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Private equity minority investments in large family firms: What influences the attitude of family firm owners?

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Abstract

This paper extends research in the field of private equity investments in family firms. It contributes to the literature by fundamentally analyzing the decision criteria of family firm owners for using minority investments of private equity investors. This type of financing might be of great interest to family firms, as the family firm owner is able to secure majority ownership and control over the family business. Likewise, minority investments might be attractive for private equity investors, as they are mostly not leveraged and therefore independent from capital market turbulences.

Using data from 21 case studies, we identify challenges induced by the family or the business that lead to the phenomenon of private equity minority investments in family firms. We find that perceived benefits and drawbacks of private equity investments are influenced by business and family characteristics. Based on pecking-order theory, resource-based view and the strategy paradigm, propositions as well as a conceptual framework are developed.

Keywords: Private equity, minority investments, family firms, financing, managerial resources

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1. Executive summary

Family firms, the most prevalent form of business, often face severe challenges, such as succession or company growth (Lansberg and Astrachan, 1994; Gersick et al., 1997; Ward, 1997). Private equity might be a solution for these challenges as it can provide funding as well as expertise to the company. However, family firm owners largely avoid private equity investments and often express their aversion towards this financial instrument (Upton and Petty, 2000; Poutziouris, 2001). One major reason is that private equity investments reduce the control of family firm owners as the private equity investors acquire a significant amount of common equity and control rights. In addition, market transparency is low and academic field reports are missing. As a consequence, family firm owners face high information opaqueness which amplifies their aversion towards private equity investments.

Existing research on private equity investments in family firms focuses on majority transactions, i.e. buyouts in family firms (e.g. Howorth et al., 2004). The novel feature of this study is that we focus on minority investments by private equity investors. This type of financing might be of great relevance to family firms, as the family firm owner is able to secure majority ownership and control over the family business while solving the challenge. Minority investments enable family firm owners to benefit - similar to start-up companies receiving smart money from venture capitalists - from the private equity investors' expertise, while maintaining control. At the same time, minority investments in family firms might also be attractive to private equity investors. Such investments are mostly not leveraged and therefore independent from capital market turbulences. They might yield stable returns and create investment opportunities in firms that are not open to majority investments.

In spite of the high relevance of private equity minority investments for family firms, academic research has ignored this particular field so far. Therefore, this paper aims at building an academic base for this research field. Using 15 case studies of large German family businesses, we investigate the rationale of family firm owners to select private equity minority investments as their financing source. In order to increase the validity of the empirical evidence, a control group of six additional case studies of family firms, which explicitly decided against private equity, is used to contrast the findings. We focus on three research questions: (1) the challenges that lead to the use of private equity, (2) ex-ante perceived benefits and drawbacks of private equity as well as (3) factors that influence the perceptions. The pecking order theory, the resource-based view and the strategy paradigm are used to explain empirical findings on these research questions.

First, the paper shows that there are various challenges that potentially lead to the use of private equity minority investments. Family firm owners may use private equity to overcome business related challenges, i.e. growth or crisis. Additionally, private equity, in contrast to other financing sources, may also help family firm owners to resolve family related challenges, e.g. the exit of shareholders, wealth extraction or shareholder conflicts.

Second, empirical findings suggest, that a minor part of the family firm owners decided in favor of private equity because it was their last financing resort, as predicted by the pecking-order theory. The major part of the family firm owners did not follow the pecking order logic. These family firms had financing alternatives and chose private equity due to its financial as well as non-financial benefits. In line with the resource-based view, their decision in favor of private equity can be explained by the company's enhancement of managerial resources through private equity investors. Yet, many family firm owners did also perceive drawbacks of private equity. According to the strategy paradigm, family goals, such as independence and long-term orientation can partly stand in contrast to requirements of private equity financing and therefore may lead to perceived drawbacks.

Third, in order to identify factors that influence the perceptions regarding private equity, the analyzed family firms are classified according to their perceived benefits and drawbacks. The taxonomy differentiates between four groups, named the smart-money seekers, the balanced rationalists, the desperate needers, and the family bulkheads. Based on these groups, propositions that

relate family and business characteristics to the perception of benefits and drawbacks are derived. Our findings suggest that the perception of non-financial benefits of private equity is influenced by challenges induced by the family, corporate governance characteristics and company size. In addition, the propositions argue that financial benefits are influenced by challenges induced by the business. Furthermore, it can be assumed that the perception of drawbacks by family firm owners is affected by the family generation and ownership dispersion. In addition, corporate governance characteristics have a complex impact on the perception of drawbacks. These propositions are the basis of an illustrative conceptual framework that summarizes all relationships between business and family characteristics and the perceived benefits and drawbacks.

Future studies might use this framework to enhance academic knowledge in this particular research field. Large sample studies across several countries, which might be based on questionnaires, could test the propositions. In addition, further research questions covering complementary aspects of private equity minority investments in family firms, such as investor selection criteria applied by family firms, could be addressed.

To our knowledge, this paper is the first academic undertaking that draws attention to private equity minority investments in family firms – a financing alternative of high potential relevance for family firms as well as investors. It starts by building a theoretical and empirical basis in this particular field. Moreover, it provides family firm owners and private equity investors with a structured overview of possible decision factors influencing the use of private equity. It enables family firm owners to critically reflect and enhance their own perceptions of private equity. Private equity investors might also derive insights into family firm decision making and discover an interesting business field.

2. Introduction

Family businesses are the most prevalent form of business organizations in most economies and are a significant driver of economic growth and activity (Gersick et al., 1997). However, family firms often face significant challenges like succession (Ward, 1987; Lansberg and Astrachan, 1994), shareholder conflicts (Harvey and Evans, 1994) and growth options (Ward, 1997). They require solutions that provide financial as well as managerial support. Private equity financing¹ is regularly promoted as a possible solution for meeting those needs, as private equity combines funding and managerial expertise. Yet, family firms are reluctant towards private equity (Upton and Petty, 2000; Poutziouris, 2001). To retain ownership and control over the family business, owner managers rely heavily on internally generated funds in order to reduce outsiders' financial influence (Berger and Udell, 1998; Poutziouris, 2001; Romano et al., 2001). However, minority investments from private equity investors might enable family firm owners to benefit from the private equity investors' funding and expertise, while maintaining control over the family firm.

Academic research on private equity in family firms is still in its infancy. In addition, the few existing investigations regularly focus on private equity investors' majority investments in family firms (e.g. Howorth et al., 2004; Wright et al., 2008). To our knowledge, minority investments by private equity investors in family firms have so far been ignored by academics.

The main contribution of this paper is to enhance research on private equity in family firms by focusing on minority investments. In order to establish a scientific basis for this particular field, it is essential to analyze in a first step the decision criteria which drive family firm owners to use private

¹ Private equity can be defined as the investment of risky equity in mature, mainly unlisted firms by professional investors, predominantly aiming at an eventual capital gain after the investment period, supplemented by dividend yield, cf. Wright and Robbie (1998).

equity minority investments. To shed light on the logic of family firm owners, this exploratory article builds upon 21 case studies.² Furthermore, we develop propositions based on the empirical findings in combination with theoretical perspectives including the pecking order theory, the resource-based view and the strategy paradigm. These propositions attempt to answer the following research questions:

- Which challenges lead to the use of private equity minority investments in family businesses?
- What are ex-ante (a) perceived benefits and (b) drawbacks of private equity minority investments from the perspective of family firm owners?
- Which family business characteristics drive the perceptions of family firm owners?

In this paper empirical evidence is drawn from 15 case study companies having experience with private equity minority investments and 6 additional case study companies, which explicitly decided against private equity and chose equity-like hybrid financing³ instead, to contrast the findings and to increase the validity of evidence. Responses cover the rationale behind the utilization of private equity and display negative as well as positive perceptions of private equity financing.

The paper is structured as follows. In chapter three the fundamental theories underlying the paper's argumentation are introduced. The qualitative methodology of the study is described in chapter four. Empirical results are presented and structured in chapter five. Illustrative tables are used to display the empirical evidence gathered from the case studies. In addition, several propositions are developed. Those are summarized in a conceptual framework displayed in chapter six. In chapter seven, the paper presents a short conclusion and implications for practitioners and future research.

