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"Stepping into the buyers' shoes" − gaining and losing real options from family departure in family firm acquisitions
(5-page Abstract)

Oliver Ahlers
INTES Center for Family Enterprises
WHU (Otto Beisheim School of Management)
Burgplatz 2
D–56179 Vallendar
Germany
Phone +49-(0)261-65 09-330
E-mail: oliver.ahlers@whu.edu

Andreas Hack
INTES Center for Family Enterprises
WHU (Otto Beisheim School of Management)
Burgplatz 2
D–56179 Vallendar
Germany
Phone +49-(0)261-65 09-330
E-mail: andreas.hack@whu.edu

Franz W. Kellermanns
Department of Management
The University of Tennessee
Knoxville, TN 37996
Phone (865)- 974-3161
and
INTES Center for Family Enterprises
WHU (Otto Beisheim School of Management)
E-mail: franz.kellermanns@whu.edu

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Introduction and context

The unique characteristics of acquiring or selling a family firm are rarely explored (for exceptions see (Dawson, 2011; Niedermeyer, Jaskiewicz, & Klein, 2010; Granata & Chirico, 2010; Chrisman, Chua, Steier et al., 2011). This is remarkable, given the international significance of family firms (Anderson & Reeb, 2003; Morck & Yeung, 2003), which are the largest receiver of private equity in many economies (Dawson, 2011), and in light of family succession challenges that lead to the sale of the family business (Wright, Hoskisson, & Busenitz, 2001; Scholes, Westhead, & Burrows, 2008). Existing research on family firms has emphasized the sellers' perspective (Zellweger & Astrachan, 2008; Zellweger, Kellermanns, Chrisman et al., 2011), stressing that family firm owners' non-financial objectives play a role when selling the business (Lipman, 2001; Chrisman, Chua, & Zahra, 2003; Scholes, Wright, Westhead et al., 2007; Scholes et al., 2008; Barron, Boehler, & Cook, 2010).

In contrast, the family firm buyer's key interest is the economic or financial value of the firm, which refers to the ability to generate cash flow at present and in the future (Damodaran, 2002). Firm valuation is essential for expressing economic value in monetary terms and thus establishing a basis for price negotiations (Granata & Chirico, 2010). Although the principles of valuation are generally well known in the corporate world, it is unclear whether the valuation approach for family firms, which are usually SMEs and vice versa, should be different and whether distinct value drivers need to be considered (Granata & Chirico, 2010).

Evidently, there is often disagreement between buyer and seller on the appropriate value of the family firm (Scholes et al., 2007). A family's perception of price is often considered to be higher due to emotional value attached to the firm (Astrachan & Jaskiewicz, 2008; Zellweger

& Astrachan, 2008; Zellweger et al., 2011). However, there is empirical evidence that family firms are acquired at a discount due to buyers' perceptions that such firms are less efficient, less professional, and less successful (Salvato, Chirico, & Sharma, 2010). This observed discount stands in contrast to research indicating that family firms experience superior economic performance and lower agency costs (Jensen & Meckling, 1976; Anderson & Reeb, 2003; Chrisman, Chua, & Litz, 2004; Villalonga & Amit, 2006; Granata & Chirico, 2010), which suggests that they should receive higher valuations.

Because family members impact vision, goals, and the creation of distinct resources and capabilities, family firms differ from non-family firms (Sharma, 2004; Habbershon, Williams, & MacMillan, 2003; Chrisman, Chua, & Litz, 2003). Accordingly, when valuing a family firm, buyers need to be aware of the existence of a unique resource base and capabilities intertwined with, influenced by, and dependent on the family (Habbershon & Williams, 1999; Habbershon et al., 2003; Sirmon & Hitt, 2003). Yet, the family as a key driving force for both competitive advantages and disadvantages has not been adequately reflected in valuation approaches. We address this gap in the literature by utilizing a real options approach that systematically reflects family influence in the process of family firm valuation.

Objectives and contribution

Our study contributes to the literature and managerial practice in at least two ways. First, we focus on the buyer of the family firm, a perspective that has been previously neglected. The process of acquiring a family firm includes valuation, which is usually followed by price negotiations, investment decisions, and post-acquisition activities (Jemison & Sitkin S. B., 1986; Pablo, Sitkin, & Jemison, 1996; Shepherd, Zacharakis, & Baron, 2003; Anand & Singh, 1997; Barkema & Schijven, 2008; Saoriniborra, 2008). For our purposes, we focus on the valuation

phase and will discuss aspects from other phases only if they are relevant for valuation. We further assume that the buyer treats the target family firm as a stand-alone investment, where the entire firm is sold and the family will exit the company soon after the sale. Second, we complement and challenge existing research on the value of family firms. To the best of our knowledge, there is not yet a valuation approach that explicitly considers the influence of the family on family firm valuation.

Proposed solution: family firm acquisition value

The value of a family firm can be more appropriately captured by complementing the discounted cash flow value (static component) with the value of future flexibility or real options (dynamic component) resulting from a new owner's discretionary power over future firm investments (Myers, 1977; Trigeorgis, 1995). We propose that the dynamic component's real options can be divided into two broad categories: those that are available to all firms with a comparable activity pattern and those that are more specific to family firms due to the central role of the family in firm performance (Dyer, 2003; Nordqvist, 2005; Bowman & Ambrosini, 2007; Astrachan, 2010). In the latter category, family exit affects family firm value by creating future flexibilities and inflexibilities to act, i.e., real options gained and/or lost over non-family firms.

The dynamic component in family firm valuation has three specific elements that need to be considered for valuation purposes: Non-family Options (NfO) as upside value, Family Options at Risk (FOaR) as downside value, and Risk Mitigation Measures (RMM), which limit the risk of downside value. We refer to the outcome of this family firm specific valuation approach as Family Firm Acquisition Value (FFAV). This is essentially the economic value a family firm represents for a buyer in which the Non-family Firm Value (NfFV) is adjusted for both expected economic losses and gains from future real options due to family exit.

We propose the following formal equation: $\boldsymbol{FFAV = NfFV + NfO - (FOaR - RMM)}$

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