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Family Business Research through the Eyes of a Lender: A Cognitive Framework for Interpreting Research Findings on Family Firms

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Whereas most extant studies comparing the performance of family firms relative to non-family firms document contradicting results, only a rather limited number of recent studies have attempted to use family firm governance structures to reconcile the conflicting empirical findings. This paper fills this gap by developing a cognitive framework that connects family firm governance, resource endowment, and resource adaptation with a firm's static default orientation. The cognitive framework is then used to propose lending criteria to a typical lender, and also to generate theoretical propositions regarding access to and cost of debt finance for different types of family firms. Apart from providing insights to lenders on the theoretical default characteristics of different types of family firms (and not family firms in general), the paper also presents a theoretical benchmark for the analysis of empirical findings on debt financing in family firms as well as observed default behavior among family firms.

Field of Research: Family Business Finance

1. Introduction

The family firm has long been the single most important vehicle for wealth accumulation for individuals and families alike. Whereas a few families have earned a reputation for entrepreneurship across generations, the majority have failed to sustain family entrepreneurship to the second generation.

While the majority of studies have focused on family firm governance and firm performance, the literature on access to debt finance is rather limited, and its orientation limits its usefulness to lenders. The extant literature fails to provide a framework that can consistently guide lenders and practitioners in understanding default behavior in family firms. Most of these studies have investigated the debt agency costs of family control and differences between access to credit between family and non-family firms. The only study that has linked contemporary family business research to firm default behavior is Nyangara (2012).

Although the default matrix in Nyangara (2012) is a commendable step towards making key output of contemporary family business research accessible to lenders, it is limited in that it does not provide usable guidance to lenders in terms of how they should identify and classify family firms for lending purposes. Dyer (2006) derives a four-way typology of family firms and suggests how owners of family firms may utilize the

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typology for strategic purposes (Dyer, 2010). However, Dyer's discussion is silent about how other stakeholders such as lenders can utilize the typology. A theoretical gap therefore still remains regarding how the typology developed in Dyer (2006, 2010) can be made accessible to lenders for default diagnostic purposes, and portfolio analysis.

This paper narrows this gap by incorporating Dyer's typology of family firms in the default matrix in Nyangara (2012), and also developing a strategic lending matrix for family firms based on the expected cash flow characteristics and debt capacities of different types of family firms. The contribution of this paper to the literature on family businesses is in three ways. Firstly, by demonstrating that different types of family firms have different cash flow and default orientations, the paper encourages lenders to recognize these differences when constructing their credit portfolios. Secondly, the paper also generates theoretical propositions regarding different types of family firms, and these propositions may be used as theoretical benchmarks by researchers seeking to explain observed differences between family and non-family firms. The development of theoretical propositions based on the typology of family firms helps isolate sample differences when analyzing findings of different empirical studies. Lastly, the cognitive framework in this paper is expected to aid structured teaching of financing aspects in the emerging field of family business finance by providing a structured way of looking at the financial characteristics and expected default behavior of different types of family firms.

The rest of the paper is organized as follows: Section 2 reviews the relevant literature on family entrepreneurship; Section 3 discusses the methodology; Section 4 covers the development of the conceptual framework; and Section 5 concludes the paper and suggests areas for further research.

2. Literature Review

While some studies conclude that family firms, by different definitions, tend to perform better than non-family firms along different dimensions (e.g. Anderson and Reeb, 2003; McConaughy et al, 2001; Beehr et al, 1997), others find either no difference, or that non-family firms perform even better, especially on governance aspects (e.g. Chrisman et al, 2004; Villalonga and Amit, 2004; Gomez-Mejia et al, 2001). Dyer (2006) attributes most of the contradicting evidence on family firm performance to sample differences. In his view, it is important to have an understanding of the family firms that are being compared to non-family firms before generalizing the findings to all family firms. There have been increased efforts to identify the different typologies and configurations that may influence family firm performance in recent years (e.g. Sharma and Nordqvist, 2008; Dyer, 2010; Chirico and Nordqvist, 2010; García-Castro and Sharma, 2011). Of the typologies developed in the literature, Dyer's typology is most appealing because it is relatively simple, while at the same time clearly incorporating the two key perspectives used in the literature to explain family firm performance; that is, agency theory and the resource-based view (RBV).

