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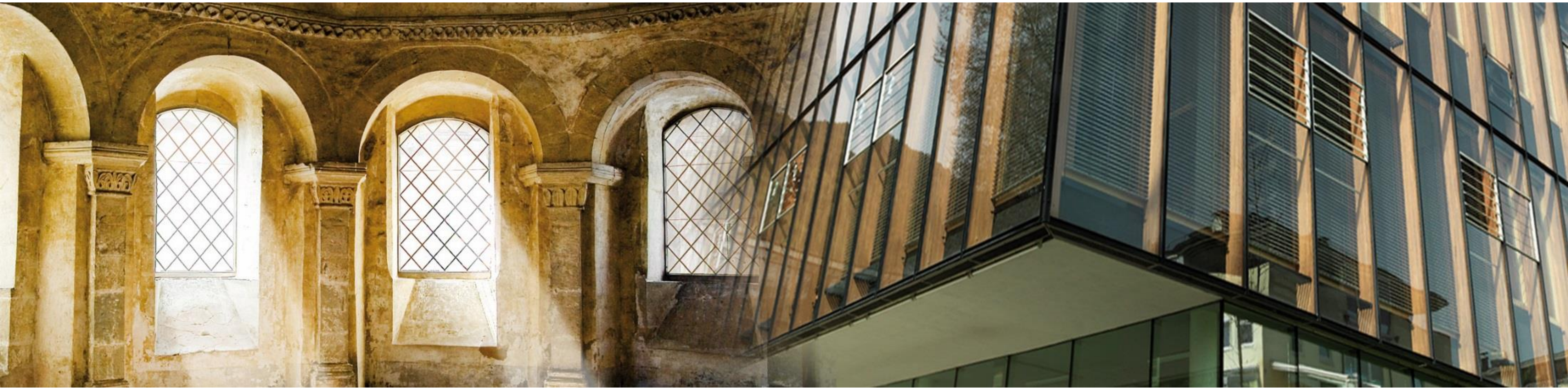
University of Applied Sciences Kufstein



The possibilities of external and internal succession from viewpoint of financial institutions

November 2015

Introduction and problem statement: Family business, succession and corporate crisis (1/2)

- Research concerning corporate crisis has now a long history and despite of this the crisis evolution process is **not fully understood** (*Krystek & Moldenhauer*, 2007, p. 40; *Situm*, 2015, p. 17).

- One potential approach to differentiate between **different stages** of crisis was provided by the IDW S 6 (*Institut der Wirtschaftsprüfer in Deutschland*, 2011).

- **Stakeholder crisis** (Stakholderkrise) = A situation, where different internal and external stakeholders are interacting and where potential conflics are manifested or already given (*Crone*, 2014, p. 5 – 6; *Portisch*, 2014, p. 10)