3. Theoretical perspectives

The following paragraphs introduce three theories that illuminate the research questions from different points of view. First, the pecking order theory is chosen as an important proxy of traditional financial theory. Second, the resource-based view is presented to explain the dynamics of smart money financing. It is a dominant theory in explaining the decision for private equity financing. Third, the strategy paradigm serves to enhance the understanding of financing decisions in family firms, by integrating the specific goals of family firm owners as financing determinants. Altogether, these theories provide a theoretical tool box for deriving propositions that explain the reasons of family firms for using minority private equity financing.

3.1. *Pecking order theory*

The pecking order theory provides a hierarchical order for companies to fill their financing needs. Myers and Majluf argue that information asymmetries between the company and potential investors lead to an undervaluation of the company by external equity providers (Myers and Majluf, 1984). Consequently, external equity is unattractive as a financing option and may only be referred to as a last

² According to Eisenhardt (1998), the number of cases should range from five to eight cases. However, due to the very different settings of the family firms after the first interviews, it was essential to enrich the sample with family firms that are comparable.

³ A hybrid is a type of mezzanine finance, occupying a middle position between common equity and senior debt (Tirole, 2006). Equity-like hybrids are treated like equity on the balance sheet, have cash flow rights similar to common equity, but have no voting rights.

resort. Accordingly, Donaldson as well as Myers found in their empirical studies that internal funds are preferred most, followed by debt, hybrid securities and as a last option external equity (Donaldson, 1961; Myers, 1984).

It is widely recognized that family firms strongly adhere to the logic of the pecking order theory (Cassar and Holmes, 2003; López-Gracia and Sánchez-Andújar, 2007). Family firms regularly display very low levels of transparency which leads to very high information asymmetries between potential external investors and the family firm. Thus the effect of undervaluation could be rather high for family firms. As a result, their financing decision is defined by an unwillingness to use external funding in general, and an even stronger aversion towards external equity in particular (Dunn and Hughes, 1995; Poutziouris, 2001; López-Gracia and Sánchez-Andújar, 2007).

Consequently, family businesses that utilize external equity may not have alternative funding sources, and external equity serves as a last resort. Following this logic, family firms with similar funding needs would opt for an equity-like hybrid if they had the opportunity to do so to avoid external equity.

3.2. *Resource-based view*

The resource-based view argues that companies' resources define their competitiveness and ability to pursue their strategies. Resources are defined as assets, capabilities and attributes that result in strengths and weaknesses of a company (Wernerfelt, 1984; Barney, 1991). Among the different types of resources are tangible resources, e.g. financial resources, as well as intangible resources, e.g. managerial or organizational resources (Grant, 1991).

Various scholars apply the resource-based view to family firms. Habbershon and Williams suggest that family firms possess unique resources due to the systemic interaction between the family, family individuals and the business itself. They call this unique bundle of resources 'familiness' and emphasize that these resources have the potential to enhance and/or limit the competitive position of the family firm (Habbershon and Williams, 1999; Habbershon et al., 2003). In particular, in the case of restricted resources, family firms may need to undertake actions in order to improve their resource profile.

The investment of a private equity company is supposed to influence the resource profile of the portfolio company. This is particularly true for start-up companies, where the 'smart money' effect of venture capitalists plays a significant role (Macmillan et al., 1989; Elango et al., 1995), but may also play an important role for later stage businesses. Besides the contribution of financial resources, private equity investors may provide managerial resources and scrutinize the deployment of un- or counterproductive resources. Thereby, they may advance the competitive position of the portfolio company (Barney et al., 2001; Wright et al., 2001). The company may aim to benefit from the private equity investors' expertise in financial engineering, management information systems, and strategy development or even may need operational support and provision of contacts. Private equity can therefore serve as valuable means to acquire necessary financial as well as managerial resources that are otherwise not available to the company (Wright and Robbie, 1998). Existing studies on resource provision by private equity investors focus on buyouts (majority investments), yet it can be suggested that the transfer of expertise to the portfolio company might also be an essential driver for family firm owners to select minority investments by private equity investors.

The extent to which the company seeks to benefit from resource provision by private equity investors depends on the pre-investment resource profile. It influences the perceived need as well as the willingness to acquire financial as well as managerial resources from outside financiers.

Consequently, it can be argued that family firms without extensive and diversified managerial resources have a rather high need to acquire skilled managerial resources from outside and may therefore consider private equity as beneficiary, compared to other financing sources. Indicators for

managerial constraints can be the non-existence of an advisory board or a lack of external managers (Hillman and Dalziel, 2003). This rationale may also be true for smaller companies which could not yet afford the time and effort to establish the necessary managerial resources internally and therefore depend on resource transfer from outside.

3.3. *Strategy paradigm*

Traditional capital structure theories focus on capital market dynamics but do not adequately describe the underlying mechanisms of the individual businesses, as they consider businesses merely as black boxes. Yet, financing decisions are the outcome of a complex relationship between strategic perspectives of the business, management and ownership. Barton and Gordon therefore propose the strategy paradigm that integrates the recognition of management literature in the financing context. They suggest that maximizing shareholder wealth does not reflect the diverse goals and preferences of decision makers in businesses (Barton and Gordon, 1987; Barton and Gordon, 1988). Besides the goal of maximizing the value of the firm, shareholders pursue personal preferences in order to optimize their personal benefit (Findlay and Whitmore, 1974).

Due to their strong personal involvement and their dominant voting power, this argument is particularly relevant to family firms. Gallo et al. (2004) as well as Romano et al. concluded that the financial logic in family firms significantly depends on personal preferences and goals of the decision makers. Intuitively, this argument provides insights into the reasoning behind family business owners perceiving the drawbacks on and benefits of private equity to the family as well as on the business (Poutziouris, 2001; Gallo et al., 2004).

Dominant goals, which family firms typically exhibit and which might influence financing decisions, are: independence, risk aversion, long-term orientation and operational excellence (Dreux, 1990; McCann et al., 2001; Westhead, 2003). Those goals can partly stand in contrast to requirements of specific financial instruments like external equity and therefore may in particular lead to perceived drawbacks.

Exemplary, empirical evidence suggests that the higher the pursuit of independence by family firm owners the greater the aversion against external capital (Poutziouris, 2001; Romano et al., 2001). Accordingly, the more closely held family businesses are likely to exhibit higher fears of losing control and perceive more drawbacks of private equity. Following this line of argument, corporate governance characteristics of the business, i.e. the existence of external management or a supervisory board, might provide an indication of whether the family firm owners hold their business closely or accept external influence. Family businesses with external management and/or supervisory boards might be less exposed to fears of losing control or independence when considering private equity.

Depending on their role within the business, individual goals, such as the preference for independence, may even lead to a sub-optimal strategy regarding shareholder value (Chrisman et al., 2003). Accordingly, studies show that family firms may forego growth in order to keep control. Poutziouris speaks in this context of an 'growth versus control' dilemma (Poutziouris, 2001). An indication of dominating goals within the family firm may be the financing challenge that induced the sale of a minority share. Family firm owners who realize that their business needs funding, e.g. for growth, may emphasize maximizing shareholder value, and personal benefits, like keeping control over the business, may play a minor role. These family firm owners recognize a funding need for the business and may have less fear of the profit expectations and the short-term orientation of private equity investors than family firm owners who have to solve family related challenges.

Additionally, family firm characteristics like generation and the dispersion of ownership might play an important role in financing decisions. Over generations, the family firm owners might become more risk-averse and family ties can diminish. Moreover, it seems to be difficult to achieve consent on changes in voting rights among dispersed and often not closely related owners. Consequently, the

aversion against and fears of private equity appears to increase over generations and the degree of ownership dispersion (Dunn and Hughes, 1995; Blanco-Mazagatos et al., 2007).