Dyer (2006) initially presents a typology of family firms based on both agency theory and the RBV, which he further develops in Dyer (2010). Dyer's work identifies the central role of family culture in shaping the business success of the family firm, and goes a long way in clarifying the mixed findings on family firm performance relative to non-family firms (Dyer 2006). While there is a temptation to classify a family firm once and stereotype it forever, Dyer (2010) acknowledges that the typology of family firms is not a static grid for any single firm; over time a firm transitions from state to state in response to strategic initiatives and environmental pressures (Dyer, 2010).

To gain insight into Dyer’s typology of family firms, it is important to appreciate the two pillars of the typology; agency theory and the RBV. The agency cost argument submits that concentrated ownership reduces conflict of interest between owners and managers and hence agency costs (e.g., Berle and Means, 1932; McConaughy et al, 2001). It further argues that competitive gains are made through the long-term perspective that family involvement in management encourages (e.g., Anderson and Reeb, 2003; Chami and Fullenkamp, 1997; Stein, 1989; Laverty, 1996). Generally, the agency cost argument posits that family firms not only suffer less information asymmetry between owners and managers, but also incur less monitoring costs due to the self-monitoring nature of family managers (Grossman and Hart, 1980; Shleifer and Vishny, 1986 as cited in Schmid et al, 2008). As a result, the family firm spends less on monitoring managers, impose~~s~~ fewer restrictions on managerial decision-making, relies less on expensive and constraining external enforcement mechanisms such as the excessive use of debt, and makes limited use of corporate diversification and other income-smoothing strategies (Schmid et al, 2008). Dyer (2006) however cautions that the realization of the agency cost advantage is conditional on the psychosocial history of the family as well as the relationship between ownership dispersion and management. The former manifests itself in family inertia (Dyer, 1986 as cited in Chirico and Nordqvist, 2010), and the latter in the “free-rider” problem (Schulze et al, 2003 as cited in Dyer, 2006). Generational involvement may therefore generate conflict and negative outcomes if not coordinated via a participative strategy (Chirico et al, 2011).

The RBV holds that family firms have access to significant social capital and family assets, as well as well-socialized human capital, which give them an advantage over matching non-family firms (Dyer, 2006). At the same time, limited access to a larger pool of skilled labor and the persistence of nepotism and paternalism in family firms may inhibit accrual of the human capital benefits, and the development of essential dynamic capabilities (Chirico and Nordqvist, 2010). Chirico and Nordqvist (2010) emphasize the significance of family business culture in generating and shaping dynamic capabilities, which are essential for creating trans-generational value. They argue that two attributes of the family business culture; paternalism and entrepreneurial orientation, influence family business performance by propagating or reducing family inertia respectively. According to this view, the accumulation and propagation of idiosyncratic knowledge within the family and business enhances the creation of dynamic capabilities, leading to superior entrepreneurial performance, and the generation of trans-generational value (Chirico and Nordqvist, 2010).

Consistent with Dyer (2006), Chirico and Nordqvist (2010) also posit that the superiority of family business performance is not an absolute but a relative phenomenon. Family firms with an open organizational culture tend to exhibit more entrepreneurial orientation and less family inertia than those with a closed organizational culture, which are more paternalistic and are associated with greater family inertia. The views taken by Chirico and Nordqvist (2010) and Dyer (2006) point to a crucial link between family capital (human, social, and physical/financial) and family culture on one hand, and firm governance and firm performance on the other. Dyer (2006) combines family capital and family culture to derive the typology of family firms along the lines of the RBV and agency theory, while Chirico and Nordqvist (2010) derive the link between family inertia, dynamic capabilities, entrepreneurial performance, and trans-generational value.