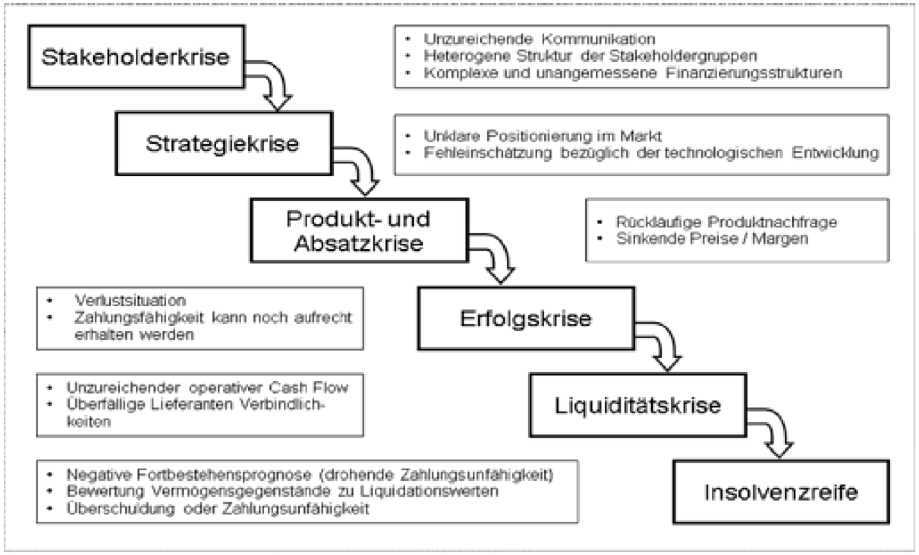

Stakeholderkrise
• Unzureichende Kommunikation
• Heterogene Struktur der Stakeholdergruppen
• Komplexe und unangemessene Finanzierungsstrukturen
Strategiekrise
• Unklare Positionierung im Markt
• Fehleinschätzung bezüglich der technologischen Entwicklung
Produkt- und Absatzkrise
• Rückläufige Produktnachfrage
• Sinkende Preise / Margen
Erfolgskrise
• Verlustsituation
• Zahlungsfähigkeit kann noch aufrecht erhalten werden
Liquiditätskrise
• Unzureichender operativer Cash Flow
• Überfällige Lieferanten Verbindlich-keiten
Insolvenzreife
• Negative Fortbestehensprognose (drohende Zahlungsunfähigkeit)
• Bewertung Vermögensgegenstände zu Liquidationswerten
• Überschuldung oder Zahlungsunfähigkeit

Figure 1. Crisis stages based on IDW S6
Source: Müller & Liebscher, 2012, S. 10.

- This is especially true for family business due to the given "**co-existence**" of the firm and the family (*Rüsen*, 2009, p. 48), which can not be in practice strictly divided (*Chua, James & Parmodita*, 2003; *Chua, Chrisman, & Chang*, 2004; *Craig & Lindsay*, 2002; *Craig & Moores*, 2006).

- As **disruptions** and **disputes** are given within families, a ongoing, an unresolved or even a implemented succession can be categorized into this type of crisis (*Burkart*, 2003).

Introduction and problem statement: Family business, succession and corporate crisis (2/2)

- Within the guide of Kammer der Wirtschaftstreuhänder (2010, p. 3) a **patriarchal management style** and a **missing succession planning** are explicitly named as indicators, which are signalling problems in management (*Rüsen*, 2009, p. 79; *Seefelder*, 2003, p. 54, *Filser, Kraus & Märk*, 2013).

- The transition to **strategic crisis** can be logically deducted, because at this stage success factors are affected and this is mainly driven by **indefinite strategic orientation**, an **inadequate business model** and/or steady **environmental changes** (*Crone*, 2014, p. 6).

- IDW S6 also names a **hazy positioning** on the market as a reason for this crisis stage. In family business these problems seem to be vacant, because a lot of studies showed that the "handling the business over" point often results out of **mental decisions** instead of concrete strategic analysed steps (*Filser, Kraus & Märk*, 2013; *Habig & Berninghaus*, 2004, p. 24; *Wiechers*, 2006, p. 195).

- The successor as well as the predecessor side have totally **different** kinds of **mental patterns**, but family business are often led using "day by day" decisions, manifested within shaky arguments to lead the business over generations and therefore to enlarge the strategic horizon over generations (*Astrachan*, 2010).

- Grounded on these definitions and factors an unsolved succession process, a succession process in progress or also an implemented succession process is associated with **higher risk** (*Dyer*, 2003; *Sharma, Chrisman & Chua*, 1996; *Sharma & Srinivas*, 2000; *Sharma & Irving*, 2005).

Introduction and problem statement: Family business, succession and financial institutions

- The role of financial institutions is given by the still high **dependence** of family business on debt financing (*Deutsche Industrie- und Handelskammer*, 2013, p. 16; *Simon*, 2012, p. 23). A succession changes the position of the financial institution in two important ways:
  1. The customer relationship manager of the financial institution faces a **new manager** and due to the **missing track record** it is not possible to evaluate the management quality (*Exler, Situm & Thurnbichler*, 2015, p. 207).
  2. The **security** situation changes as the old managers will demand **exemption** and financial institutions will receive new securities form successor, which may not be of that **high quality** (*Exler, Situm & Thurnbichler*, 2015, p. 207 – 208).