4. Qualitative methodology

A qualitative research methodology was chosen to explore in-depth rationales for family firms to use private equity. Perceived benefits and drawbacks of the family firm prior to the investments play an essential role therein. Qualitative studies, such as case studies, make the analysis of context sensitive research questions possible. They provide insights into unexplored complex causalities and relationships. Furthermore, they enable us to test the theory and to generate propositions for explored causalities (Eisenhardt, 1989). As the introduced research questions focus on under-researched issues and require the understanding of complex decision drivers, the use of multiple case studies is appropriate for this study. Multiple case studies enhance external validity, as empirical evidence is more compelling and robust (Yin, 2003). The 21 case studies in this paper are derived from 47 semi-structured interviews, numerous company documents and publicly available information. Semi-structured interviews were conducted with various persons involved in the private equity transaction of the case study company, such as family members, managers, private equity investors and external experts like lawyers. The design of the semi-structured questionnaire was based on expectations derived from the pecking order theory, the resource-based view and the strategy paradigm.

The case study companies were identified and selected by employing theoretical sampling criteria: First, it was ensured that the case studies were diverse in size, age, industry as well as family generation and influence. Second, in order to avoid being biased towards successful private equity investments, the sampling procedure included case study companies with positive, mediocre, and negative experience with private equity investments. Third, as already mentioned above, various types of interviewees were approached in order to be able to compare the findings across different perspectives. Finally, following theoretical replication, the selected case studies cover, on the one hand, family firms that used private equity and, on the other hand, family firms that decided against private equity investments but in favor of equity-like hybrids.

Family firm minority transactions were identified using a wide variety of databases, such as SDC Platinum, Amadeus, and MergerMarket, in addition to web research. The geographical focus was Germany as it seems to be an ideal region for the underlying research questions. First, Germany's corporate landscape is dominated by family firms. Second, German family firms are characterized by establishing and maintaining strong family control over generations (Klein, 2000). The first selection criterion was the existence of a private equity minority investment (less than 50 percent) since 1980. Yet, it was not decisive whether the private equity investors already exited the family firm or were still invested. Furthermore, the selection required the companies to be family firms. This paper defines a firm as a family firm, if it meets the following two conditions: more than 50% of ordinary voting shares are owned by members of the largest single family group related by blood or marriage and the company is perceived by the CEO/president to be a family business (Westhead and Cowling, 1998). Due to limited information, large individual blockholders, shareholders with the identical surname or endowments with a large shareholding were used as proxies for identifying portfolio companies as family firms during the investment period. The selection criteria, according to the family firm definition underlying this paper, were then verified within the interviews. Another requirement was company size: only companies with a sales volume exceeding €20 million were included in the sample. This threshold was chosen because of the relatively higher transaction costs for private equity investors when investing in smaller companies which make smaller firms unattractive for private

equity players. Therefore, private equity investors seldom offer equity financing for companies below sales of approximately €20 million.

A total of 87 family firms with private equity minority investments were identified in Germany which seems to constitute a fairly complete database for minority investments of private equity groups in large German family firms from 1980 to 2007. 21 family firms responded positively to our request for case study research. Six companies were dismissed after in-depth interviews and research due to very low family influence prior or during the private equity investment. To the remaining 15 case study companies, which include companies that used private equity financing, six case study companies, which used equity-like hybrids instead of private equity financing, were added for theoretical replication purposes.

For every case study company, several relevant persons were interviewed. Family firm owners, managers, private equity investors as well as external experts, like lawyers, reported on their experience. Based on the perspective of the research questions, the family firm owners' opinion was the most relevant and was therefore used as evidence. However, the experience of the other parties was used to validate the findings and to reduce common method bias. Interviews were executed in teams including at least two authors. The interview included open-ended questions, which enabled the interviewees to freely express their experiences and opinions, as well as rank-order scaled questions. Furthermore, all interview partners were ensured that their company data and reported experience would only be published anonymously (family firm A, B, C, etc.), to improve the truthfulness of the statements. Having asked all interviewees for permission, every interview was taped and later on transcribed. Each interview lasted 50 to 120 minutes.

Besides the reported experience of the interview partners, financial, ownership, and transaction data was collected during the interviews in order to characterize the individual cases. Internal company documents, e.g. transaction contracts or annual reports, were made available to the authors. Furthermore, multiple public sources of evidence (especially the aforementioned databases) were utilized to crosscheck this data in order to increase consistency and reliability.

Table 1 summarizes the company and deal characteristics of the interviewed family firms. As already mentioned, the business names are fictitious in order to preserve confidentiality. All tables presented in this article rank the family firms from high family influence to low family influence prior to the private equity investment.⁴

⁴ The concept of *substantial family influence (SFI)* measures the family influence through ownership, management and/or governance and uses the calculated influence as distinguishing criterion of whether or not a company can be classified as a family firm. Accordingly, the SFI is calculated by adding the family's share of ownership, share of seats on the management board and advisory board, respectively (Klein, 2000).

Table 1
Description of cases during the investment period

				Share of family during the investment period										Size of company in year of investment			Characteristics of minority investment		
Company	Family Generation	Company Age		Share of common stock	Share of management	New advisory board	Share of advisory board	Subst. family influence (SFI)	Revenue	Headcount	Year of entry	Year of exit	Private equity share						
Minority investments																			
		years		percent	percent	yes/no	percent		€ million	number				percent					
Family firm A	1	48		60%	100%	yes	50%	2,10	20	200	1987	-	40%						
Family firm B	4	100		75%	100%	no	33%	2,08	80	450	2000	2006	25%						
Family firm C	3	60		75%	100%	yes	0%	1,75	83	1,078	1996	2001	25%						
Family firm D	5	150		69%	100%	no	0%	1,69	400	2,200	2002	2006	31%						
Family firm E	1	30		66%	66%	yes	33%	1,65	40	220	1999	2007	33%						
Family firm F	3	85		80%	50%	no	33%	1,63	316	2,800	1993	2003	20%						
Family firm G	3	60		60%	100%	yes	0%	1,60	30	300	2004	2006	40%						
Family firm H	5-7	130		80%	0%	no	56%	1,36	50	780	2000	-	20%						
Family firm I	1	40		81%	0%	no	50%	1,31	20	100	2001	2003	19%						
Family firm J	7	220		70%	20%	no	40%	1,30	450	3,000	1996	2006	30%						
Family firm K	4	100		76%	0%	no	40%	1,16	115	650	2005	2007	24%						
Family firm L	5	124		75%	0%	no	33%	1,08	113	500	2003	-	25%						
Family firm M	3	115		67%	0%	no	33%	1,00	250	1,700	1995	-	33%						
Family firm N	4	130		51%	0%	yes	33%	0,84	380	4,300	2003	2006	49%						
Family firm O	4	100		45%	0%	yes	33%	0,78	50	500	2001	2007	33%						
Equity-like hybrid																			
Family firm I	7	180		100%	100%	yes	33%	2,33	ca.30	250	1990	2007	0%						
Family firm II	4	116		100%	100%	no	33%	2,33	130	800	2004	-	0%						
Family firm III	2	38		100%	100%	no	0%	2,00	60	200	2004	-	0%						
Family firm IV	2	30		100%	50%	yes	33%	1,83	120	600	2003	2006	0%						
Family firm V	4	80		100%	50%	yes	25%	1,75	60	500	2002	2007	0%						
Family firm VI	2	70		100%	25%	no	0%	1,25	249	2,250	2003	-	0%						

5. Empirical evidence

In this section, interview evidence is presented to answer the introduced research questions. First, challenges that led to the use of private equity are described and structured. Second, the benefits and drawbacks perceived by family firm owners will be explored and structured. Third, the sample will be analyzed for patterns to identify propositions initiating further research. All observations are presented in tables that provide a structured overview of the findings as well as the corresponding quotes of the family firm owners.

5.1. Challenges leading to the use of private equity

Interviews showed that the family firms were confronted with a wide variety of challenges that were either caused by the business, the family, or a combination of both (Table 2). This categorization is in line with the Family Business Triangle developed by Dreux (1990).

First, if the challenge was induced by the business, the additional financing need was met by a capital increase, which was used either for (1) growth or (2) crisis. In nine out of 15 cases, the business needed capital for growth, e.g. internationalization and/or acquisition (firms A, B, E, G, H, I, J, M, N). Besides the ambition for growth, three out of 15 businesses were confronted by a crisis and needed financing to overcome the crisis (firms F, G, K).

