Capital Structure of Family Companies

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***Abstract*----**The forming of a capital structure in a firm is considered a "puzzle" in the literature of corporate finance. Factors such as size of firms, tax, cost of bankruptcy and the cost of agency, have been documented as significant determinants of capital structure decisions in a company. This conceptual paper aims to shed light on the factors the influence the forming of capital structure within family based companies rather than corporate companies. This objective is achieved by the review of various hypotheses, such as: the pecking order, the trade-off, and agency cost, and how likely family based companies are influenced by such theories in forming a capital structure, given the unique features of family based firms in terms of risk aversion, fear to lose control and long-term orientation, among others. There is a scant attempt to focus on the capital structure of family based firms in the literature. Besides, there is no consensus among studies about the decision forming of capital in family based firms; this, in turn, has been reviewed with the purpose of providing family based firms' motivation in using particular capital structure over the other structures.

***Keywords*—** Capital structure theories, family companies, capital structure motivation.

I. INTRODUCTION

FAMILY firms are widely available throughout the world. For instance, in Europe, about 50% of companies may be categorized as family based companies (Price Waterhouse Coopers Family Business Survey 2007/08). In Latin America, between 65% and 90% of all registered firms are run by families. In the USA, the percentage is 95%. Family firms also greatly contribute to GNP. For example, in member countries of the European Union, family companies contribute between 35% and 65% of the GNP. In countries such Sweden, the contribution of family companies to the GDP is over half in the private business sector. Furthermore, a great deal of research indicated that families' shareholdings are common in public traded companies throughout the world. They have large shares and are represented by executives and members of the board of directors, for instance, in East Asia [1], in the Western Europe [2], and in the USA [3] [4].

However, family based companies face challenges such as the caring of family along with searching for a robust commercial and financial position. The capital structure of family companies is considered as an ambiguous issue. As several of these companies are small-medium sized and closed corporations, access to funds may be limited. The matter of usage equities and/or debts as a financing source is a great concern in family firms. The decision of the firm related to capital structure is seen as one that is clearly interrelated with other decisions (dividends policy), as the decision of the company is to keep profits rather than distribute them in the form of dividends, and could be considered as a financing decision.

The subject of capital structure has been extensively examined. Despite that, the consensus among scholars has not yet been reached, given the heterogeneity of the findings in many of the studies throughout recent decades, which made [5] to claim that capital structure is a "puzzle". According to Vieira [6], it still remains a "puzzle". Despite the great amount of literature that analyzed the capital structure of companies, the studies conducted on this subject related to family based firms are limited [6].

However, most of the theoretical and empirical studies that addressed these topics concentrated on the large amount of public listed firms that dispersed ownership structures. It is doubtful that these findings could be applied to firms under the control of large stockholders, particularly those owned by families, because family firms have specific goals and incentives when compared with non-family firms. They do not exclusively pursue the aim of maximizing value, but also follow non-economic goals as well [7]. Several portfolios of families may be undiversified, which basically consists of their companies, and thus, carry exaggerated risks [8]. It is argued that family companies have more aversion of risk and losing control than non family firms, so they avert to employ the debt in their capital [9] [10]. [11] indicated that companies tend to favor debt over equity in the case of losing control over the firm.

Additionally, their long-run orientation, desire of transferring a firm to the next generation, and concern about their reputation [12] [13], can support the direction of avoiding employing debt. On the other hand, avoiding consequences of debt-covenant violations and the desire to preserve their dominant position and control makes families more predisposed to prevent the entrance new stockholders, which leads to an increase in the debt ratio [14]. Therefore, they may follow strategies that concentrate on the survival of the company in the long-run rather than focus on the maximization of value [13]. Furthermore, thinking in their heirs may push them to favor long-run orientation [12].

Indeed, the reputation issue of family companies also affects their selection of capital structure. Owners of family firms are often able to build stable and durable relations with external providers financing due to the long term nature of their companies. For instance, the owners of family firms are able to form individual connections with banks, as it is also

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expected that these relations will grow with upcoming generation because their presence in the firm allows such interactions. If a family company would then engage in improper actions, external parties would anticipate similar actions to former family members in the future. The reputation of the family therefore helps to create a longer permanent economic position for family firms than their counterparts (non-family firms), where altering the management is more considerable. Thus, if they maintain a good reputation, their access and ability to raise capital would be easier than their counterparts [3].