- From viewpoint of financial institutions the **risk** must be appraised like for a „new customer“: Why?
  1. Even if there is a **track record** about the performance of the firm and its association to management, this past knowledge may not be helpful for judging the new management any more (*Chemmanur, Paeglis & Simonyan*, 2009, p. 1051).
  2. Beside of this the **intentions** and management capabilities of the successor as well as the **quality** and intentions of the transferor shall be clarified (*Halter, Dehlen, Sieger & Wolter*, 2013, p. 42).

Conclusion:

Management quality is the **most important determinant** for the success of a firm. A weak management is in most cases the reason for corporate insolvencies (*Doumpos & Zopounidis*, 1998; *Jasra, Khan, Hunjra, Rahman & Azam*, 2011; *Pervan & Kuvek*, 2013, p. 194; *Spicka*, 2013).

Introduction and problem statement: Family business, succession, financial institutions and capital structure

- Increased risk is associated with additional **bankruptcy costs** caused by information asymmetry and adverse selection (*Byoun*, 2008, p. 3094). When this market imperfections is considered, then market prices are adjusted appropriately according to risk of default (*Almeida & Philippon*, 2008, p. 105; *Ang*, 1976, p. 555; *Morris*, 1982, p. 285; *Nissim & Penman*, 2005, p. 538 and 542; *Pindado, Rodrigues & de la Torre*, 2008, p. 379 – 381).

- Debt financing remains in Germany on of the **most important** financing sources family businesses (*Deutscher Industrie- und Handelskammertag*, 2013, p. 16) and according to the degree of leverage it is interesting to have knowledge about the actual cost of capital, because they are indirectly responsible for enterprise value. Firms seeking to optimize their capital structure must minimize their cost of capital (*Castanias*, 1983, p. 1617; *Nissim & Penman*, 2003, p. 538).

- For firms in crisis moving away from their optimal capital structure, it is difficult to come back to this point due to increased **adjustment costs** (*Drobetz & Wanzenried,* 2006, p. 942 – 944; *Liang & Bathala*, 2009, p. 7; *Pindado, Rodrigues & de la Torre*, 2006, p. 379 – 381). Implicitly this means that it is not possible to increase **enterprise value** in the short-term.

Conclusion:

A firm having an optimal capital structure during succession is **losing** its optimal capital structure (and destroys firm value) due to **increased bankruptcy costs** and is not in the position to come back in short-term due to **increased adjustment costs**.

Methodology and research questions

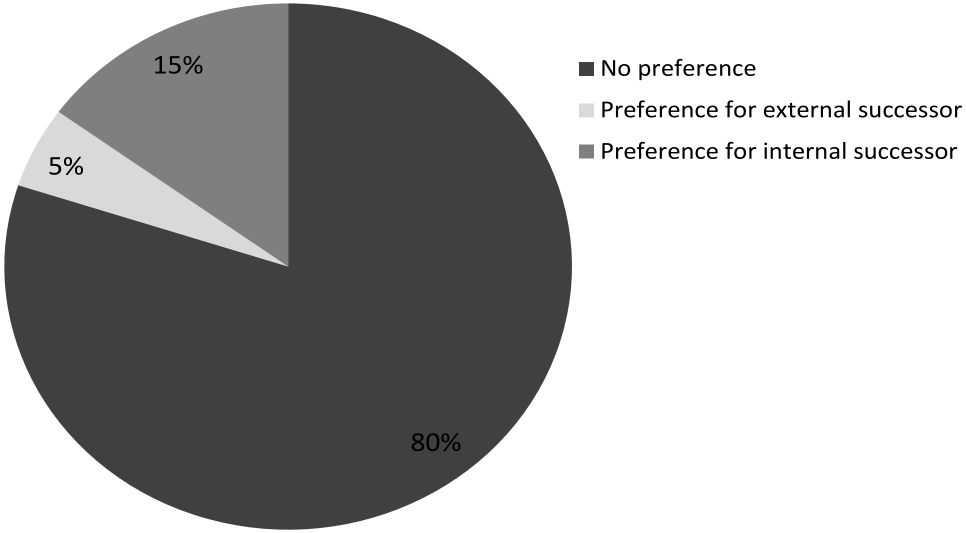
- Questionnaire sent to 215 financial institutions in Austria and Germany. **40** returned an filled questionnaires were received.