Nyangara (2012) develops a default risk matrix to capture the impact of trans-generational value (Zellweger et al, 2012) and emotional value (Zellweger and Astrachan, 2008) on strategic and non-strategic default attributes of family firms. While the default matrix in Nyangara (2012) is a commendable step towards making key output of contemporary family business research accessible to lenders, it is limited in that it does not provide usable guidance to lenders in terms of how they should identify and classify family firms for lending purposes. Also, the view taken by Dyer (2010) focuses on how owners of family firms may utilize his typology of family firms for strategic purposes, yet is silent about how other stakeholders such as lenders can utilize the typology. A theoretical gap therefore still remains regarding how the typology developed in Dyer (2006, 2010) can be made accessible to lenders for default diagnostic purposes, and portfolio analysis.

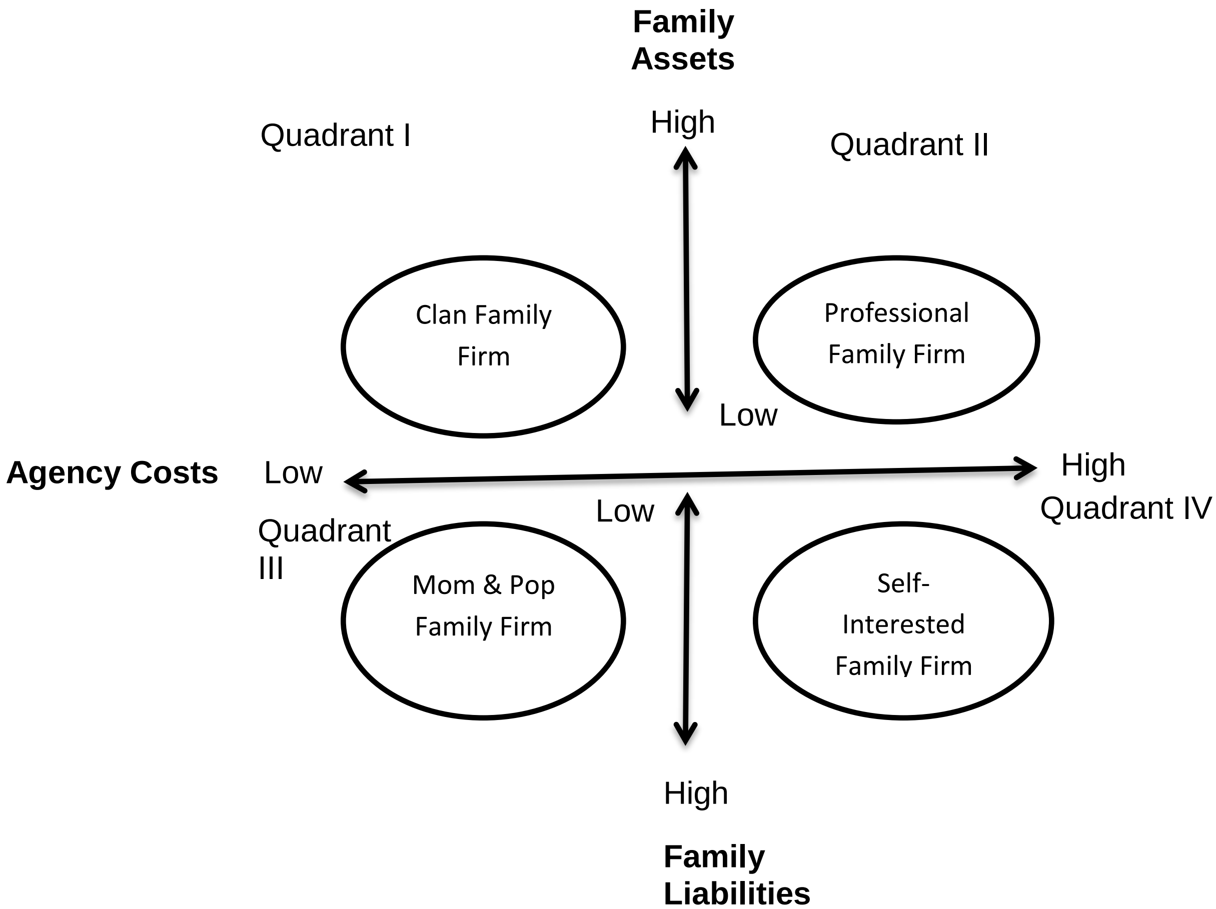
3. Methodology

The approach taken to develop the conceptual framework and theoretical propositions in this paper is purely qualitative. It is difficult to clearly classify the approach within the context of existing qualitative theory development approaches, as it involves aspects of both deductive and inductive reasoning. For example, I utilize deductive reasoning to convert existing general knowledge based on agency theory to build expectations regarding the expected effort level by non-family managers, and hence the agency costs of debt for family firms that employ professional managers. On the other hand, I employ inductive reasoning to derive propositions regarding the default orientations of family firms with defined family and business attributes, based on empirical evidence generated from only a small sub-sample of family firms in the world. Generally, the study employs logical reinterpretation and reconfiguration of existing empirical and theoretical knowledge to derive new insights on the family firms that are of particular relevance to lenders.

4. Development of the Conceptual Framework

The conceptual framework for the analysis of strategic and non-strategic default risk in family firms is based on Dyer’s (2006) typology of family firms (Figure 1 below) and Nyangara’s (2012) default risk matrix.

Figure 1: Dyer's Typology of Family Firms



Adapted from Dyer, W.G. Jr, 2006, "Examining the Family Effect on Firm Performance", Family Business Review, 19(4), 253-273

Dyer's typology of family firms is based on family culture, family capital, and family managerial involvement. Figure 1 above show~~s~~ Dyer's typology of family firms, with family assets/liabilities on the vertical axis, and agency costs on the horizontal axis. A simple questionnaire can be used to locate a family firm on the typology grid in Figure 1 above (see Dyer, 2010). The approach adopted in Dyer (2006) to derive the typology of family firms is outlined in the following paragraphs.

