

thebigpicture

guideposts for the private investor

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thebigpicture guideposts for the private investor is published by *thebigpicture* Economics (ABN 71 040 787 936). The author, John A Robertson, while working in Australia, London and New York, has over 20 years experience in international financial and commodity markets, corporate strategy, financial and business evaluation and government policy. He has been Chief Economist and a director of a leading Australian investment bank. He has been a top-rated institutional equity analyst and has marketed investment advice in all the major international financial centres.

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BUY THE FOUNDER; SELL THE KIDS

Today's corporate governance rules imply that family control of public companies is not in the best interests of portfolio shareholders. This is too simplistic a view of life according to some recent research.

There are two conflicting schools of thought about the impact on minority shareholder value of family controlled companies.

- To some, decisions are likely to be motivated by the best interests of the family and, only by coincidence and occasionally, will they be in the interests of other shareholders.
- To others, families are focused on building and managing their wealth - more so than professional managers - so that, by aligning themselves deliberately with the family bloc, portfolio investors will also benefit.

There has been conflicting empirical evidence about which of these views might be more likely to prevail. Now, a study by two US academics¹ suggests that, in coming to a judgement on this question, careful distinctions need to be drawn to differentiate amongst family ownership, family control and family management as well as between first generation and later generations of family membership. The same conclusions do not hold across all these boundaries.

V&A conclude that value is created by having a founder as a CEO or Chairman (with a hired CEO). However, once the founder leaves, things change. Family ownership without founder-management or family ownership where subsequent generations are in charge puts value at risk.

V&A go further in exploring the nature of the governance standards which should apply:

"Founders create the most value when no control-enhancing mechanisms facilitate the expropriation of non-family shareholders. Examples include multiple share classes with differential voting rights, pyramids, cross-holdings, or voting agreements. Descendant-CEOs destroy value whether or not the family has established control-enhancing mechanisms."

The V&A study was based on an analysis of all the Fortune 500 companies during 1994-2000. The sample excludes financial services companies, utilities and government entities. For those firms that meet the established criteria, data from all years between 1994 and 2000 are included, even if the firm is not in the Fortune 500 list in a particular year.

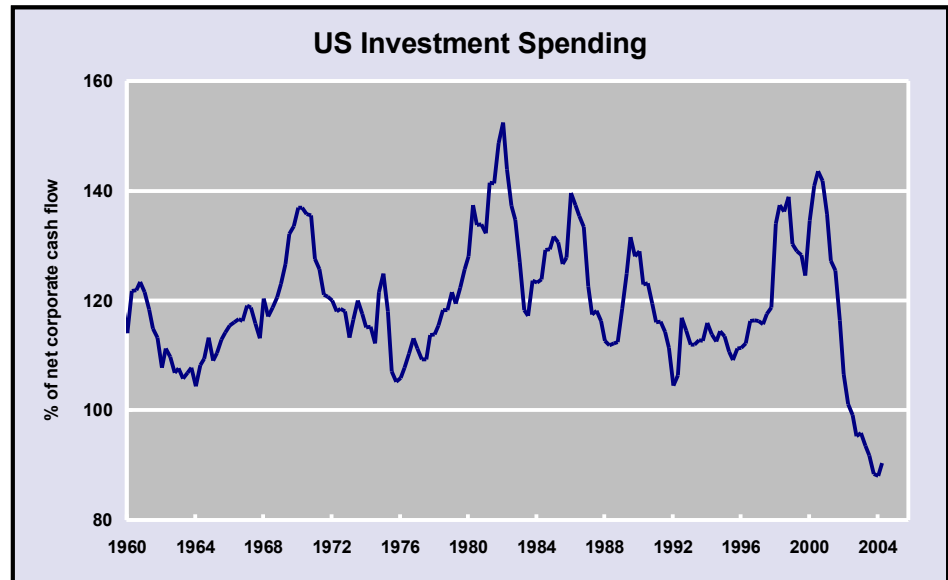
The sample used by V&A comprises a panel of 52,787 shareholder-firm-year observations, representing 2,808 firm-years from 508 Fortune 500 firms during the period 1994-2000.