- Following questions were answered:
  - Preferences of financial institutions between **internal** and **external** succession
  - Association of potential **success factors** towards one of the two succession types
  - **Preferences** of financial institutions concerning internal and external succession for stable firms and firms in crisis
  - Relation between **requested** financing in context MBO/MBI and **approved financing**

- Beside of questions to be answered on a nominal scale at several questions the respondents had to assign the importance of chosen variables on an ordinal scale reaching from one (very attractive) to six (not attractive at all) for external and internal succession in family businesses. To assess, whether the preferences for certain types of external succession are statistically different for firm in distress and non-distressed a U-test on a five percent level was applied (*Ho*, 2006, p. 9).

Empirical results:
Preference between internal and external succession solutions

- 80 % of the respondents answered that there is **no** difference between the two types of succession concerning preference.
- This result is providing evidence that the origin of the successor is **not relevant** from viewpoint of financial institutions. The finding seems not surprising based on prior results, because one of the main reasons for bankruptcies is mis-management (*Spicka*, 2013, p. 165; *Whitaker*, 1999, p. 131 – 132).



- The reason for this result seems appealing as financial institutions cannot determine the **management quality** of the internal successor. The same problem appears for the external successor. The results would confirm the previously described problem of information asymmetry (*Chemmanur, Paeglis & Simonyan*, 2009, p. 1051).
- The results are interesting, because they do not cope with some proposals of literature concerning a successful succession. It is argued that untimely planning of the succession process is important to clarify potential conflicts within the family and to guarantee a successful succession (*Hacker & Schönherr*, 2007, p. 57; *Pinkwart, Kolb & Heinemann*, 2006, p. 106; *Rüsen*, 2009, p. 79).

Conclusion:

The results of this study provide evidence that within the succession process the financial structure of the firm should not be neglected and it needs more to convince financial institutions about the sustainable development of the firm, then only a premature succession.

Empirical results:
Potential success factors towards one of the two succession types

Success factors	Internal succession		indifferent		External succession	
	Σ	%	Σ	%	Σ	%
An established value system (culture, behavior) can be better continued (Baumgartner, 2009, p. 61; Huber, Kirchdörfer, Rotfuß & Schmidt, 2010, p. 133)	31.00	77.50%	9.00	22.50%	0.00	0.00%
Stronger acceptance of the successor by customers and suppliers (Alderson, 2011, p. 61; Suchy, Lueger, Forschauer & Nosé, 2012, p. 348)	21.00	52.50%	14.00	35.00%	5.00	12.50%
Stronger acceptance of the successor by employees (Alderson, 2012, p. 61; Majer, 2006, p. 70)	19.00	47.50%	14.00	35.00%	7.00	17.50%
Qualification of the successor (Education, Know-How) (Gleißner, 2006, p. 214; Groth, von Schlippe & Rüsen, 2012, p. 100)	2.00	5.00%	25.00	62.50%	13.00	32.50%
The information for financing (financial statements analysis, financial situation of the successor etc.) is prepared more professionally (Niggemann & Simmert, 2013, p. 107)	0.00	0.00%	23.00	57.50%	17.00	42.50%
There is less potential for conflicts between transferor and successor (Groth, von Schlippe & Rüsen, 2012, p. 100; Collins et al., 2012, p. 32)	5.00	12.50%	11.00	27.50%	24.00	60.00%
Transferor shows a higher willingness to give up management (Spelsberg, 2011, p. 64)	9.00	22.50%	10.00	25.00%	21.00	52.50%
Successor shows a higher will for succession (Ebner, 2011, p. 25; Groth, von Schlippe & Rüsen, 2012, p. 100)	5.00	12.50%	14.00	35.00%	21.00	52.50%

Conclusion:

Even if different success factors are associated towards the two succession types based on the assumptions of financial institutions, they are not are in majority indifferent between these two types based on the previous results.

