Valuation of Family Firms when compared with Nonfamily Firms in Acquisitions

In today's business landscape, the most prominent strategy used by corporations, large and small, for their business growth is acquisition. There are multiple factors that motivate businesses to consider acquisitions for expansions: increased globalization, dynamic markets, sophisticated products and services, and changing consumer demands. Because of these rapid changes, it is increasingly becoming difficult for a single firm to develop all resources and capabilities required to develop and sustain its competitive advantage. Hence, to overcome such resource-based constraints to growth, a company (acquirer) acquires another company (target), which has complementary resources. The rationale for acquisition is that the synergy created after recombining of resources post acquisition will create competitive advantage. One of the critical issues in the acquisition is the valuation of the target firm. The acquirer must thoroughly evaluate the tangible and intangible resources of the potential target firm to determine its economic value and price to be paid for the acquisition.

Although family businesses are the most common forms of organizations across the world, accounting for more than 75 percent of registered companies in most economies, very few studies have been done on the acquisition of family firms. Considering the fact that family firms around the world have superior performance in comparison to non-family business, one must expect that family firms will be valued higher than a non-family firm for acquisition. In family firms, the family owners and managers view themselves as stewards of the family firm; their interests are aligned with the objectives of the firm, have a long term focus, nurture their employees, and build enduring relationships with their customers. The integration of family and business systems in a family firm creates unique resources and capabilities, and hence competitive advantage. Therefore, family firms must be valued higher.

In a recent study by Granata and Chirico (2010), however, the authors found evidence contrary the expectation. They reported that in the context of acquisition, family firms, despite their superior performance, are under-valued in comparison to non-family firms. The authors used multiples—the ratio of a market price variable (such as the stock price, the market capitalization) to a particular value driver (such as earnings, revenues, or the work force) as a measure of value in their study. They specifically used two multiples, EBIT (Earnings before interest and taxes) and EBITDA (Earnings before interest, taxes, depreciation, and amortization of intangibles), as both are often applied in the analysis of mergers and acquisition. In their study, the authors found that (1) EBIT for both family and non-family firms is valued similarly. That means the acquirer does not see the advantages of the family firms, (2) for EBITDA, which is a more accurate indicator of firm valuation, family firms multiple are lower compared to that of non-family firms. That means the acquirer pays less (that is, acquires at a discounted price) for family firms. To explain the contradictory findings, the author claimed that when it comes to the valuation of a family firm, the acquirers tend to focus on the negative public perceptions rather than focus on the advantages of the family firms. The acquirers regard the family firm as unprofessional and inefficient organization in which decision making is driven by emotions rather than by the economic rationality, and hence undervalue the target family firm.

The study has implications for owners of the acquirer and as well as the target company. The acquirer must be cognizant of the fact that the real value of the target family firm could be underestimated.

Therefore, when a family firm is unwilling to sell the company at a lower price, the acquirer might risk losing a valuable investment opportunity. For the owners of target family firms, as they are likely to get a lower price for their firm than its actual worth, during the negotiation process they must focus on mitigating the negative perceptions of the acquirer and emphasize the strengths of the firm so that they get a fair price in the deal.

Source: Granata, D and Chirico, F (2010) *Measures of Value in Acquisitions: Family versus Nonfamily Firms*. Family Business Review, 23(4), 341-354.