According to Dyer, the "clan" family firm is characterized as one in which long-term family and firm goals are isomorphic, and the firm leverages on strong social ties, a well-regulated and coordinated family system, and committed, skilled, and well-socialized family members. Dyer give~~s~~ first-generation family firms owned and managed by committed family members as an example of a typical clan family firm. Clan family firms are taken to be associated with low agency costs and have substantial family assets. The "professional" family firm differs from the clan type in that it is based on a professional culture, and hires managers based on pure merit (Dyer, 2006). It is further noted that this firm avoids opportunism and nepotism, and attracts the best talent. In

Dyer's view, the professional family firm is out-performed by the clan family firm only because it incurs higher agency costs of monitoring professional managers.

Dyer also identifies another family-centric firm type and calls it the "mom and pop" family firm. This firm has the agency cost advantage of clan family firms but is associated with paternalism and often fails to leverage on social capital to acquire family assets and grow, for example a small grocery store (Dyer, 2006). The fourth and last family firm type is the "self-interested" family firm. Unlike the professional family firm, the self-interested family firm incurs high agency costs not because it employs professional managers, but due to high family inertia and excessive opportunism (Dyer, 2006). As a result, the firm also fails to build family assets. Dyer further submits that competition for self-enrichment opportunities among family members with little or no ownership stake in the business creates conflict in the business, resulting in short-termism and failure to develop and disseminate dynamic capabilities.

When firm managers have little emotional attachment to the business they tend to exert less effort, compromising firm performance (Nyangara, 2012). This is worse when the manager is incompetent, for example where nepotism is the norm (Chirico and Nordqvist, 2010). The negative impact on performance of lack of emotional attachment is moderated by a higher level of skill or competence, such as when managers are hired based on merit (Dyer, 2010). In this paper, I argue that while professional managers may not be part-owners, their professional commitment to work tends to compensate for lack of emotional attachment due to non-ownership, so that on a balance of forces, family firms with professional management tend to perform better than those that employ family members with less skill. Following this argument, and also taking account of higher family assets, I propose that professional family firms perform better than self-interested family firms and "mom and pop" family firms in line with Dyer (2006, 2010).