Second, if the challenge was induced by the family, the controlling shareholder wanted to either sell part of the company to enable (3) an exit of a shareholder (e.g. succession), to extract (4) personal wealth, or to alleviate (5) a conflict among shareholders. In four out of 15 cases, the exit of a family member was a succession problem (firms G, I, L, O). In two out of 15 companies, a family branch wanted to leave the business (firms A, C). The extraction of personal wealth (firms A, J, K) was another important challenge, the family firm owners wanted to overcome. Third, and most intriguing, five out of 15 family firm owners stated that a combination of business and family issues led to a sale of shares and a capital increase (firms A, G, I, J, K). However, the interview results indicate that in most of these cases there was one dominant challenge that led family shareholders to solve other problems as well (firms A, G, I, J). In case A, for example, the family firm owner had to pay off his brother, which was not possible out of available financial resources. This challenge led the family firm owner to reassess his private situation, resulting in the decision to diversify his wealth, which had been completely invested in the business until then. Additionally, he reckoned that the business urgently needed funding to generate future growth. Only in family firm K was the family firm owner as well as the business in a financial crisis. Both problems were equally urgent and had to be resolved.

In contrast, all of the companies that selected equity-like hybrid financing, wanted to finance growth (firms I, II, III, IV, V, VI); there were no restructuring issues or any challenges induced by the family itself. This observation seems quite obvious, as equity-like hybrid financing does not have any 'smart money' or shareholder structure effects which would be necessary for solving other challenges - it is a pure provision of money.

To sum up, there are various reasons that potentially lead to the use of private equity minority investments as a financing option. Family firms use private equity to fund business needs, i.e. growth or crisis. Additionally, private equity, in contrast to other financing sources, may also serve to resolve family issues, e.g. the exit of shareholders, wealth extraction or shareholder conflicts.

Table 2
Overview of types of challenges
Brackets () indicate a secondary challenge

Company	Challenges induced by the business		Challenges induced by the family			Empirical evidence from family firm owners
	(1) Growth	(2) Crisis	(3) Exit of shareholder	(4) Wealth extraction	(5) Shareholder conflicts	
Minority investments						
Family firm A	(✓)		✓	(✓)		There was a second ineligible shareholder, who got paid off and should be substituted by a new shareholder. Besides, money in addition to bank loan financing was needed to secure future company growth. Additionally, my parents wanted to diversify their wealth and afford a better living.
Family firm B	✓					We, as a middle-sized mechanical engineering company, were hardly able to finance already realized and planned growth in the future on our own.
Family firm C			✓			It was a shareholder exit in a family business - a rather common issue.
Family firm D					✓	A private equity company needed to get invested in order to serve as neutral shareholder - there were no financing goals, [...] There was no clear power structure among the family shareholders - no definite majorities due to ten different family shareholders - resulting in severe conflicts.
Family firm E	✓					In those days, we were clear market leader in the industry - then the IPO boom emerged and I feared to loose market power. I thought "holy shit - I don't want to be second [...] and decided to invest.
Family firm F		✓				The investment was during the crisis in the mechanical engineering industry - we also suffered from it and our equity ratio did fell tremendously - it was a crisis situation.
Family firm G	✓	✓	(✓)			The company was forced to expand but did not have the financial resources [...] Due to the capital intensive business model and strategic reorientations the company had liquidity problems. [...] alongside with the investment, the father wanted to exit the business.
Family firm H	✓					Until 2005, we realized organic growth of 15% p.a. on average. And of course, as traditional capital intensive manufacturing company, we had to ask ourselves: where do we get the money from to finance the growth?
Family firm I	(✓)		✓			One of my first goals as new manager was to offset the past situation among the shareholders and to initiate succession plans - furthermore, the raised money was used to finance growth.
Family firm J	✓			(✓)		We had high growth rates, small cash flows, due to the internationalization low profits resulting in low equity ratios - that's why we were searching for equity financing growth.[...] Another goal was to increase the fungibility of shares for our heirs, who were to be confronted with tax liabilities.
Family firm K		✓		✓		Two problems had to be solved. The private indebtedness of the family shareholder as well as the company's liquidity.
Family firm L			✓			There were changes in the shareholders' structure. Some of the heirs wanted to exit the company and focus on other projects. Therefore we had to pay them off and substitute their share with new equity.
Family firm M	✓					The company decided in the early 90ies, similar to other Mittelstand companies, that it had to launch a second level of international expansion.
Family firm N	✓					In those days, we launched a very ambitious growth strategy and had to restructure investments in the USA.
Family firm O			✓			It was clear that the family members did not want to serve as successors and that the current shareholders planned to exit the company in the near future.
Sum	7 (2)	3	5 (1)	1 (2)	1	
	(A), B, E, G, H, (I), J, M, N	F, G, K	A, C, (G), I, L, O	(A), (D), K	D	

5.2. Perceptions of private equity

As outlined earlier, the cases demonstrate that there are several challenges that may induce family firm owners to concern themselves with external equity. However, the essential decision determinants which finally led to private equity (or to equity-like hybrid financing), after the family business identified the challenge, are not yet explored. Therefore, this section analyzes ex-ante perceived the benefits and drawbacks of private equity as perceived ex-ante by family businesses.

5.2.1. Perceived benefits

A family business accepting a private equity minority investment seems to be an interesting phenomenon, as family firms are suggested to have high levels of aversion against private equity in general. However, literature has not yet explored what occasionally drives family firms to choose this kind of financing. The following paragraphs categorize and discuss possible drivers for the selection of private equity minority investments (Table 3).⁵ As the pecking order theory as well as the resource-based view seem suitable to explain positive aspects of private equity financing, the perceived benefits are to be explained by those two theories.

The perceived advantages can be divided into two categories (1) *financial benefits* and (2) *non-financial benefits*. Financial benefits include (1a) *capital structure effects* as well as (1b) the provision of *financing as a last resort*. Capital structure effects refer to the increase of the debt-equity ratio. This was a major benefit in nine out of 15 family firms that selected private equity as their financing source (firms B, F, G, H, J, K, L, M, N). The explanations and individual reasoning of the family firm owners, however, were divergent. For example, father and son of firm L had the philosophy to finance their business with at least 40% common equity. In order to keep the ratio at this level they intended to increase their common equity. In contrast, other family businesses were confronted with a very low share of common equity and were forced to improve their capital structure.

Six out of the nine family firms that expected capital structure effects chose private equity financing as no other alternative was available (firms F, G, H, J, K, N). It was their last financing resort to solve their challenge. These companies faced situations, in which the importance of solving their challenge dominated their potential fears of losing control to a private equity investor.

Apart from the financial benefits, several family firms perceive private equity as providing (2) *non-financial benefits* to the family firm. Non-financial benefits can be distinguished into benefits for the (2a) *business* and benefits for the (2b) *family/shareholders*.

In line with the resource-based view, non-financial benefits for the business can be described as the provision of managerial resources by private equity investors which may lead to several improvements within the business. In eleven out of 15 cases the family firm owners wanted the business to benefit from the experience, know-how and network of private equity investors (firms A, B, C, D, E, I, J, K, L, M, O). First, several family firm owners wanted to professionalize the corporate governance with regard to supervisory, management and decision making (firms A, B, D, K, L, M, O). Second, family firm owners had specific expectations of private equity investors, e.g. to support internationalization (firm I), their IPO agenda (firms D, E, J), or to upgrade their management information systems (firm C).

Moreover, the decision to utilize private equity can be driven by non-financial benefits for the family/shareholders. This rationale applied to three family firms in our sample (firms A, C, D). Two of them wanted to have a neutral shareholder as opposed to a biased strategic investor. Another benefit for the family was the reduction of risk linked to the existence of owner-managers. The owner-

⁵ Other financing sources, under the premise of keeping the business in family control are retained earnings, debt, hybrids, IPO, employee share plans, debt-equity-swap etc.

managers of firms A and D saw a benefit for the family's wealth by reducing the dependency on their person. They explicitly stated that they were afraid of an accident that would lead to chaos in the family and the business. Consequently, they were eager to get a competent shareholder who would be able to take over the business in case of injury or death of the owner-manager.