Empirical results:
Internal and external succession solutions under distress

- **Distress** was defined based on § 23 (equity ratio lower than 8 %) and 24 (debt coverage period above 15 years) of Austrian reorganization law.

- The financial institutions had to assign their **preference** for selected succession types (*Arzac*, 2008, p. 262; *Habig & Berninghaus*, 2004, p. 104 – 105; *Weber*, 2009, p. 70 - 71; *Weitnauer*, 2003, p. 15) on a Likert-scale from 1 – 6 for two different economic situations of the firm. The differences between the assignments were all statistically significant on the 5 percent level based on U-test.

- The results were ranked by means. Following results were found:
  - For financially stable firms financial institutions preferred **MBO** over **succession by a manager** followed by a strategic investor.
  - For distressed firms the sale to a **strategic investor** is more interesting than MBI or MBO solutions.
  - In distress situation there is the danger of diminishing assets reducing collateral and increasing bankruptcy costs (*Herzog, Koziol & Thabe*, 2008, p. 727). Here the potential for **overpayment** exists (*Allert & Seagon*, 2007, p. 7; *Colley & Volkan*, 1988, p. 36; *Tearney*, 1973, p. 42).
  - MBO and MBI seem interesting as potential successor would not try the acquision, if they are not convinced about the future potential of the firm. It also can reduce **information asymmetry** *(Stahl & Hoffelner, 2003)*.

Conclusion:

As the ranking orders between the two economic situations of the firm are for all types of succession statistically significant on the 5 % level it can be assumed that the assignments are **not random**. They are rather replication the **risk view of financial institutions**.

Empirical results:
MBO/MBI financing in banking practice

- About 85 % of the respondents answered that less than 10 % of requested financing in case of succession activities are related to MBO/MBI situations. Effectively **less than 5 %** of these requested financing had been really granted.

- Even if the **importance of external succession** seems to increase based on actual studies (Philipp, 2012, p. 5), this aspect is not visible in the number of requested and granted credits.

- This may be attributable to the fact that the external successor needs to pay the enterprise value and for this a **private loan** is taken (Jütjen, 1992, p. 9). The repayment of the loan depends on the performance of the firms.

- In most cases the value of **securities** associated with the loan are low, so that the financial institution is facing and additional risk beside of the one already given on the entrepreneurial sphere.

Conclusion:
Even if MBO and MBI solutions could be an appropriate solution for successions, the percentage of granted credit obligations remains low. This is mainly attributed by the fact that successors need credit financing to pay the succession and this is amplifying the risk of financial institutions.

Final conclusions and limitations

- A preparation of an internal succession without **entrustment** concerning the leadership qualities of the successor towards he financial partner is useless from practical viewpoint

- As long as there is lack about knowledge concerning **management quality** financial institutions do not prefer the internal over external solutions in general.

- The findings are in contrast to the results that an **early integration** of the successor can create trust (*Freund*, 1998, p. 66 – 67) and that a **resolved** internal succession is improving the rating of the firm (*Frien*, 2006, p. 32 – 33). Family business are based on the IDW S6 always in a potential crisis.

- The preference concerning the external type of succession depends from viewpoint of financial institution on the economic and financial situation of the firm, which is clearly a **risk-based view** associated with the likelihood of bankruptcy costs. This aspect is especially relevant for situations, where leverage is high and this is the reason for higher interest charged by debtholders (Almeida & Philippon, 2008, p. 105; Ang, 1976, p. 555; Morris, 1982, p. 285; Nissim & Penman, 2003, p. 538).

- Actually **low number** of respondents. However, the quality of the respondents was quite good, because all of them were handling with **family business** within **different sizes**. Additionally, the respondents (credit managers and customers relationship managers) had mostly **several years** of experience, so that it can be assumed that the provided answers are replicating the reality quite well.

Recommendations for further research and hypothesis

- The integration of the view of financial institutions seems to be of relevance due to the dependence on debt financing. A decision for succession must consider the interest of financial institutions and for this several underlying factors are of relevance.

- The question is what must be done from perspective of successor, to convince financial institutions about the succession and to create trust, so that further financing is guaranteed?