Nyangara (2012) uses the concept of emotional value to proxy the extent to which the average family manager is attached to the family firm, and by extension, the managerial effort level and firm earnings performance. The average managers in clan family firms and professional family firms are expected, within the context of the conceptual framework developed in this paper, to exhibit more emotional value than the average manager in a "mom and pop" family firm or a self-interested family firm. Consistent with Nyangara (2012), clan family firms and professional family firms are therefore expected to have low nonstrategic default risk, while the "mom and pop" family firm and the self-interested family firm are proposed to have more nonstrategic default risk. Nonstrategic default occurs when cash flows are inadequate to meet debt service, even when collateral value is high.

The concept of trans-generational value has become popular in characterizing the effects of entrepreneurial performance and succession in family firms (Zellweger et al, 2012; Chirico and Nordqvist, 2010). Trans-generational value tends to be high in family firms with extensive family involvement and commitment, heavy ownership concentration (especially by the founding family), strong ties between firm and family reputation, and a family culture promoting the development and transmission of business knowledge across generations (Zellweger et al, 2012). Such attributes are the defining features of the clan family firm, but apply to some extent to the “mom and pop” family firm. In this paper, the professional family firm is characterized as having dispersed ownership and a relatively loose connection between family culture and reputation, and firm governance and reputation/image. Thus, the professional family firm type is open to non-family shareholding or even listing, as long as there is good business sense. It is also expected to be more inclined to diversify into unrelated business segments, just like non-family firms (Schmid et al, 2008). The behavior of this type of firm is therefore expected to be close to that of a non-family firm, where the decision to default on debt is largely based on financial variables, and not a desire to safeguard family capital or maintain the business within the family.

It is expected, within the context of this framework, that professional family firms tend to exhibit less trans-generational value than clan family firms and, to a lesser extent, the “mom and pop” family firm. On this basis, the professional firm is hypothesized to have more strategic default risk than both the clan family firm and the “mom and pop” family firm. Strategic default occurs when a firm fails to pay the full amount of debt service in a debt contract even though it possesses the resources to do so (Goto et al, 2010). Due to the negative effect of family inertia, and the opportunism and short-termism in the “self-interested” family firm (Dyer, 2006), no difference in strategic default risk is expected between the “self-interested” family firm and the professional family firm.

Figure 2 below shows that the professional firm is hypothesized as having low nonstrategic default risk and high strategic default risk. The clan family firm is postulated to exhibit both low nonstrategic default risk and low strategic default risk, while the “mom and pop” family firm has high nonstrategic default risk but low strategic default risk. The worst default risk is the “self-interested” family firm, which has both high nonstrategic default risk and high strategic default risk.

Figure 2: Family Firm Default Risk Matrix

Professional Family Firm • Low non-strategic default risk • High strategic default risk	**Clan Family Firm** • Low non-strategic default risk • Low strategic default risk	*High*
Self-Interested Family Firm • High non-strategic default risk • High strategic default risk	**Mom and Pop Family Firm** • High non-strategic default risk • Low strategic default risk	***Emotional Value*** *Low*
Low	***Trans-generational value*** *High*	

An extension to the default matrix, the strategic lending matrix in Figure 3 below, uses the cash flow attributes and debt capacities of the four types of family firms to give strategic guidance to lenders.

In Figure 3 below, professional firms are characterized as having high but unstable cash flows due to the twin effects of greater entrepreneurial orientation and better entrepreneurial performance. Entrepreneurial orientation is associated with greater innovativeness, risk-taking, and proactiveness (Miller, 1983 as cited in Chirico and Nordqvist, 2010). Therefore, while cash flows may be high due to greater innovation and proactiveness, the assumption of greater risk in the process makes the cash flows unstable. Business risk is therefore relatively high in professional family firms. Due to relatively high business risk, professional firms are hypothesized to have moderate debt capacity (there is an inverse relationship between business risk and debt capacity) compared to clan family firms.