In comparison with the family firm owners who decided in favor of private equity, the ones who decided in favor of equity-like hybrids only reported financial benefits. Their central goal was to improve their capital structure. They did not perceive any other, non-financial benefits from equity-like hybrids. This finding emphasizes the 'smart money' character of private equity financing, which is explicitly perceived by companies that used this form of financing but not by companies that used equity-like hybrids. This might be explained by the great involvement of private equity investors in family firms. They do not only provide money but also become shareholders of the company and therefore are much more likely to be interested in providing managerial resources to the portfolio company.

To sum up, the reported benefits can be explained to a large extent by the pecking order theory and the resource-based view. First, family firms decided in favor of private equity because they perceived it as a last resort to solve their problem, adhering to the pecking order theory. Second, according to the resource-based view, family firms used private equity for the provision of capital structure benefits and/or managerial resources by the investors. In particular, the professionalization of business processes through the broad expertise of the investors was welcomed by several family firms. By contrast, in the case of equity-like hybrids, family firms did not perceive any other benefits than the provision of financial resources.

Table 3
Overview of perceived benefits

Company	Perceived benefits						Empirical evidence from family firm owners
	(1)			(2)			
	Financial			Non-financial			
	(1a) Capital structure effects	(1b) Last resort	(2a) Business / Professionalization Corporate Governance	(2b) Family / shareholders Neutral shareholder	Risk reduction of family wealth		
Minority investments							
Family firm A			✓		✓	We wanted a shareholder who supports our growth plans and who enforces a certain professional decision making process. Additionally, family businesses with only one owner family face a significant cluster risk. If something had happened to my father, the business would have gone to my mother who had no appropriate education to run the business. That's why we wanted a second shareholder who is capable of leading the business in case of a casualty.	
Family firm B	✓		✓			Certainly, we could have achieved debt financing, although, this would have been quite expensive (!). Additionally, to increase common equity is the only economic alternative to really improve your capital structure [...] moreover, we believed in a big opportunity for the business. Private equity investors bring a lot of knowledge and experience to the table.	
Family firm C			✓	✓		We did not have enough capital to buy out the exit of the other family branch. So we had to sell a share. Under no circumstances we wanted a market participant or competitor in our business. We liked the neutrality of private equity players who focused on return [...] additionally we expected a boost of professionalization especially in the areas of corporate planning, controlling and reporting.	
Family firm D			✓	✓	✓	Our shareholder structure was strongly dispersed and there was a large conflict among family members. My goal was to take on a professional neutral shareholder that could alleviate the conflict. Additionally, the whole business was concentrated on my person. If something had happened to me the traditional family business would have sunk [...] our ultimate goal was the IPO. A private equity player knows how to successfully prepare an IPO.	
Family firm E			✓			I did not have the competence to do an IPO on my own. That's why I needed support in preparing this business transformation.	
Family firm F	✓	✓				We were faced with a net worth (equity) covenant breach of one of our bond issues. This would have been disastrous for the family business. Therefore we were forced to issue common equity to an external investor. However, we always planned to get the shares in the hands of the family again. That's why we didn't want any other alternatives like IPO or employee contribution. It is easier to buy back from a single shareholder where the goals are clear.	
Family firm G	✓	✓				We wanted to expand and didn't have sufficient assets. In order to improve our capital structure and liquidity we had to sell a share to an external equity provider. Mezzanine or debt was not possible.	
Family firm H	✓	✓				Debt would have increased our gearing tremendously. And there is always this uncertainty how the auditors and banks evaluate mezzanine. Private equity was the only possibility to improve our capital structure substantially.	
Family firm I			✓			The family owners limited the growth of the business due to their local mindset. We thought that private equity would reduce these barriers and prepare the business for globalisation. In addition, the company was stagnating due to the conflict among the two family branches. Therefore, a neutral shareholder was the preferred option.	
Family firm J	✓	✓	✓			The banks did not finance any growth ambitions. Therefore there was no alternative. The second advantage of private equity was their experience in preparing an IPO, which was our medium term goal.	
Family firm K	✓	✓	✓			This was a significant financial relieve for us. We jumped from almost bankruptcy to investment grade. On top we had management problems and we hoped that the private equity investor would solve this problem.	
Family firm L	✓		✓			We had to pay out 2/3 of our equity. We had and still have the philosophy that our capital structure should have 40% straight equity. Our goal is long-term safety and a comfortable negotiation position with our house banks [...] additionally, we wanted to have a professional shareholder who is free of family issues and conflict potential. Private equity investors are very professional and only look at the profit of the business.	
Family firm M	✓		✓			As the company feared that the investment might lead to a worse financial status, they were looking for an external equity partner who was willing to keep the control of the business with the family [...] We were about to face succession in the next years and we had the expectation that a private equity investor would professionalize the decision making process, also with regards to a possible solution for the succession problem.	
Family firm N	✓	✓				Back in these days (2001/02), an IPO was not possible. Banks were not open for financing large growth projects and no strategic partner wanted to invest. Therefore, private equity was the only provider of funding.	
Family firm O			✓			We did not have any successor in our family and wanted to prepare the business for future challenges. To fulfill this task a capable management and a professional shareholder had to be installed.	
	9	6	7	5	2	2	
	B, F, G, H, J, K, L, M, N	F, G, H, J, N, K	A, B, D, K, L, M, O	C, D, E, I, J	C, D	A, D	

5.2.2. *Perceived drawbacks*

In order to fully understand the motivation of family firm owners selecting private equity as a financing source, it is also important to analyze the drawbacks of private equity as perceived by family firm owners. Again, perceived drawbacks can be divided into two categories: (1) *business related drawbacks* and (2) *family related drawbacks* (Table 4). The first drawback category was concerned with the business itself (firms, B, D, F, L, M). Here, all five family businesses associated private equity with a threat to the long-term orientation of the family business, an explicit company goal that was definitely seen as a competitive advantage (firms B, D, F, L, M). In line with this apprehension, three family firm owners feared the profit expectations of private equity investors leading to a “figures” driven management (firms F, L, M). However, it has to be emphasized that these business related drawbacks were only superficially related to the business: When asked for the major fears behind the business related drawbacks, the family firm owners related them to familial worries, such as the loss of control or majority of ownership in the family business. For example, family firm owner L did not fear the profit expectations due to the resulting pressure on performance. In fact, he planned to buy back the shares of the investors and feared that if the business grew significantly, the family would not be able to afford the buy-back, so that the private equity investor might sell his share at an inflated price to some outsider and the family would lose control over the company.

In contrast to the business related perspective, the second category relates to a potential deterioration of the family position in the business induced by the private equity investor (firms D, F, H, M). Here, one group of family businesses was afraid of a creeping reduction in ownership or even the loss of the majority (firms D, H). Family firm owners F and M were afraid that the family would lose control over the business due to special minority investor rights, although they did not fear a creeping reduction in ownership. In contrast, several other family firm owners explicitly stated that they were not afraid of losing the family business because they kept the majority of shares and regarded themselves to be controlling shareholders.

None of the family firm owners was afraid that the business might lose its culture or values. Even when explicitly asked for, they denied any related fears. This is an interesting observation, as private equity investors and family firms are supposed to display rather different corporate cultures and values. Yet, family firms seem to be confident in conserving their management style and culture. This might be primarily explained by the continued strong position of the family, even after selling a minority stake to a private equity investor.

Besides the companies that reported fears of private equity, several family firm owners explicitly denied any kind of perceived drawbacks (firms A, C, E, I, J, O). At first sight, this is quite astonishing, given the widespread aversion of family firms to private equity. Yet, this phenomenon can be explained by the family firm owners’ explanations of their non-existent anxiety. Family firm owners J and O had former experience with private equity, either directly or through the advisory board. Family businesses C and I did not see any threats, as they kept the majority of shares and the management of the business. The owner of family business E admitted his over-confident and fearless attitude and that “without him the business would collapse”. Nevertheless, the aforementioned drawbacks were perceptions of the family firm owners who finally decided in favor of private equity financing. It should therefore be interesting to investigate the perceived drawbacks of private equity among the family businesses that decided against this form of financing but chose equity-like hybrids instead.

The perceived drawbacks of private equity were significantly more intense among family firm owners who decided in favor of equity-like hybrid financing. All firms feared business and family related drawbacks (firms I, II, III, IV, V, VI). Especially, the fear of losing control was mentioned by all family firm owners. Some even explicitly stated that they preferred greater control over a higher return on investment (IV, VI). Family firm owner IV stated:

We wanted to keep our entrepreneurial freedom. Maximizing return on investment is not always our main objective. Therefore, we did not want an outsider to influence our business decisions.

