The strategic behavior of family firms

LAYMEN SUMMARY

When we think about corporations and their primary objective, many think about profit maximization. This is not wrong, given that most of us tend to think about non-family firms in a business context. However, to the surprise of many, the most prevalent form of business is, in fact, the family firm, and this organizational form does not follow a simple profit maximization principle. In my field of study (strategic management research), we try to understand how companies behave and why. In other words, we try to find out what firm characteristics and other factors affect a firm's behavior and how they respond to changing circumstances. For this, we build models and evaluate how accurate our predictions are. This is useful because accurate models allow us to identify inefficiencies (economically sub-optimal choices) in firm behavior and advise policymakers and managers on what they can do differently to resolve these problems. Economically speaking, irrational behavior does not produce optimal financial outcomes and occurs naturally – in part – because we are human beings, and our perception and emotions largely determine our behavior. In addition, our cognitive abilities have a limited capacity to assimilate and process information. Let me provide you with an example: A financial crisis can scare managers because they have never been in a situation like this or because everyone else seems to freak out. This likely affects the cognitive processes of a manager even when there is no severe threat to their own firm in this new situation. As a result, a manager may act irrationally by focusing on short-term cost savings. The manager may fire employees or abandon important long-term projects without rationally considering the long-term consequences of such actions. This example demonstrates that a perceived threat can impair a rational assessment and lead to a misjudgment of an appropriate response.

In my work, I consider family firms and the impact of this ownership type on strategic decision-making. It is the prevailing opinion that emotional considerations have greater priority in the decision-making process of family firms compared to their non-family firm counterparts. To family firms, things like reputation, relationships, dynastic succession, preserving control over the firm, and other factors play a significant role and affect their strategic choices. From a purely economic perspective it can be considered irrational behavior to prioritize these non-financial goals because it does not necessarily maximize profits. Hence, traditional economic models often do a poor job of predicting family firm behavior, and we need new models to accurately predict family firm behavior. These models have to consider how non-financial goals affect the decision-making process of family firms. The field of family business research is still relatively young (15 years), and the theories and models that are currently used require significant development for us to comprehend why family firms behave the way they do. Understanding their behavior can address many economic inefficiencies and inequalities for firms, employees, partners, investors, and policymakers. This helps to foster global prosperity and benefits the society as a whole.

In Chapter 2, I study the presence of influential owners other than the family owners themselves and what impact their presence has on the innovation behavior. To do so, I study family firms traded at the U.S. stock exchange (i.e., S&P 1500). Traditionally, publicly traded firms are owned by many different owners each having a say in what the company is supposed to do via voting rights. A firm's ownership structure is important because today's economy has changed dramatically. A few decades ago, public firms were characterized by a dispersed ownership structure. In other words, lots of people owned tiny fractions of a given firm and each individual had very little power. Nowadays, large institutional owners dominate the stock market. Institutional investors own much larger portions of a single firm, which equips them with significant voting power to influence a firm's strategy. An institutional investor is a corporation that collects money from individuals and then invests on behalf of its clients (e.g., public pension funds, mutual funds, and hedge funds). An individual employed in public service, for example, pays a monthly pension contribution. This contribution is collected by a state-governed public pension fund and (partly) invested in stocks to ensure the availability of sufficient money to pay out the promised retirement pension in the future. Since, today, institutional investors hold the majority of all outstanding stock, they also have much power to influence corporate behavior. How is this relevant to family firm research you may ask. Family business theory suggests that family firms act in accordance with the preferences of the owning family. This premise rests on the assumption that it is the owning family who has the ability to decide over corporate decision. However, in this chapter, I show that the strategic preferences of other influential owners also play an essential role and that family firms cannot act in full accordance with their preferences in a public setting. This highlights the necessity to adjust our models to reflect the ownership structure. In particular, I find that it is insufficient to look at the strategic preferences of family firms in isolation – like we currently do. I demonstrate this by investigating the impact of one particularly aggressive institutional investor type (i.e., the activist hedge fund), which is focused on generating significant profits for its clients in a short amount of time. This is primarily achieved by promoting large dividend payouts from a company's cash reserves, selling business units, selling patents, and firing employees. Overall, my results reveal that the presence of this institutional investor has detrimental effects on the innovation output of family firms.