- It is also not clear, which effect the succession process is having on the capital structure of the firms, its associated cost of capital and finally on the enterprise value.

HYPOTHESIS:

The capital structure before definitive succession must be "sup-optimal" and deviate form the optimal capital structure based on the trade-off theory of finance.

- If succession (in every types) is associated with risk (bankruptcy risk), then financial institutions will charge **higher risk premium** in order to be compensated for this risk.
- This increases the **average cost of capital**, creates a deviance form **optimal capital structure** and **destroys firm value**.
- A movement towards optimal capital structure is difficult due to high **adjustment costs**.
- To prevent from this occurrences, within succession a **"sub-optimal" capital structure** must be prepared, which is then after compensation for risk "automatically" moving towards optimal capital structure.

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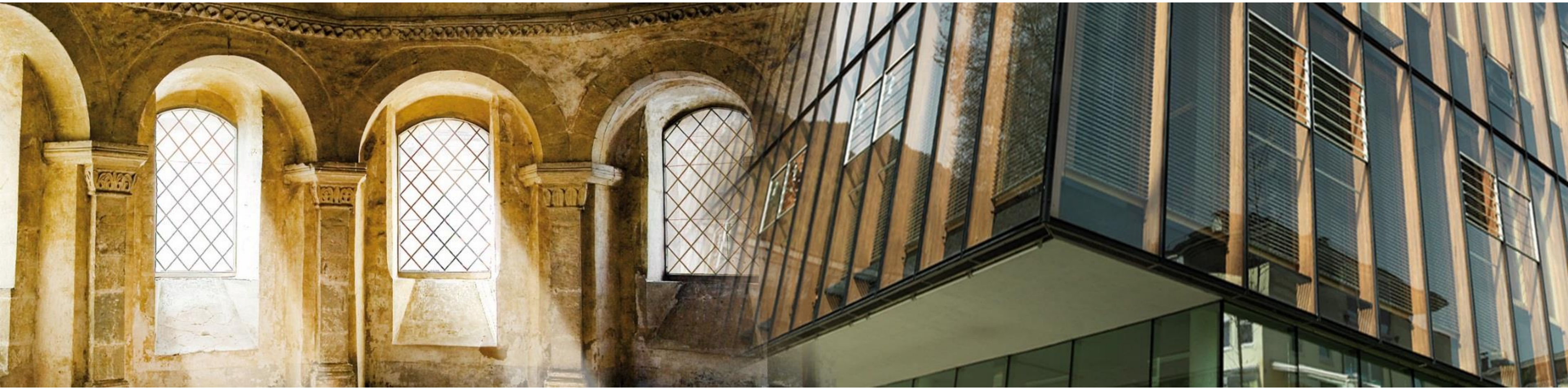
Contact data



Prof. (FH) Dr. Dr. Mario Situm, MBA
Institute für Corporate Restructuring
University of Applied Sciences, Kufstein
Andreas Hofer Straße 7 | 6330 Kufstein
mario.situm@fh-kufstein.ac.at
http://restrukturierung.fh-kufstein.ac.at

Dr. Stefan Märk
Senior Lecturer Entrepreneurship & Family Business
University of Applied Sciences, Salzburg, Austria
stefan.maerk@fh-salzburg.ac.at
http://fh-salzburg.ac.at

Backup I – Rank order of preferences and differences

Rank order of preferences for external succession for distressed and non-distressed firms

Rank	Non-distressed firm	Ø	Distressed firms	Ø
1	MBO	1.8000	Strategic investor	1.8000
2	Employed manager	2.0250	MBI	2.4750
3	Strategic investor	2.2000	MBO	2.9250
4	EBO	2.7750	Employed manager	3.1500
5	MBI	2.8250	Financial investor	3.2750
6	Financial investor	4.1250	EBO	3.4500