In addition, five of these family firm owners thought of private equity as being harmful to the business due to the short-term orientation and the high profit expectations. Two family firm owners feared the loss of the family business when selling a minority share to a private equity investor. Moreover, one family firm even had a clause in the articles of association that no non-family member could acquire a share in the family business.

The analysis shows that the disadvantages perceived by family firms of private equity can be mostly explained by personal or familial preferences, which supports the arguments of the strategy paradigm. The loss of control and ownership were the major drawbacks perceived by family firm owners. As expected, businesses that selected equity-like hybrid financing had a higher aversion to private equity.

Table 4
Overview of perceived drawbacks

Company	Perceived drawbacks			No fears / disadvantages	Empirical evidence from family firm owners
	(1) Business related Threat to long-term orientation	(2) Family related Creeping reduction in ownership	Threat to independence / control		
Family firm A				✓	Family owners often fear the loss of control or independence. In our case we wanted to have the influence and a professional shareholder.
Family firm B	✓				The typical German/Swabian family business is long-term oriented and risk-averse. We did not want an investor who talks about the exit right after he bought the shares.
Family firm C				✓	As we were confronted with the exit of the other family branch we wanted to run the business on our own. As we saw that we need an equity partner, we did not have any significant concerns.
Family firm D	✓	✓			Our biggest fear was that private equity investors would buy a minority share to open the door for a "cold" takeover. And the other issue was their short-term perspective.
Family firm E				✓	Back in these days I was kind of arrogant. I believed that without me the business would go down. I did not have any fears.
Family firm F	✓	✓	✓		We are a family business and wanted to remain in the ownership of the family. We wanted to keep control and minimize the influence of external capital providers. External equity providers want controlling and voting rights and they want to make big money.
Family firm G					Information denied.
Family firm H		✓			Before the private equity investment the shareholders had a safe investment with moderate returns. They were afraid of significant changes and did not exactly know what the consequences are [...] some family members even feared that the family will lose the majority.
Family firm I				✓	Due to the fact that management would be kept in place and we were only selling a minority, we did not have any concerns regarding independence or control
Family firm J				✓	We had limited fears due to the fact that we were urged by our debt providers. And we knew the private equity company.
Family firm K					Information denied.
Family firm L	✓	✓			The main disadvantage is that the investors want a relatively high return on their investment. Consequently, it is very expensive to buy back the share [...] additionally, they have a different time frame. They have a different view on cash flow and Capex and are interested in short-term success [...] we were afraid of the typical locusts who disappear after five years with 100% return.
Family firm M	✓	✓	✓		Considering that we were a 100 year old traditional third generation family business, we were afraid to lose control and are forced to change our long-term view. Additionally, we feared that we are going to be managed by numbers to satisfy the financial expectations.
Family firm N					Information denied.
Family firm O				✓	One of our board members was an internationally renowned manager who had a lot of experience with private equity. Therefore, we did not have any fears and we knew exactly what the partnership would look like.
	5	3	2	2	6
	B, D, F, L, M	F, L, M	D, H	F, M	A, C, E, I, J, O

5.3. *Classification of family firms according to their perception of benefits and drawbacks*

After having structured and analyzed the perceived benefits and drawbacks of private equity for family firm owners, the following section will identify possible factors that influence these perceptions. First, family firm owners are classified in groups which show emergent similarities in their perceptions of private equity. These groups serve to identify more objectively and robust determinants of the perceptions. Therefore, in a second step, these groups are tested against possible factors influencing their perception of private equity. These factors are related to the type of challenge as well as corporate governance and family business characteristics. Additionally, we try to extract the influence of company size and transaction year. Third, theoretically oriented propositions which influence the attitude of family firms towards private equity are presented. Table 5 which includes all perceived benefits and drawbacks, unveils four emergent groups that exhibit similarities in their perceptions.

The first group, the smart-money seekers, lists five cases which decided in favor of private equity based on non-financial benefits only (firms A, C, D, E, I, O). Although they had other financing alternatives available, they went for private equity, not following the pecking order logic. The perceived benefits were mainly improving the resources of the business. In addition, this group perceived only few business or family related drawbacks.⁶ Intuitively, this group supports the resource-based view, and prefers business to owner interests.

The second group, the balanced rationalists, includes three cases, which also had other financing alternatives but deliberately decided in favor of private equity because of the combination of capital structure effects and non-financial benefits for their business (firms B, L, M). Non-financial benefits were all related to the business and especially the improvement in corporate governance mechanisms. Contrary to the first group, they are likely to perceive significant drawbacks for their business and/or the family. However, similar to the first group, family firm owners assign priority to the interests of the business at the expense of familial interests. Thereby, they adhere to the resource-based view, although they also have personal and individual preferences, which are backed by the strategy paradigm.

The third group, the desperate needers, consists of six cases where the family businesses decided in favor of private equity because they had no other financing alternative (firms F, G, H, J, K, N). These companies seemed less likely to perceive non-financial benefits, neither for their business nor for their family.⁷ This group followed the logic of the pecking order theory and chose private equity because it was their last resort for financing.

The fourth group, the family bulkheads, includes family firm owners, who decided against private equity and in favor of equity-like hybrids because they predominantly needed financial support to strengthen their capital structure (firms I, II, III, IV, V, VI). They did not see any non-financial benefits for their business from private equity and were heavily exposed to drawbacks threatening the family or the business, which can be explained by the extended goal set of family firms introduced by the strategy paradigm. Consequently, this group may emphasize their personal and/or familial benefit when considering financing and business decisions.

⁶ Exception is case D that also perceived drawbacks.

⁷ Exceptions are cases J and C, both of whom perceived benefits for the specific business need or the family.

Table 5
Overview of perceived benefits and drawbacks of groups

Group	Perceived benefits				Perceived drawbacks			
	(1)		(2)		(1) business related		(2) family related	
	Financial		Non-financial		Threat to long-term orientation	Return expectations / costs	Creeping reduction in ownership	Threat to independence / control
	(1a) Capital structure effects	(1b) Last resort	(2a) Business / Professionalization Corporate Governance	(2b) Family / shareholders Neutral shareholder Risk reduction				
<i>Smart-money seekers</i>	A, C, D, E, I, O		A, D, O	C, D, E, I	D		D	A, C, E, I, O
<i>Balanced rationalists</i>	B, L, M	B, L, M	B, L, M		B, L, M	L, M		M
<i>Desperate needers</i>	F, G, H, J, K, N	F, G, H, J, K, N	K	J	F	F	H	F
<i>Family bulkheads</i>	I, II, III, IV, V, VI	I, II, III, IV, V, VI			II, III, IV, V, VI	I, II, III, IV, VI	III, V	I, II, III, IV, V, VI
								-

5.4. Influence of family and business characteristics on the perception of benefits and drawbacks

The following section analyzes the typical characteristics of the classified groups to derive propositions on the factors that drive the utilization of private equity by family firms (Table 6).

Group I: Smart-money seekers

The first group (firms A, C, D, E, I, O) was able to choose from different financing alternatives and decided in favor of private equity because of non-financial benefits. Strongly perceived non-financial benefits consisted mainly of business related benefits and focused on corporate governance improvements or a specific need, like support in the IPO agenda or the internationalization strategy.