Clan family firms are proposed to have high and stable cash flows due to low agency costs, better entrepreneurial performance, and the tendency to employ income smoothing techniques (according to the risk aversion hypothesis of family ownership by Schmid et al, 2008). In addition, clan family firms tend to have higher debt capacity than professional family firms due to the “undiversified shareholder” effect on debt agency costs (Anderson et al, 2003). Anderson et al (2003) find that concentrated equity ownership in family firms reduces the agency cost of debt, especially when the founder serves as the CEO. As argued earlier, professional family firms are expected to be more open to dilution of family control, and therefore are associated with dispersed equity ownership, which tends to increase the agency cost of debt, and in some cases, reduce debt capacity.

Figure 3: Family Firm Strategic Lending Matrix

<u>Professional Family Firm</u> *Cash Flow and Debt Capacity* • High, unstable cash flow • Moderate debt capacity *Strategy* • Lend moderately on standard terms • Monitor closely • Perfect directors' guarantees	**<u>Clan Family Firm</u>** *Cash Flow and Debt Capacity* • High, stable cash flow • High debt capacity *Strategy* • Lend to retain and grow • Employ competitive pricing • Emphasize relationship lending • Support talent development • Perfect directors' guarantees	*High*
<u>Self-Interested Family Firm</u> *Cash Flow and Debt Capacity* • Low, unstable cash flow • No debt capacity *Strategy* • Retain at minimum cost • Provide minimum or no lending • Focus on non-lending products • Perfect directors' guarantees	**<u>Mom and Pop Family Firm</u>** *Cash Flow and Debt Capacity* • Low, stable cash flow • Low debt capacity *Strategy* • Provide minimum lending to retain • Support talent development • Perfect directors' guarantees	***Family Assets*** *Low*
High	***Agency Costs*** *Low*	

Self-interested family firms are usually associated with the presence of descendants of the founder in senior management positions, so that the control, focus, and stability of the founder are no longer a part of dominant firm culture (Dyer, 2006, 2010). As a result of opportunistic managerial behavior in self-interested family firms, as well as incompetence, agency costs of debt are high and cash flow is low and unstable. The firm can only assume minimum debt or no debt at all. The "mom and pop" family firm is better than the self-interested family firm due to the "undiversified shareholder" effect (Anderson et al, 2003) and the focus and discipline of the founders (Dyer, 2006). The firm therefore has low but stable cash flow, and can manage with some minimum level of debt to fund permanent working capital requirements and regular fixed asset maintenance.

On the basis of the cash flow characteristics and debt capacities of different family firms, strategic guidance is proposed to assist lenders in constructing their lending portfolios and allocating resources to support client relationship management. Generally, banks need to focus their resources on acquiring and retaining clan family firms and professional family firms, and minimize the cost of retaining “mom and pop” and self-interested family firms. The implication of the above point is that lenders need to ensure that their understanding of family firms is not confined to firm dynamics, but should include an understanding of family dynamics as well. Family guarantees are an important source of soft information about family dynamics and an effective way of leveraging social capital, and therefore limiting strategic default behavior.

4.1 Statement of Theoretical Propositions

Proposition 1: Clan family firms are expected to have greater access to debt finance, at a lower cost than all other types of family firms of equal size.

Proposition 2: Clan family firms are expected to exhibit the lowest propensity to default compared to all other types of family firms.

Proposition 3: Professional family firms are expected to have greater access to debt finance, but no debt cost advantage compared to self-interested family firms of equal size.

Proposition 4: Professional family firms are expected to exhibit greater strategic default propensity, but a lower non-strategic default propensity than “mom and pop” family firms.

