Chapter 6

The Listed Family Company: The View of Capital Market Participants

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Abstract

Based on his many years of experience in the investment field, the author discusses which criteria capital market participants consider when they evaluate listed family firms. The evaluation criteria are divided into these four groups: competitive quality, growth prospects, sentiment, and valuation.

Keywords: Capital market participants; institutional investors; stock analysts; competitive quality; growth prospects; sentiment; valuation

The following chapter is based on my many years of experience in the investment field, especially as a stock analyst. Working as a stock analyst entails not only analyzing the companies' data, but also direct contact with the companies and investors, so in a sense with both sides, that is, issuers and investors. My work also often involved listed family companies and Small and Medium-sized Enterprises (SMEs). The following comments are based on this experience. They describe how major capital market participants view listed family corporations.

According to my impression, institutional investors and stock analysts focus on four groups of selection criteria with respect to listed family companies: (1) competitive quality; (2) growth prospects; (3) sentiment; and (4) valuation.

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(1) *Competitive quality*:
Generally speaking, for competitive quality focus and differentiation matter. The family name as a brand name could be such a differentiator. For a closer look, one should distinguish between different stakeholders.

We begin with the *customers*. In the business-to-consumer case, it often improves the market position of a company if it makes its status of being a family firm visible for the customers. The family name as a company name or brand name creates trust in this respect. A stronger competitive position makes a company more attractive to investors. The family firm effect on the competitive position of a company is less pronounced in the business-to-business case.

Being a family firm might also affect *employees* and thus impact the company's position on the labor market. Recently, the purpose of a company and of corporate activity has come into the spotlight. Particularly generations Y, Z, and younger might find purpose more easily in a family business where there is not such a strict separation of ownership and control, where owners are not anonymous shareholders and blockholders but visible persons of flesh and blood who are emotionally attached to their family business and think in generations. Family firms of this kind have a competitive advantage in the labor market which increases their attractiveness for investors.

Turning finally to *competitors* as the last group of stakeholders, I would not expect a competitive effect here. Instead, I assume that the effect of being a family firm is neutral.

(2) *Growth prospects*:
Investors love growth and are willing to pay substantially higher prices for strong growth prospects. For example, the effect of the growth rate in the dividend discount model demonstrates the value effect of growth nicely. In the case of family firms, investors try to find out whether the owning family is an obstacle to, or promoter of, growth. More specifically, do business history and family statements indicate a family mindset that is open for stronger growth or a more hesitant mindset? Also strongly important is the topic of financing of growth, for example, the funding of major new capital expenditure programs or acquisitions. If growth requires capital increases, would the family be able to participate or, if they are not able to participate, would they at least allow that their controlling position in the company becomes weaker? If the family agrees to none of these two options, growth prospects of the family firm are weaker, and its attractiveness to investors suffers.

(3) *Sentiment*:
Several factors shape the sentiment of investors with regard to listed companies.

The *shareholder structure* matters. Investors appreciate an entrepreneurial major shareholder. As this is often the case for family firms, this aspect may cause a markup on the share price investors are willing to pay.

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A strongly significant aspect for investors is the *alignment of interests*. Research calls this topic agency problem 2, that is, the conflict between the dominating shareholder and the remaining shareholders. This is of course an issue in the case of listed family firms, as they are characterized by a strong, possibly even dominating, position of the owning family. If investors conclude that a certain owning family tends to exploit its power at the expense of the other shareholders, this will lead to a discount. However, as mentioned above, potential negative effects might be outweighed by the entrepreneurial attitude of the owning family.

Another relevant issue is the *voting right* attached to the shares, that is, does the family business offer ordinary shares with voting rights or only preference shares without voting rights to the nonfamily shareholders. As families often want to secure their controlling position in the company, issuing preference shares is an attractive option for them. In the end, the valuation effect of the share types offered to nonfamily shareholders depends on whether investors trust the family that they will not misuse their powerful position but will align their interests with those of the external shareholders and use their entrepreneurial attitude to the benefit of all shareholders.

The share price investors are willing to pay is also affected by the *probability of a takeover*. When there is a change of control in a company, selling shareholders often earn an extra premium on top of the price at which the voting share traded before the probability of a takeover was reflected in the price. Thus, all other things being equal, the probability of a future change of control increases the share price. In case of a family business, the probability of a change in control is usually very low, thus, reducing the share price. This can be expected to change when there are signs that the owning family might be willing to give up control in the foreseeable future.

Active capital market communication is another relevant topic. Nonfamily shareholders depend on the information provided by the company. In case owning families have a tendency to secrecy and avoiding proactive capital market communication, such a habit could justify a valuation discount.

Finally, the *liquidity of the shares* is an issue. Investors typically appreciate liquid shares because this allows them to also conduct bigger transactions without having to accept immediacy discounts in case of sales or immediacy surcharges in case of purchases. As a consequence of the big share block held by the family, the free float of listed family firms is often comparatively small, making the share less liquid. This could justify a valuation discount from the perspective of institutional shareholders.

(4) *Valuation*:

Regardless of whether stock analysts and institutional investors use a cash flow-based valuation method such as discounted cash flow or a valuation approach using multiples, the above factors will be included in the company valuation either directly or in the form of a premium or discount.

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