Most of this group's family firm owners were confronted by a challenge that was induced by the family.⁸ Firms A, C, I, and O faced a shareholder exit, while family firm owner D tried to master a shareholder conflict. In both situations, the family firm owners considered the managerial resources of the private equity investors a contribution to the solution of their family related challenge. They assessed the provision of non-financial benefits not only as a helpful side-effect of private equity but as the primary reason for choosing private equity. This suggests the following proposition:

P1: *In line with the resource-based view, family firm owners who face a challenge induced by the family are likely to perceive non-financial benefits of private equity.*

In terms of corporate governance, the majority of firms in this group did not have any external management before the investment (firms A, C, D, E, O). This might indicate that this group of family firms exhibits a higher need of external managerial resources. This may, therefore, lead to the following proposition:

P2: *In line with the resource-based view, family firm owners who neither employ any external management nor an advisory board are likely to perceive non-financial benefits of private equity.*

Considering the corporate governance characteristics of these family firms, their owners seem rather introverted, given their relatively low deployment of external management and an external advisory board. In fact, interviews showed that these family firm owners were the antithesis to introverted. Their generational and ownership structure might explain this observation. Generation and dispersion in ownership seem to have a remarkable impact on the perception of private equity. Family firm owners A, E, and I founded their businesses and therefore are the first generation, holding 100% of common equity.⁹ They can be described as more risk-taking, self-confident, extroverted and acting to maximize the value of the business. As family firm owner E stated: Family business D, in contrast, was in the 5th generation and the ownership was dispersed among three different family branches, each having several claimholders.¹⁰ The family firm owner with the largest block holding commented that it

⁸ Except for family firm owner E, who wanted to grow his business.

⁹ In A and E the wives of the owners held 50%, but mainly due to reduce risks and tax savings. They did not have any practical vote in the business.

¹⁰ Family business O was in the second generation, with two brothers sharing ownership and management. Their interests were aligned and they both wanted to exit the business in the medium term. They were open to outside influence and considered private equity as a very good opportunity for the business and value growth.

took enormous effort and time to find a consensus among the different shareholder parties. He complained about their risk-averse attitude, conflicting goals and low interest in the business. This contrasting example shows that increasing dispersion and generation lead to divergent perceptions of private equity among shareholders. Therefore, this discussion suggests the following propositions:

P3a: *In line with the strategy paradigm, first generation family firm owners are not likely to perceive drawbacks of private equity.*

P3b: *In line with the strategy paradigm, family firm owners who face high ownership dispersion in their family business are likely to perceive drawbacks of private equity.*

Business size seems to be another important explanation of the perception of private equity. Family businesses A, E, I, O were among the smallest in terms of revenue. It may be suggested that they did not have the time, effort and knowledge to establish all needed (managerial) resources. Additionally, they did not have the size to afford - or the skill to select - excellent external managers. Therefore, they wanted and needed an external equity partner with aligned business interests to transfer the needed managerial resources to the business. This suggests the following proposition:

P4: *In line with the resource based view, family firm owners of smaller businesses are likely to perceive non-financial benefits of private equity.*

Group II: Balanced rationalists

The second group (firms B, L, M) was also able to choose from different financing alternatives. In contrast to group I, the firms in this group decided in favor of private equity on the basis of a combination of financial and non-financial benefits perceived of this financing form. In addition, the perceived non-financial benefits were mainly business and not family related benefits. With regards to non-financial benefits, the family firm owners only wanted to improve the corporate governance mechanisms. In addition, they seemed to perceive several drawbacks related to a minority private equity investment.¹¹

The majority of these family firm owners, as opposed to group I, was confronted by a challenge induced by the business.¹² However, this type of challenge was also dominant in groups that decided against private equity, which does not allow for proposing a causal relationship.

In terms of corporate governance, all of the family firm owners made use of an advisory board and most of them employed external managers (firms L, M). This implies two suggestions. On the one hand, the family firm owners are open to external influence in the form of management, advisory board and capital providers. This suggests that these companies clearly see a benefit from enhancing their managerial resources by corporate governance constellations as well as through private equity financing (firms B, L, M). Consequently, in line with the resource-based view, family firm owners who employ external management and an advisory board already experienced the importance of external managerial resources and wanted to further improve their corporate governance. Thus, they seemed likely to perceive non-financial benefits of private equity investors (supports P2). At the same time, some of those, seemingly extroverted, family firm owners were afraid of losing further influence over their business and thereby lose the characteristics of a family business (firms B, L, M). This suggests the following proposition:

¹¹ Family firm owner K did not comment on any drawback/fear.

¹² Except for family firm owner L, who was confronted with an exit of a shareholder.

P5: *In line with the strategy paradigm, family firm owners who employ external management and advisory boards are likely to perceive drawbacks of private equity, which are related to their fear of losing even more control over the family business.*

Family businesses in group II were at least in the 3rd generation; however, the ownership structure was still quite consolidated (not more than two family members holding 100%). Family firm owners described their businesses as family-rooted and traditional with a strong long-term focus (firms B, L, M). Hence, they were afraid that external investors would threaten their independence/control (firm M), the long-term orientation (firms B, L, M) and demand a high return on their investment (firms L, M). For example, family firm owner M stated:

Consequently, in line with the strategy paradigm, the perceived drawbacks of private equity increase over generations (supports P3a). Their relatively high concentration of family ownership allows them to act in concert as the largest block holder during the investment period, which diminished their fear of losing control through the private equity investment ex-ante. Hence, increasing dispersion is likely to result in the perception of stronger drawbacks of private equity (supports P3b).

Regarding the size of the business, it is interesting to see that, even though P4 suggests that size is negatively related to the perception of non-financial benefits, family businesses of considerable size may still benefit from corporate governance improvements.

Group III: Desperate needers

The third and largest group (firms F, G, H, J, K, N) decided in favor of private equity, in contrast to group I and II, because they had no financing alternative. They reported mainly capital structure benefits (firms F, G, H, J, K, N). Only family firm owners K and J perceived non-financial benefits. Of them, J was also the one who did not perceive any drawbacks.

The type of challenge the family firm owners of group III faced, reveals interesting findings. Most of the family firm owners faced problems that were induced by the business. Family firm owners G, H, J, N faced the typical ‘growth versus control’ dilemma. They had to decide whether to realize the growth opportunity, which would maximize the firm’s value, or to keep full control over the business. Similarly, family firm owners F, G, and K had the choice of seeing their business collapse or share control with external investors.¹³ Being asked whether they would have preferred equity-like hybrid financing, the family firm owners of group III replied that this would have been their first choice, if available.

Looking at ownership dispersion and generation does not reveal any emergent pattern, nor does controlling for size and transaction year. No additional propositions can be derived from this group of family firm owners. So, if financing is needed for the business and there are no alternative funding sources available, the owner’s perception of private equity may be dominated by capital structure effects and the company’s situation but not by specific business or family characteristics. This leads to the following proposition:

P6: *In line with the pecking order theory, family firm owners who need financing for their business and have no alternative to private equity are likely to perceive financial benefits of private equity.*

¹³ Family firm owner C faced an exit of a shareholder and did not have the funding available. To prevent the shareholder from selling his share in the family business to an anonymous investor, the family firm owner preferred to select his partner himself.

Group IV: Family bulkheads

In contrast to the three groups of family firm owners who satisfied their financing needs by using private equity, it is interesting to analyze the characteristics of the businesses that explicitly decided against private equity but in favor of equity-like hybrid financing. As opposed to groups I and II, but similar to group III, these family firm owners only needed funding to realize their growth options and were uninterested in benefiting from the managerial resources of private equity investors. Additionally, they expressed a wide array of drawbacks of private equity. Their main goal was to optimize the business value, under the premise of unaffected family control and independence. Several family firm owners stated that they would have preferred to retain 100% control to selling a share in the business to a private equity investor.

Looking at the corporate governance characteristics reveals that these family firm owners held their business very closely. In none of the businesses did the family firm owners deploy an advisory board. This observation confirms their primary goal of staying independent and supports the rationale of the strategy paradigm, as family firm owners' goals affect financing decisions. This leads to the suggestion that family firms with no or only arbitrary external influence perceive many drawbacks of private equity due to their high aversion towards sharing control with outsiders. Therefore, proposition five may be extended by suggesting a U-shaped relationship between external influence by and the perception of control related drawbacks of private equity. Thus proposition five is extended to:

P5 extended: *In line with the strategy paradigm, a U-shaped relationship between the extent of external influence in corporate governance bodies of family firms and the perception of drawbacks of private equity is likely.*

Company characteristics concerning generation and dispersion do not provide explanatory insights. Size shows that even some family firm owners of small businesses (firms III, IV) did not see any non-financial benefits related to private equity. However, the year of entry shows that equity-like hybrid financing was available predominantly after the year 2001 (firms II, III, IV, V, VI). Without this form of financing, growth of these companies would have been impeded by the decision of the family firm owner to prefer control to growth.