Family firms, as defined, represent 37 percent of the sample or 1,041 family firm-years from 193 different firms. Families own an average of 16 percent of the equity of the

"...some of the most successful companies listed on the Australian market have strong family links. News Corporation, Westfield, Publishing and Broadcasting and Harvey Norman are three that stand out."

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THE WEEKLY CHART SPOT



Source: US Bureau of Economic Analysis & *thebigpicture* Economics

US business managers have been reluctant to invest despite the strength of their recent profit growth. Having failed to extract benefits from the last investment cycle and having been spooked by new governance rules, their levels of spending on hard assets relative to their financial capacity is at an all-time low.

BUY THE FOUNDER; SELL THE KIDS CONT'D

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Fortune 500 firms in which they are present. However, 50 percent of them use some control enhancing mechanism to boost their voting strength relative to their share ownership stake.

In assessing value, V&A use Tobin's q , the ratio of the firm's market value to the replacement cost of its assets, as the primary measure.

The family firms in the sample are statistically different from the non-family firms in several respects. Family firms are:

- better performers than non-family firms;
- smaller (in assets, sales, and employees) than non-family firms;
- younger (63 versus 74 years old); and,
- higher growth than non-family firms.

One of the issues not addressed fully by the authors of the study (although acknowledged by them) is whether these differences are a consequence of family involvement or whether they are simply due to the family companies being at a different stage of their corporate life cycles than the average.

This can have some implications for the study conclusions. The superior performance of family firms could be driven, for example, by the predominance among

them of early-stage, high-growth firms that have reached the Fortune 500 while still under founder management or control.

V&A drew other empirical conclusions from their data about the performance and attributes of family firms.

- The average equity ownership by non-family blocs is significantly lower in family firms than it is in non-family firms.
- The mean level of ownership by non-family blocs in family firms is exactly the same as the mean family ownership in these firms (16 percent).
- Family firms have a significantly lower proportion of independent directors than do non-family firms.
- Family firms have significantly lower dividend rates.
- Leverage is lower in family firms.
- Family firms have higher capital expenditures.
- R&D expenditures are slightly lower.
- Family firms are less prone to being diversified than non-family firms.
- Consistent with their diversification profile, family firms' stock returns show higher levels of risk, both systematic and idiosyncratic.

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1. Belén Villalonga and Raphael Amit, "How Do Family Ownership, Control, and Management Affect Firm Value?", Harvard Business School and The Wharton School, Working Paper, August 2004 (V&A).

LABOR AVOIDS ITS PAST CONT'D

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ditional constituencies were among the losers.

But whatever the political fallout, these were among the great transforming economic events of the past three decades. Without them, most economists would agree, the economic success of the past ten years would not have been feasible.

Since Labor has been so crucial to this more recent performance, it is unfortunate that its contemporary leaders have

felt uncomfortable claiming credit. Of course, the fault is theirs. At the crucial time, they lost their nerve and, consequently, their moral authority to claim a share of government.

None of this is to say that Messrs Hawke, Keating or Latham are preferable in any way to Messrs Howard or Costello but there is a danger of the simplistic sloganeering which comes with election campaigns rewriting history and, in doing so, obscuring our ability to distinguish good policy from bad in the future. ■

BUY THE FOUNDER; SELL THE KIDS CONT'D

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Minority shareholders can face a risk of value erosion by management or by large (family, institutional or corporate) shareholder blocs. A judgement about their best interests, therefore, is not always between family involvement and any other alternative. There might be times when value is eroded by having a family involvement but by less than if other control blocs were affecting minority shareholder value.

Indeed, the findings about family ownership and control suggest that the benefits of family *ownership* make minority shareholders better off than they would have been in a non-family firm. However, family *management*, as measured by the presence of a family CEO, has no significant effect on value.

Contrary to the much-touted monitoring role of independent directors, V&A find that the proportion of independent directors on the board does not significantly affect firm value.

Mechanisms to enhance control such as multiple share classes, pyramids, cross-holdings, or voting agreements reduce shareholder value, particularly in founder-CEO firms. V&A find that the presence of control-enhancing mechanisms gives rise to a significant discount in industry-adjusted q relative to founder-CEO firms without such mechanisms.