The study of [15] may be considered as one among the first studies that addressed the subject of capital structure, based on the conditions of the perfect market. In this vein, they indicated that the value of a firm is not affected by the financing decision of the company. [16], among others, supported this point of view. However, many scholars challenged this hypothesis (the capital structure irrelevance), based on the fact that perfect market conditions do not exist in the real world, but what actually exists is an imperfect market (i.e., tax, cost of bankruptcy and information asymmetry), which effect the value of firm, according to the financing policy of the company (using debt to reduce tax burdens may increase financial distress) [17] [18]. The increased level of debt in capital structure leads to the increase in financial risk, thus, the probability of bankruptcy will increase.

After a few years, [19] admitted that the effect of debt on the tax shield made it preferable in capital structure over equity, as the benefits of usage of the debt decrease the weighted average cost of capital, thus increase the value of the company. However, there is the optimal capital structure, where it can increase the firm's value and reduce the weighted average cost of capital. Due to a certain point, the cost of capital will increase to compensate the higher level of risk of finance with the assumption of maintaining a constant cost of capital, thus, the substitution of equity for debt in capital has a limit [20].

Definition of family firm in literature

There is no consensus about the definition of family firms in the existing literature, which can be generalized for such an organization type. Several scholars consider firms as family firm if they are controlled and managed by family members from different generations [3]. [21] also considered any company managed by a founder or the family members of the founder as a family company. In a similar manner [3] and [22] considered a company as a family firm as long as the founding family or individuals possess a part of the firm, or if they have a position in the firm such as a member of the board. [4] also concentrated on these basics to define a company as a family firm, which are the involvement in the management of firm and ownership of the firm. However, [23] takes another perspective in defining a family company, and concentrated on the blood relation between the founder and present CEO.

II. Literature Review

The pecking ordering theory

The approach of the Pecking Order stated that firms pursue a hierarchical sequence in their selection of the financing sources, in order to reduce costs of finance [5] [24]. Thus, firms rely on the internal sources firstly, then the debt (whether the issuance of debt instruments or loans) when internal sources are insufficient, and they leave the finance by the issuance of equity as a later option. This implies that firms with a high level of profits have a lower leverage ratio due to being capable to finance investment needs by internal sources, and external sources are not necessary. However, when the company is unprofitable, their cash flows are not enough to fitful investments needs, and they tend to use debt within the alternatives of external financing, as it is closest to the top of the hierarchy. In this vein, the need of external borrowing will decrease with an increase in the profitability of the company [25]. Other studies documented that the relation between profitability and debt is negative [26] [27].

[5] indicated that firms pursue a pecking order when issuing equities [24]. [28] pointed out that this concept seems to be suitable for family firms. Generally, firms attempt to avert the increasing cost of asymmetric information (because level of information may not be enough for assessment stock, which leads to mispricing for a stock) and financial distress costs related with the pecking order, but in family based companies, the main forces behind the pecking order financing decision are preserving control and independence over the firm [29]. However, there is no prediction for a specific target capital structure by the pecking order theory. Thus, family firms prefer to rely on internal sources of finance (self-financing) over using debt, as it is risky. This means that leverage will be lower, but as the internal source is exhausted, family firms will favor to finance by debt rather than equity, thus increasing the leverage.

[30] examined the decisions of the capital structure in small and medium family firms by using a questionnaire in Australia. Their findings indicated that the debt ratio is small in these firms and it related with the size of the company, control of family, planning and objectives of the business. Also, they found out that the older owners of the business relate with preference of finance sources (they prefer lower equity). One explanation to this may be that they fear losing control over firms as the entrance of new stockholders means that shares of the firm will dilute. [30] also argued that the hypothesis of the Pecking Order offers useful explication for the financing decisions in family based firms.

In the vein of the approach of the Pecking Order, the need to borrow decreases with having more cash, thus, authors argued that the relation between cash and usage of debt is negative. However, the aversion of risk in family firms, specifically the risk of financial distress, may reinforce that relation [10]. This is consistent with the argument, which is that family companies resort to internal sources in order to finance growth. However, it contradicts with the assumption of the Pecking Order theory, where it anticipated that the relation between growth and debt is positive, as the company needs to finance its new projects or expand. Also, the theory proposed a negative relation between profitability and usage of debt because of favoring of the firm and the internal sources over external sources, thus, higher profitability of the company and an increase in the usage of internal financing lead to a lower debt ratio. However, researchers empirically documented that family companies are outperformed when compared with counterparts of non-family companies [12] [3] [31]. This could explain the argument relating financing growth. Thus, **(ref here)** considered the evidences that family companies are more profitable than their counterparts and the Pecking Order assumption, which anticipated that family firms if used debt will at lower level because of they produce more internal resources, [6].

