997; Allouche et al., 2008).

When two parties form a relationship upon financing an operation, two informational asymmetry risks arise – the risk of adverse selection (i.e. related to the inability to ex ante establish the borrower’s creditworthiness) and the risk of moral hazard (i.e. the risk of the borrower engaging in opportunistic behaviour toward the provider of funds by adopting an investment strategy that is not entirely consistent with what was previously indicated).

The stated objective of family businesses of perpetuating their company requires them to protect their reputation with various stakeholders (lenders, suppliers, clients, employees and shareholders), which helps establish a relationship of trust in the long term, and they also need to maintain trust with the providers of funds, particularly the banks, which helps reduce information asymmetry.

Reputation and trust contribute to a reduction in the risks of adverse selection and moral hazard, which are likely to impact financing structure and risk premia, especially compared with those of non-family businesses.

In conclusion to this section of our paper, we have shown that specific features of family businesses (in particular the prioritisation of the double constraint of sustainability and control over the risk-reward ratio) call into question modern financial theory’s traditional model (CAPM), as well as the different theories of agency costs and information asymmetry. Consequently, this two-fold constraint calls into question the traditional criteria used when choosing financial structure and would appear to justify the lower debt levels that family businesses have in comparison to non-family businesses.

\textsuperscript{15} - The transfer or substitution of assets involves transferring a portion of the economic risk to lenders without any compensation (Galai and Masulis, 1976).
CONCLUSION
CONCLUSION

The financial and the economic crises which have been ongoing since 2008, the scarcity of financial resources and the reduced profitability levels of companies, which consequently reduces self-financing, have brought the subject of searching for the optimal debt level back into the spotlight – a quest not dissimilar to the search for the Holy Grail. Many family firms that want to finance their development and growth have asked themselves the following strategic question: Do the intrinsic characteristics family businesses justify a level of debt below that of non-family businesses?

We have shown that in order to address this issue, it was necessary to integrate two parameters specific to family businesses: the continuity of the company and the maintenance of control. By integrating these two components into modern financial theory, we revisited the capital asset pricing model (CAPM), Signalling Theory, Pecking Order Theory, Trade-Off Theory and Market Timing Theory.

According to the CAPM, the goal of any company is to maximise the market value of its shares, based on a risk-return criterion, which also allows the entity to define an appropriate financial structure and a corresponding leverage ratio. We have shown that when assessing a family business, it is necessary to consider a four-dimensional CAPM in order to allow the double constraint of continuity and control to be integrated. Therefore, in the event of conflict, the classic risk-return criterion is relegated and the two-fold condition of perpetuity and control is prioritised. This behaviour is key for shareholders, because decisions taken by family businesses may go against to the interests of its shareholders (arbitration between perpetuity and profitability).

We have thus highlighted that this four-dimensional approach modifies the criteria for choosing a means of financing and justifies the notion that family businesses might have a different funding structure to non-family firms.

Beyond the CAPM, we also showed that the specificities of family businesses impacted agency costs and the management of information asymmetry, which thus challenges the traditional order of prioritisation for non-family businesses (self-financing, debt and then equity).

More specifically, family businesses seem to be able to reduce agency conflicts, particularly those between shareholders and CEOs (given these roles are often held by people from the same family), especially if the family entrenchment is optimal (as opposed to opportunistic) – that is to say if the controlling family members offer the potentially external CEO (with family governance) enough leeway to choose investment and financing policies allowing him or her to create value.

Ultimately, family businesses favour self-financing as it offers them financial flexibility, it enables them to protect the continuity of the company (debt increases the probability of failure) and it maintains control (non-family capital injections dilute the family shareholding), and it does not require the disclosure of information (family businesses are
generally more secretive than their non-family counterparts).

For these same reasons (probability of failure and maintaining control), when self-financing is not sufficient, capital injections from within the family are preferred over diluting family control. If such a family capital increase is not possible, then recourse to debt is considered (in ascending order of disclosure of information – bank loans, private placements, and then bonds).

Capital increases, hybrid financing or a public listing are considered as a last resort, with the fear of dilution sometimes superseding any objective reference.

Within the new context of historically low interest rates where some family businesses are financing themselves (with bonds or private placements) at costs of lower than 1% per annum over a 5-7 year period, the financial distress paradigm is probably less constraining. We can therefore ask ourselves if family businesses have sufficiently integrated into this new environment. In other words, have they taken on sufficient amounts of debt? In the face of restrictive bank lending, sometimes for regulatory reasons (Basel III), new modes of financing should be developed specifically for family businesses in order to integrate this double constraint of perpetuating the company and maintaining control. Such financing could include hybrid financing of quasi-equity without the opening-up of capital (OBsARs for example – bonds with redeemable equity warrants) or the issuance of pooled bonds.
Références


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