Test for statistical differences in rank orders based on U-test

Succession type	Type of firm	Mean	Median	Std.-Dev.	Mann-Whitney-Test
Employed manager	non-distressed	2.0250	2.0000	0.9470	0.0001
	distressed	3.1500	3.0000	1.2920	
Financial investor	non-distressed	4.1250	4.0000	1.2023	0.0014
	distressed	3.2750	3.0000	1.2192	
Strategic investor	non-distressed	2.2000	2.0000	1.0670	0.0373
	distressed	1.8000	1.5000	1.0178	
MBO	non-distressed	1.8000	2.0000	0.6485	0.0000
	distressed	2.9250	3.0000	1.1183	
MBI	non-distressed	2.8250	3.0000	0.9578	0.0407
	distressed	2.4750	2.0000	1.0374	
EBO	non-distressed	2.7750	2.5000	1.3105	0.0188
	distressed	3.4500	4.0000	1.3765	

Backup II – MBO/MBI financing in banking practice

Proportion of requested and granted MBO/MBI financings for family businesses

	Category	Absolute frequency	Relative frequency	Cumulated relative frequency
Requested financing	less than 3 %	8	20.00%	20.00%
	> 3 % and < 5 %	14	35.00%	55.00%
	> 5 % and < 10 %	12	30.00%	85.00%
	more than 10 %	6	15.00%	100.00%
Granted financing	less than 1 %	5	12.50%	12.50%
	> 1 % and < 3 %	21	52.50%	65.00%
	> 3 % and < 5 %	10	25.00%	90.00%
	more than 5 %	4	10.00%	100.00%

Backup III – „Sub-optimal“ capital structure

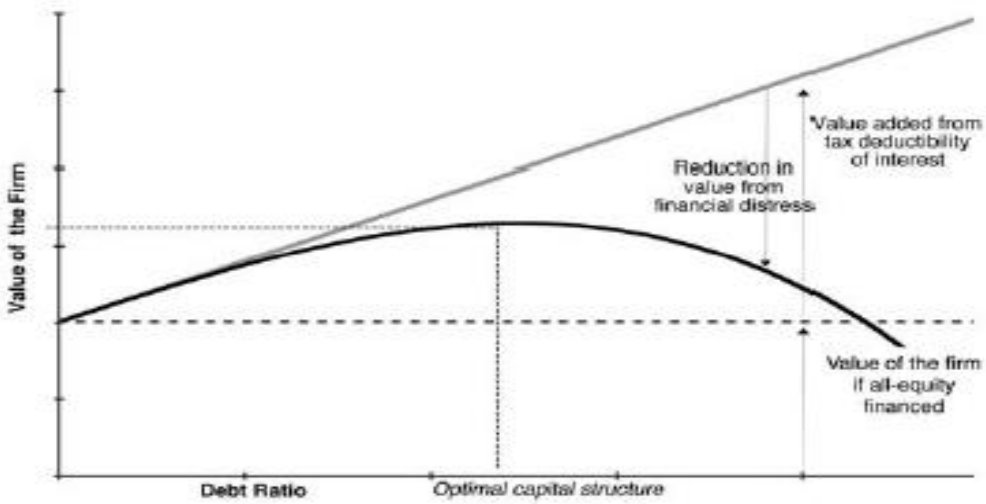


Figure 2. Capital structure and its effect on the enterprise value
Source: Fabozzi & Peterson, 2002, p. 615.

- The optimal capital structure is reached at the point, where the **slope** of the function for the enterprise value is **zero**.
- At that point the **tax benefits** are offset by the **bankruptcy** (and agency) **costs** (*Myers*, 1993, p. 82).
- Whenever this balance is not given, a firm is having a sub-optimal capital structure and it is associated with a lower enterprise value. In these cases the slope of the function must be higher or lower than zero.

- A firms out of optimal capital structure can come back to this point by adjustment of capital structure and associated costs. However, adjustment is costly and especially for firm in distress **much more costly**, so that it is **difficult** to move towards optimal capital structure (Drobetz & Wanzenried 2006, p. 942 – 944; Liang & Bathala 2009, p. 7; Pindado, Rodrigues & de la Torre 2006, p. 379 – 381).
- In order to avoid this problem a “**sub-optimal**” capital structure (with a slope of higher/lower than zero) must be chosen before succession, so that after all of the incurred costs the capital structure moves automatically towards optimal point. It also means that before succession the firm must destroy some of its enterprise value.