Trade-off theory

The Trade-off theory gathers the pros and cons of the usage of debt. On the one side, the usage of debt in capital structure gives a reduction of tax burdens; However, an increase in the level of debt comes with the risk of bankruptcy, since the likelihood of bankruptcy rises with the degree of the company's indebtedness [32] at a lower level of leverage, and the likelihood of the firm's bankruptcy may not be serious, but at a higher level of indebtedness, agency problems and costs of bankruptcy become serious, and costs of bankruptcy are more than the tax benefits of debt [33]. Therefore, the hypothesis of the trade-off argued that there is an optimal leverage ratio, which is the point where the cost of failure and the tax benefits of debt are equal (i.e., incremental cost of failing equals marginal tax benefits of the debt).

The trade-off theory proposes that a firm selects its optimal capital structure through balancing the benefit and cost of using debt. On the one hand, the use of debt mitigates the tax shield of the firm. However, it increases the likelihood of financial distress [5]. Members of the family derive private benefits from control on the firms. These benefits will be imperiled in the case of financial distress, or insolvency. Often, this is related with alter in control of the firm [9]. In addition, the owners of family firms may be endangered in case of financial distress or insolvency of their firms, as their investment is lower or undiversified [34], and because a bankruptcy in the firm may mean bankruptcy for the owners (families), as they are undiversified [35]. Thus family firms aim to mitigate the use of debt, since increasing the leverage will accompany with increasing the likelihood of financial distress [34] [9]. They may abide to "financial conservatism" [36] [P. 81]. However, the aversion to use debt can go hand in hand with the sacrifice of profitable projects [9]. The findings of [37] and [38] indicate that companies have a target for their debt ratio, and this evidence supported the hypothesis of the trade-off in the USA and 16 European countries.

Agency theory

[17] developed the agency theory, and they argued about the importance of agency conflicts in corporate finance. The main assumption of this theory is that the interests of principle and agents will diverge due to the separation between ownership and management. This creates conflicts and tension among parties, and leads to higher agency costs, as some stakeholders may focus on actions that benefit them only, if even that be on the account of others' expenses. The owners may not be able to watch the behavior of managers, which in turn, may help managers to engage in actions that are unknown to stockholders. This increases the asymmetric information among parties, so that they do not share similar information about firm. Thus, the managers of the firm would behave in their private interests (perks, security of job) and not maximize the value of the firm. The free cash flow theory is similar to the agency cost approach, where cash may be exploited by managers to destroy the value of the company through perks or investing in worthless projects if not distributed to shareholders. [39] described this case as follows: "The problem is how to motivate managers to disgorge the cash rather than investing it below the cost of capital and/or wasting it on organizational inefficiencies". the use of debt could act as one possible solution for this dilemma, as it puts constraint on managers through increasing the risk of default, which in turn, forces the management to reduce the perks or waste the resources of the firm.

The importance of the relation between ownership structure and financial structure is considered as the importance of the relationship between corporate governance and the performance of the firm. [8] stated that external large shareholders may alleviate opportunism of managers, which leads to reduce agency problems between managers and stockholders. If external large stockholders can provide monitoring of managers effectively, management may not be able to modify debt ratio according to their private interests as freely as these did not exist. In this case, a company with external large stockholders is probable to possess higher leverage ratio, at least until the point where the risk of bankruptcy becomes serious, then may induce to reduce debt ratio. [40] indicated that the relation between ownership of managers and leverage ratio is negative, because increasing their ownership could push the company to minimize the debt ratio on order to avoid the risk of default or decrease it. [41] indicated that management prefers certain kinds of investors over others, because various kinds of investors have different abilities to constrain their options. As a consequence, management works to maximize the value of the company if such a favorite investor remain in charge when the performance of company is good, but a feature of debt (debt covenants) is to constrain management options following bad performance. However, others argued that, when managerial ownership is low, the leverage ratio is high, as the agency cost is also less. As their ownership increases, the probability of opportunism behaviors may increase. Therefore, they resort to reduce debt ratio [42]. [43] stated that usage of debt by firms could be considered as a credible signal to restrict an empire building, particularly in family companies, as they may be a main candidate for such behaviors.