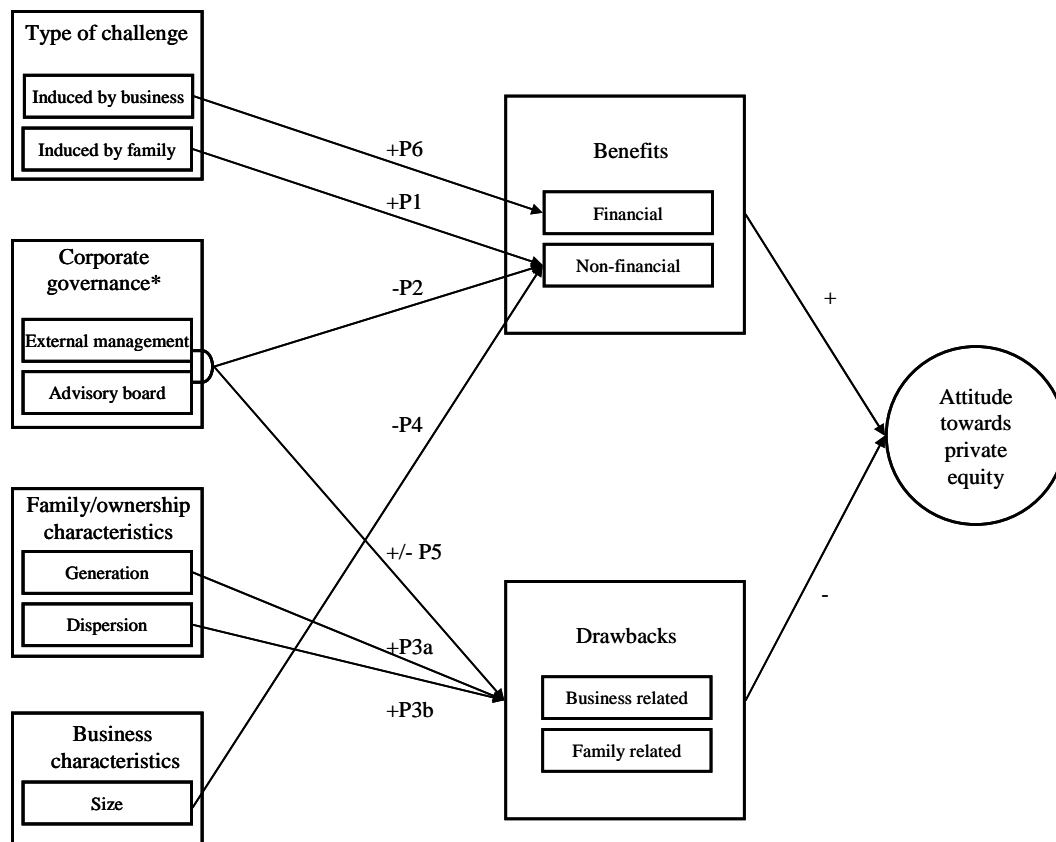
Table 6
Overview of group characteristics

Group	Challenges induced by the business		Challenges induced by the family			Advisory board existence before investment	External management existence	Generation				Business size						
	(1)	(2)	(3)	(4)	(5)			1	2	3	4							
	Growth	Crisis	Exit of shareholder	Wealth extraction	Shareholder conflicts	yes	no	yes	no	1	2	3	4	>4	20-50m	51-100m	101-250m	>250m
Smart-money seekers	A, C, D, E, I, O	E	A, C, I, O	D		D, I	A, C, E, O	I	A, C, D, E, O	A, E, I	C	O	D		A, E, I, O	C	D	
Balanced rationalists	B, L, M	B, M	L			B, L, M		L, M	B		M	B	L			B	L, M	
Desperate needers	F, G, H, J, K, N	G, H, J, N	F, G, K	K		F, H, J, K	G, N	F, H, J, K	G, N	F, G,	N, K	H, J			G, H	K	F, J, N	
Family bulkheads	I, II, III, IV, V, VI	I, II, III, IV, V, VI					I, II, III, IV, V, VI	I, II, III, IV, V, VI	I, II, III	III, IV, VI	II, V	I			III, IV	V, VI	I, II	

6. Discussion: A conceptual framework

Empirical evidence from our 21 case studies indicates that there are various drivers for and against the decision in favor of private equity financing. A categorization as well as a structured analysis of factors that influence the perceived benefits and drawbacks and thereby also the attitude towards private equity helps to understand family firm owners' decision making. Figure 1 summarizes our findings in a post-analysis conceptual framework that provides a clearer illustration of the respective relationships. The type of challenge, corporate governance characteristics prior to the private equity investment, family and ownership structures as well as the size of the business seem to influence the perception of non-financial benefits and drawbacks of private equity. This, in turn, influences the decision in favor of or against private equity. The analysis demonstrates that family firm owners do not only decide in favor of private equity because it is their last resort of financing. They also consider managerial resources and family related strategies in their decision.

Following the logic of the post-analysis conceptual framework, we suggest that the perception of non-financial benefits of private equity is positively influenced by challenges induced by the family and negatively influenced by the existence of external influence in corporate governance bodies as well as company size. In addition, the framework shows that financial benefits are positively influenced by challenges induced by the business. Furthermore, it can be assumed that the perception of drawbacks by family firm owners is positively affected by the family generation and ownership dispersion. In addition, the external influence in corporate governance bodies has a U-shaped impact on the perception of drawbacks.



* Note: corporate governance prior to private equity investment

Fig. 1. Post-analysis conceptual framework

7. Conclusion

Findings from the empirical analysis suggest that private equity is not only considered as a last financing resort. Depending on the specific company situation and character, private equity is conceived as a helpful solution of several problems of the family firm. Family firms not only perceive financial but emphasize non-financial benefits of private equity, as it enables them to enhance their managerial resource profile. Nevertheless, several family firm owners perceived drawbacks of private equity, which mainly derive from family related goals, like independence, that may be affected by private equity investments.

7.1. *Implications for practitioners*

The paper draws the attention to private equity in general and minority investments in particular. Minority investments are largely neglected in research as well as practice. Yet, this form of external equity may offer valuable benefits to family firm owners. Next to the provision of financing and capital structure effects, private equity, similar to venture capital in start-up companies, provides managerial resources, which may enhance corporate governance practices and add specific expertise to successfully pursue business strategies, like IPOs or internationalization.

Furthermore, the structured analysis and categorization of benefits and drawbacks enables family firm owners, who face challenges that might be met by private equity financing, to critically reflect on their own perceptions and decision-making processes. In particular, the distinction between family or business driven decision factors is essential for supporting family firm owners in their assessment of private equity investments. Therefore, it is of great importance that family firm owners clearly define family as well as business goals and set priorities before they start to evaluate financing alternatives.

Our empirical findings may help private equity investors improve their understanding of the complex decision factors of family firm owners. Perceived drawbacks are mainly explained by family related fears. The provision of non-financial benefits may outweigh these drawbacks in the case that the family firm has to solve not only financial issues but also challenges induced by the family that require the provision of managerial resources by private equity investors. Private equity investors may leverage these academic insights by emphasizing non-financial benefits in their communication strategy and improve their perception among family firms. In addition, these findings suggest that private equity investors have to be well aware of the family related goals in approaching family firms.

7.2. *Implications for future research*

The analyzed research questions cover only one part of the overall topic of minority investments by private equity investors in family firms. Future studies might investigate research questions which arise along with the chronological investment process following the decision in favor of private equity financing. First, it is valuable to analyze the detailed process steps (approach, contact, negotiation and advisory) which lead to the minority investment and how the family firm owners select the private equity investor. Second, an analysis of contract design might provide valuable insights into decisive contractual agreements between private equity investor and family firm concerning e.g. the investors' voting and liquidation rights. Contract design might resolve severe conflicts of interest between the investors and the family. Third, it is of great interest to investigate the impact of private equity investments on the performance of family firms. A detailed analysis of the levers that drive the success of the partnership would increase the transparency of this form of financing.

Because of the explorative nature of this study, future research may empirically test the developed propositions and the conceptual framework in a larger sample study. A questionnaire-based survey sent to a representative sample may be used to assess the findings. It would be of great interest to enlarge the sample of investigated minority investments across European countries.

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