Proposition 5: Self-interested family firms are expected to have the least access to debt finance compared to all other types of family firms.

Proposition 6: Self-interested family firms are expected to exhibit the highest propensity to default compared to all other types of family firms.

4.2 Implications of the Theoretical Propositions

The above propositions have important implications for lenders and family business researchers. In particular, propositions 2, 4, and 6 provide a priori default guidance to lenders when evaluating borrowing proposals by family firms. Having classified a prospective borrower into an appropriate family firm category, a lender can proceed to apply the theoretical propositions above as a preliminary qualitative screening device. Because the propositions are based on a qualitative analysis of firm behavioral characteristics, lenders can use the guidance to complement results of quantitative default modeling devices to arrive at a more informed lending decision both in terms of the volume and pricing of debt. Lenders can also use the propositions as part of their continuous monitoring. Since firm typologies are not static, a lender can trace the migration of firms through the typology grid and deduce default implications based on the theoretical propositions. A transition from a self-interested firm to a professional family firm is a positive development from a non-strategic default perspective and the lender can expect cash flow coverage ratios to improve as a result. That way, the lender can consider increasing volume of debt finance to the firm and avoid losing an improving client to competition.

Furthermore, lenders can also use the propositions for diversification purposes. A credit portfolio made up of entirely professional family firms or entirely “mom and pop” family firms unduly exposes the lender to a significant level of either strategic or non-strategic default risk. By categorizing family firms for lending purposes, the lender can decide on the best mix of default risk to have in the credit portfolio. The propositions may also be used in portfolio diagnostics to determine the extent of concentration of a family firm credit portfolio and take remedial action. It is important however to note that the propositions are developed from a qualitative cognitive device and a lending decision may not be made purely on the basis of the propositions. A default prediction model is always needed as the primary lending tool.

Propositions 1, 3, and 5 are particularly relevant to researchers in the family business field, especially in light of contradictory findings in the literature. A research sample that is made up of predominantly clan family firms may exhibit better access to debt or lower agency costs of debt when compared to non-family firms; one made up of professional family firms may exhibit no differences; and one made up of self-interested family firms may exhibit less access or higher agency costs of debt compared to non-family firms. In the absence of a device for picking these sample differences, the empirical findings may be interpreted as contradictory, yet they are not. The theoretical propositions in this paper should therefore assist future researchers interested in the relative access to and cost of debt finance by family and non-family firms in isolating genuine departures from expectations and mere sample differences. Taking an advocacy perspective, family business researchers can address negative lender perceptions about family businesses in different parts of the world by clarifying the differences between types of family firms.

Entrepreneurial educationists should also find the propositions useful as they highlight the winning configurations of the family-business nexus, for attracting debt finance and reducing the cost thereof, as well as creating trans-generational value. The family firm typology literature in general tends to clarify the role of family in business, which assists in coordinating the interaction of the family system with the business system.

5. Conclusion and Areas for Further Research

The development of a conceptual framework for analyzing family firm default behavior is a new line of inquiry in family business research. Harnessing the effect of family culture on firm governance and entrepreneurial orientation assists our understanding of the family effect not only on firm performance and the creation of trans-generational value, but also on firm behavior and attitude towards risk. It is clear from the conceptual framework developed in this paper that family culture is a crucial determinant of default behavior, and that entrepreneurial orientation and effective succession planning are key issues every lender must consider before lending to a family business. While professional management may improve firm entrepreneurial performance, it increases agency costs of debt and also creates scope for ownership dispersion and less effective knowledge propagation and transmission across generations. Family firms with high and stable cash flows tend to have more debt capacity and are associated with low agency costs of debt, while those with low and unstable cash flows are usually associated with succession problems, opportunism, and short-termism.

Areas for further research include the development of a default scoring matrix for family firms and studies into the impact of family culture on firm growth. In addition, studies of the firm life-cycle effect on family inertia and family firm behavior in terms of capital structure choices, risk aversion, and default behavior will also enhance our understanding of family firm dynamics.

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