Family Business Succession and Its Impact on Financial Structure and Performance

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About one third of family businesses are known to survive to the second generation while only 10%-15% make it to the third generation. Therefore, succession is the most significant step in family business lifecycle. In this article, the authors present interesting research findings on how leadership succession influences family firm's financial structure and performance. The study was based on the analysis of firm-level panel data that covered the period from 1991 to 2006 and was sourced from 152 small and mid-sized businesses. The variables taken into consideration were the firm's total debt, total assets, return on assets, year of succession and the generation leading the firm.

Impact of Succession on Financial Structure

The authors note from the extant literature on family business succession that as the family firm progresses from one generation to the next it becomes risk averse. This may change the way the firm manages its capital requirements as it passes through stages of succession.

1. ***From founder to second generation*** - When the firm leadership changes hands from the founder to the second generation the successor's willingness and ability to borrow decreases. They try to avoid a highly leveraged capital structure, as their focus is more on wealth preservation than on creation of additional wealth. Thus, this logic limits debt financing and retains the capital structure.

2. ***From third generation and beyond*** - As a family firm passes on to later generations or becomes a cousin consortium, the ownership is more dispersed. At this stage, the risk preferences of family members become more in sync with those of the institutional investors who want the business to take risks for future growth. Thus, the successors of later generations have higher willingness to take risk and may opt for debt financing.

Thus, the authors suggest that the trend of being averse to debt financing as observed after the first transition may be neutralized or even reversed in the next inter-generational transition.

Impact of Succession on Performance

The authors note that the extant literature on the effect of succession on firm performance remains inconclusive. Several studies suggest that succession changes business goals and lowers willingness to grow that leads to stagnation in business. However, the authors note that even on firm performance the succession has a differential effect depending on the generations among which it takes place.

1. ***From founder to second generation*** - The authors suggest that when the family business leadership passes on from the

founder to the second generation, succession has a negative effect on firm growth. Succession at this stage also adversely affects firm profitability. This may be attributed to the successor's risk-averse attitude and focus on wealth preservation instead of growth.

2. ***From third generation and beyond*** - As the family firm leadership goes to third or later generation, the successor desires to break the stagnation or status quo and grow the business. This may be attributed, in part, to the fresh knowledge and insights that the newer generations bring to the business. Yet another reason may be a desire that they may have to break free from the 'founder's shadow.' They might be more willing to take risks compared to their predecessors. This stage of succession has a neutral or positive effect on firm growth and profitability.

Therefore, succession from the founder to the second generation may adversely affect firm performance while this effect may be neutralized or even turn positive as the firm later transits to third generation or beyond.

Practical Implications

It is important for the founding generation of the family businesses not to teach their children to shy away from taking calculated risks in business. Wealth preservation is an important goal they must strive to achieve, but not to the detriment of business growth. On the other hand, without curbing their entrepreneurship behaviour, the members of third or later generations must be made aware of the need to take decisions in accordance with their risk appetite. Such prudent behaviour helps family business survive, especially through the testing times of an economic crisis.

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