



*"Unequaled Personalized Service"*

**January 2010**

## **Research Perspective – Family Ownership Matters**

We evaluate stocks based on three primary measures: the price of a stock relative to what we think its underlying business is worth, the quality of the underlying business, and the cash earnings the business can generate. When determining these measures, we look at many business characteristics, one of which is whether founders of a company and their family members have ownership and are still involved in the business. All else equal, we prefer companies whose founders and family members own a sizeable amount of stock and help run the company. This Research Perspective describes why we typically like these “family-owned” firms.

In our view, investing in a family-owned firm has many benefits, which include:

- Company founders and their families typically use *sweat equity* to build their business over time. As a result of their time and effort, family members running businesses truly care about the firms they have created and run, and sometimes even see these organizations as extensions of themselves. Having members of a founding family run a company over the long-term can also preserve business knowledge that could otherwise be lost. For many of them, failure is not an option... a good thing for shareholders.
- Additionally, founding families typically own significant amounts of company stock, often constituting the vast majority of their net worth. This makes them more “aligned” with other shareholders, meaning they feel pain like other shareholders when the stock goes down, and they experience the upside like other shareholders when the stock increases. You would be surprised how many management teams lack this simple incentive structure or minimize its use in favor of more complex compensation schemes such as stock options.

A vested personal interest in a firm, coupled with having significant stock ownership, creates a powerful incentive for founding families to take actions that are in the best interests of long-term shareholders.

- We believe family members of family-owned firms are working for their personal *balance sheet* (growing net worth) instead of their *income statement*. In contrast, many other firms are run by CEO’s that work for annual compensation and do not have skin in the game.
- One of the greatest benefits for family-owned firms is their increased ability to focus on the long-term. It is our experience that many shareholders are so focused on short-term quarterly earnings numbers that management teams are under tremendous pressure to reach those short-term numbers, even at the detriment to companies’ long-term viability. We believe firms with significant family ownership are more likely to allow management teams (whether family

members or even hired hands) the time and resources to take on projects and make decisions that may be unpopular at the time but are likely to be in the best interests of long-term shareholders.

- We believe founding families are less likely to do foolish things with corporate cash compared to others because they perceive that cash to be important to their net worth and the well-being of their companies. For example, many family-owned companies we have examined are less likely to dole out big compensation without requisite performance. Additionally, recent research has shown that companies with large insider ownership (such as family-owned companies) are less likely to make expensive acquisitions than other firms.<sup>1</sup> We think this is because management teams without large ownership stakes are less likely to think like owners, and so they typically pay higher prices for acquisitions that can harm shareholder value in pursuit of more power (a bigger company to run, more pay for running a larger company).
- Other recent studies support our point of view toward family-owned companies. One research piece showed that founding-family owned firms outperformed non-family owned firms in terms of profitability and market value.<sup>2</sup> In another study, Professor Rüdiger Fahlenbrach analyzed 2,327 large, publicly listed U.S. firms during the 1992-2002 time period and showed just how significantly the stock prices of firms run by their founders (“founder-CEO firms”) outperformed other firms from 1993-2002. The outperformance is displayed in Chart 1 below.

Additionally, the same study revealed that founder-CEO firms spent more money on research and development and capital expenditures than other firms. These results are captured in Chart 2 below. We believe this supports our opinion that family-owned firms are more likely to take on projects and invest in their businesses for longer-term benefits, even if these actions might reduce short-term profits.

Chart 1

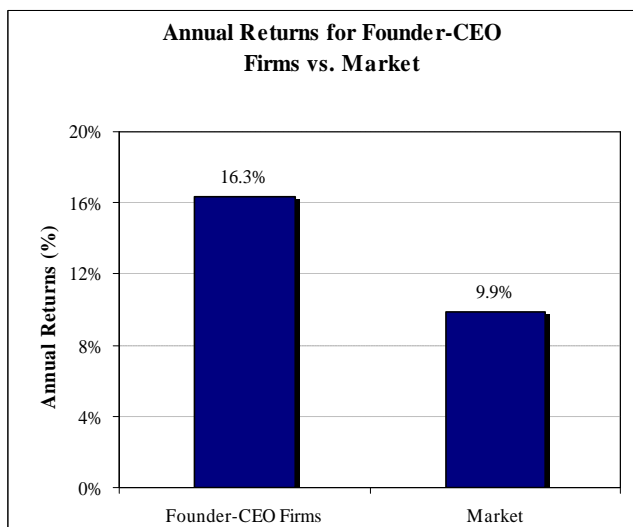
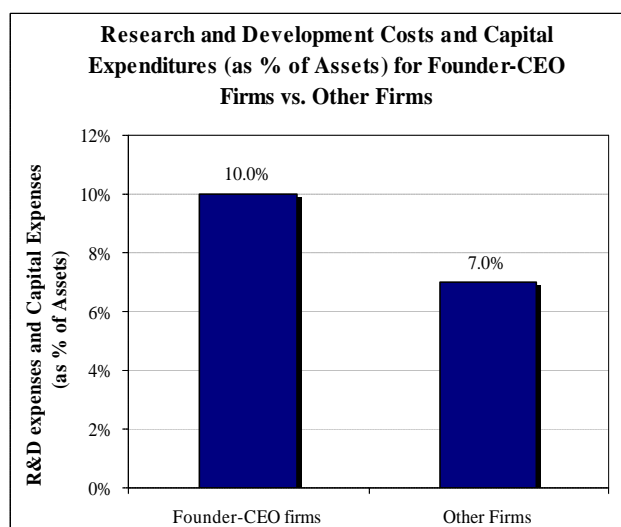


Chart 2



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There are certainly examples of publicly-traded, family-owned firms that have fallen victim to the potential costs of being family firms. It is possible that the founding families can abuse their power and/or enrich themselves at the expense of other shareholders. For example, founding families may be able to elevate themselves and loved ones to management and board positions instead of more qualified individuals. Additionally, founding families might be able to use the companies' cash flow

for their own benefit (pay themselves higher salaries, finance their personal piggy banks with company funds, make expensive acquisitions in the pursuit of additional power). We are mindful of these potential risks, and evaluate and monitor them when investing in family-owned firms. However, in general we believe the benefits of family firms are quite compelling relative to their potential problems.

## Conclusion

We believe companies owned and controlled by founders and their family members are a good place to look for attractive investments. Despite some potential drawbacks to investing in these firms, we believe they have characteristics that increase the probability of creating long-term shareholder value. Recent studies support our conclusion. Therefore, it is no surprise that many of the companies in our portfolios have significant founding family ownership and control.

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<sup>1</sup> Barger, Leonce L., Frederik P. Schlingemann, Rene M. Stulz, and Chad J. Zutter. "Why do private acquirers pay so little compared to public acquirers?" N. pag. Oct. 2007. Web. 20 Dec. 2009. <[http://www.cob.ohio-state.edu/fin/dice/seminars/BSSZ\\_093007%20RMS.pdf](http://www.cob.ohio-state.edu/fin/dice/seminars/BSSZ_093007%20RMS.pdf)>.

<sup>2</sup> Anderson, Ronald C., and David M. Reeb. "Founding-Family Ownership and Firm Performance: Evidence from the S&P 500." *The Journal of Finance* 58.3 (2003): 1301-327. Print.

<sup>3</sup> Fahlenbrach, Rüdiger. Founder-CEOs, Investment Decisions, and Stock Market Performance. Working paper. Fisher College of Business, 8 Aug. 2007. Web. 11 Jan. 2010. <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=606527](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=606527)>.

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