Thus, in light of the agency theory introduced by [17], it is expected that family companies be free of agency costs (particularly conflict between principle and agent), on the consideration that the owner and management of the firm is the same person (if that is the case, then diverging interests between principle-agent do not exist). This argument has been strongly transferred to this kind of firm and is used as a solid suggestion to depict non-conflicts among parties in such firms (i.e., zero agency cost). [3] and [4] supported this assumption, and they proposed that the structure of incentives that exists in family companies helps to reduce agency conflicts between various claimants. Due to the incentive of owners in these firms being great to monitor the managers behaviors, as they are less or undiversified [13] [4]. However, the interests of large stockholders should not necessarily be in line with minority interests, as the large stockholders may follow their own interests, and this increases the possibility of the expropriation of small stockholders' wealth, which is considered as the main disadvantage of concentrated ownership in general [8], and family ownership in particular [45]. Even though the role of debt as a disciplining device in family companies is less [46], it assists to discipline the expropriation family itself [47].

[13] examined the debt policy of family companies in the USA with a sample of 252 companies during the period of 1993-1998. The findings showed that the cost of debt in family based companies is low when compared with their counterparts. This in line with the hypothesis that the ownership of a founding-family in publicly traded companies minimizes the agency cost of debt. This is also consistent with the notion of the incentive structure of family companies, which leads to fewer agency conflicts among the shareholders and creditors. This may be because the family cares about their long-term relation with the providers of debt, thus, they care about the reputation of the firm and the personal reputation. Their investments generally focus on their companies (i.e., undiversified investment), thus, the loss of firms may mean the loss of everything for them.

In contrast, [48] pointed out in the study of Spanish listed companies during the period of 1990-1999 that family companies are less worried about risk of finance, and are more worried preserving control over the company than non-family companies. In addition, the evidence of [47] and [49] showed that firms controlled by families used a higher leverage ratio when compared with their counterparts, thus, they concluded that family companies employ debt as a replacement for independent directors. Furthermore, they proposed that family companies do not expropriate wealth (minority), but they might adopt a higher leverage ratio in order to enhance oversight.

[3] examined the difference in the capital structure between family and non-family firms in USA with a sample of 2108 companies during the period of 1993-1999. They considered firms as family firms if they had a stake of 5% and the founder was a part of the board of directors. They pointed out that there was no difference between them, and the founder does not have an effect on the level of debt in U.S. industrial companies.

In Germany, [46] argued that family has a negative effect on use of debt, and they attributed this to the involvement of the founder CEO in the management of the firm.

In contrast, [50]'s cross-country study (sample consisting of 3608 companies from 36 countries) revealed that the relation between ownership of family and leverage ratio is a significant positive. [50] argued that maintaining control of the firm could explain this finding, as the family is worried about loss of control if the financing is done by external equity rather than debt, as the use of debt gives financing without diluting control of the family on the firm.

[51] indicated that companies with large stockholders exhibit high leverage because of their unreadiness to dilute ownership structure. Accordingly, family companies used debt to avoid loss of control. This concept is also supported by the survey of [52], which revealed that fear from loss of control is considered to be a predominant factor in determining acceptance of equity financing in family based companies. [53] indicated that the relation between leverage ratio and insider ownership is significant [54]. Family companies used, on average, 20% more in debt than non-family counterparts. On the contrary, [55] proposed that family companies have more aversion of risk, and therefore are reluctant to use debt. [56] also pointed out that the debt ratio among family companies was lower. The results of [3] revealed that insider ownership (either managers or families) does not affect on the decision of capital structure, and family firms use somewhat less debt (18.42%) when compared with non-family companies (19.42%); despite that, the results were not significant in their analysis.

III. Conclusion

To conclude, the capital structure of family firms requires a complicated decision, unlike corporate companies, who rely on conventional factors to determine their capital structure policy. Family firms possess unique characteristics, and forming their capital structure requires them to look beyond conventional factors. Certainly, family firms have a different motivation when choosing a particular capital structure over another.

Among the factors that influence the formulation of capital structure are: firm reputation, fear of loss of control, being risk averse and concentrating on long term orientation.

Thus, it is likely to anticipate that family firms employ a lower or higher level of debt in their capital structure based on these characteristics. For instance, fear of losing control and transferring a firm to the next generation may make family firms favor debt over equity. However, this may not be the case in non-family companies, where there may be more concerns about the tax burdens. On the other hand, the cost of financial distress may lead to reduce the use of debt by family firms. Particularly, most of their investments focus on the firm. Therefore, family firms and their capital structure formulation should be assessed individually rather than stereotyping the findings based on corporate companies.

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