In Chapter 3, I also look at family firms and their innovation behavior. This time, however, I am not interested in the innovation outcomes but rather in the resources required to innovate. Innovation is essential and considered a primary driver of growth and prosperity. Think about major technological breakthroughs like health care advances, electricity, transportation, and communication technology, and how they completely transformed the world we are living in today to become a better place for all of us. Today's innovation landscape is becoming increasingly competitive and fast-paced. Innovation projects require lots of capital and returns are uncertain and often take a long time. As a result, internal financing has become increasingly difficult and less attractive. Imagine you invest a lot of money in an innovation that your company can only benefit from for a short amount of time or, even worse, a competitor is faster than you, and you do not reap any benefits. From research, we know that innovation has a very high and positive impact on firm performance and survival on average. In other words, not every innovation project is a success but if you undertake many innovation projects the benefits outweigh the costs of failed projects. Although family firms are said to be long-term oriented, they are considered less innovative. It is often argued that this is because innovation is very risky and requires lots of capital. As we know, non-family firms follow a profit maximization strategy, but family firms generally prioritize security and maintaining control over their firm even at the cost of financial performance. This is problematic for innovation. However, there are good alternatives to financing innovation internally. 'Open innovation' reduces both risk and capital requirements and may be an excellent strategy for family firms. Open innovation refers to firms partnering up with external collaborators to generate innovation together. In this research project, I investigate if family firms are more or less likely to engage in open innovation compared to non-family firms, and how different internal and external factors affect this relationship. From my research, it becomes apparent that family firms are less likely to engage in open innovation compared to non-family firms. This is surprising given the enormous benefits described above and the fact that family-owned firms should have a superior ability to nurture such partnerships. Nevertheless, the explanation makes sense if we consider that ability alone is not enough – willingness is just as important. Family owners likely lack the willingness to engage in open innovation strategies because it requires, at least in part, to give up control over an innovation's trajectory. As pointed out earlier, the non-financial objective of control retention weighs very high in the decision-making process of family firms. Nevertheless, I also find that there are solutions to this paradox situation. Both willingness and ability appear to be significantly affected by several factors such as the firm's generational stage, the presence of non-family managers in a firm's top management team, and the type of open innovation partner (e.g., customer, supplier, competitor, or research institute). This is important because it informs the debate about changes a family firm can implement to increase their probability to engage in and benefit from open innovation strategies.

In my last chapter, I devote my attention to prosocial behavior on behalf of family firms. Prosocial behavior (also known as corporate social responsibility - CSR) means that a firm behaves socially responsibly above and beyond what is legally required. This could take the form of community engagement, favorable employee healthcare treatment, supporting humanitarian causes domestically or abroad, and much more. In the literature, many studies rely on the assumption that family firms are concerned with their reputation and follow a long-term orientation. Prosocial behavior has been shown to positively affect long-term financial performance and to foster a good reputation. This suggests that family firms should do better than non-family firms regarding prosocial activities and my statistical analysis attests to this proposition. In addition, I show that this is not always the case. The findings suggest that the temporal orientation of family firms is not stable over time. In other words, the prevailing assumption of family business research that family firms are always long-term oriented does not appear to be true – at least in the context of this particular investment type. The results suggest that situations of financial distress can significantly shorten the long-term focus of family firms and hence their behavior toward prosocial activities. Surprisingly, a global financial crisis leads to short-term behavior of family firms even if the respective firm's survival is not under threat. Increasing levels of bankruptcy risk, which potentially threatens a firm's survival, on the other hand, did not lead to the adoption of short-term behavior. This finding informs scholars about the conditional nature of the assumption that family firms act in accordance with a long-temporal orientation. Moreover, the findings represent a significant contribution because they demonstrate the interplay between internal and external situational factors (i.e., bankruptcy risk and financial crisis) and how they can affect temporal orientation.