Despite this discount, according to V&A, minority shareholders are likely to be better off in a family firm than they would have been in a non-family firm. Founder-CEO firms with control enhancing mechanisms are about 25 percent more valuable than non-family firms.

These data are drawn entirely from the US

market so there will be some question about how applicable the conclusions might be in Australia. That said, the structural and valuation characteristics of the two markets are so similar that the empirical analysis, however incomplete, would be hard to ignore in drawing some conclusions about how family involvement might affect value in the local market context.

While larger listed companies generally do not show strong founder influences, there are notable exceptions. Conspicuously, some of the most successful companies listed on the Australian market have strong family links. News Corporation, Westfield Holdings, Publishing and Broadcasting and Harvey Norman are three that stand out.

There are also examples among smaller listed groups of founder involvement and continuing family management.

If the corporate governance orthodoxy is correct, investors should discount the value of these companies. The V&A conclusions call into question the governance orthodoxy and suggest a different set of guideposts for stock selection.

According to V&A, a portfolio comprising the companies run by Messrs Packer, Murdoch, Lowy and Harvey (as well as the smaller company equivalents) would actually be preferable. However, the V&A analysis would also suggest that investors should be wary of the succession when the capacity of the later generations of the family to add value diminishes.

The V&A conclusions suggest that having dad found the company and stay on as chairman is an attractive option but that keeping the kids around might damage portfolio performance. ■

“...the benefits of family ownership make minority shareholders better off... family management, as measured by the presence of a family CEO, has no significant effect on value.”

LABOR AVOIDS ITS PAST

One of the causes of Labor's recent election loss is now thought to be its inability to persuade electors of its economic management credentials. This might be partly a communications issue but is also a consequence of post-Keating Labor trying to distance itself from some of its greatest successes.

The government is now widely credited with achieving an important electoral advantage by being able to paint Labor as the party of high interest rates. The assertion behind the scare campaign that interest rates will always be higher under Labor was untrue. No professional economist was prepared to risk his reputation by supporting the government but the mud seemed to stick.

That alone is enough to cause some deep disquiet about our democracy. It says one group with enough money to repeat a lie frequently enough could capture government.

However, Labor abetted the government's attempts to portray it in this way. Perhaps it has done as much to reinforce perceptions of its economic capabilities as the government. The irony is that this need not have been the case. The Hawke/Keating years were not the economic disasters being portrayed by the coalition. And even the Whitlam years might have had the occasional redeeming feature.

In the 1970s, when this writer was a policy economist in Canberra, professional economists were arguing that fundamental changes to the Australian economy were required for it to achieve its potential. This generally meant opening Australian industry to more competition to make the economy more adaptable to change. To achieve the latter, most agreed there should be greater wage flexibility and less reliance on the centralised wage fixing system.

Political folklore suggests that the Liberal Party is the protagonist of freer labour markets. However, in successive Labor governments people like Jim McClelland and Laurie Brereton did much to further

the cause of freer labour markets since they were more adept at dealing with some of the entrenched labour interests than the conservatives. The latter had some strong feelings about breaking the strength of unions but lacked finesse when it came to getting changes implemented.

Labor ministers were also critical in being able to persuade union officials to cut back on their wage demands partly in exchange for more tax based benefits. This was hardly the ideal since it was a personality based policy which could not be sustained in the longer term. However, it did much to break the back of inflationary expectations which had become embedded in the Australian economy.

Perhaps, too, the structural swing toward a service economy did as much as anything to break down the power of the more militant manufacturing unions and rebalance the negotiating power between employers and employees.

By the time the Liberals came along much of the heavy lifting on industrial relations had been done.

The same could be said, too, of the opening of manufacturing to greater competition. The tariff cut in 1973 under the Whitlam government was an enormous shock to the policy psyche in Australia. There is still debate about whether it was the best way to implement change. Arguably, it was not.

However, by the 1975 and 1977 election campaigns the only parties hostile to industry restructuring were the Liberals and National Party.

Other changes which were critical to a more market based and adaptable economic system were the floating of the exchange rate and allowing the market to set longer-term interest rates. Again, these initiatives were reliant on Labor party politicians putting them into effect.

Perhaps these changes were too esoteric for the bulk of the electorate to understand. Unfortunately, too, each came with winners and losers. Some of Labor's tra-

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