Family Business Succession and its impact on Financial Structure and Performance

Family business succession is one of the most difficult steps in the life cycle of family firms. Studies have shown that only one third of family businesses survive into the second generation and only 10% to 15% make it to the third generation. What is the impact of the family business succession on the financial structure and performance of the firm? A recent research by Vincent Molly, Eddy Laveren and Marc Deloof (2010) revisited this issue by studying a sample of family firms over a period of time. Their sample constituted of 152 small- to medium-sized businesses and data were gathered over a period 1991 to 2006. They used the leverage capital structure or debt rate, measured by taking the total amount of debt to total assets ratio as the indicator of the firm's financial structure. They analyzed firm performance by looking at the growth rate and profitability of the firm. To measure growth rate, they took into consideration growth in total assets. The profitability was measured by operating return on assets.

The results of their study showed that the effect of succession on the financial structure and performance of the family firms depends on the type of succession; that is, whether the succession is from the first to the second generation or whether the succession is between later generations. Specifically, they found that succession from the first generation to the second generation negatively impact the debt rate of the company, whereas in successions between later generations the impact on the debt rate of the company was positive. Similarly, growth rate decreases in the succession from first generation to second generation, although in next generation succession there is no effect on the firm growth. However, either type of the succession has no significant effect on the profitability of the family firms.

The finding that succession from the first generation to the second generation has negative impact on the financial structure and growth rate of the family firm is because the transition from the founder to the second generation is the most turbulent one. It is characterized by higher conflicts and higher risk aversion. In comparison, in the next generation successions, the family firms are less vulnerable to conflicts and have lower risk aversion. The family members have broad experience after the prior successions. Moreover, the agency costs in cousin consortiums, often found in third generation family firms, are lower compared to that in the sibling partnerships of the second generation. This implies that in the next generation family firms the family members are more willing to opt for debt financing to fuel the firm's growth. Also, given that the next generation family firms are already grown in size the need for debt financing becomes critical. The finding that profitability is not negatively affected by either type of succession despite lower growth is because descendents are able to reap the benefits of investments made by the founder in the capital assets and R&D. Overall, the authors of the study concluded that succession should not necessarily be seen as a negative event in the life cycle of a family business. They proposed several initiatives to facilitate a smooth transition in family business succession. Some of the proposals are the following: 1) introduction of multiple voting rights so that family members could keep the control of the business, 2) lower taxation of financial transfers, such as inheritance or gift of shares, in family business succession 3) well-structured training programs for both the incumbent and next generation successors.

Source: Molly, V., Laveren, E., and Deloof, M (2010) Family Business Succession and its impact on Financial Structure and Performance. Family Business Review, Vol 23 (2)