ie business school

BancaMarch

Corporate Governance in Publicly Traded Family Firms

III BANCA MARCH - IE REPORT

EXECUTIVE SUMMARY

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Dear Reader,

This year, the III Banca March-IE Business School Family Business Report is about corporate governance. Undoubtedly, one of the areas where more emphasis is being put by investors, especially for its implications on the viability of enterprises in the long-term.

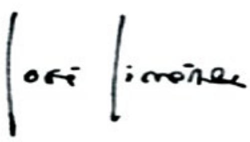
The report compares Corporate Governance initiative of European companies versus American companies. To this end, it is analyzed more than 1,100 companies from seven countries in the period 2008-2013, collecting the full impact of the global economic crisis.

In the other hand, late last year we celebrated the third anniversary of the launch of our fund The Family Businesses Fund, which aims to invest in family firms listed globally, with a philosophy of value where the analysis of corporate governance is an essential component. Since its launch until May 2015, the fund cumulative return amounted to 63%, becoming the most profitable investment strategy of March AM.

I would also like to take this opportunity to thank the excellent research of professors Cristina Cruz and Lucia Garcés, as well as the other teachers of IE Business School who have participated. Without their effort and dedication it would not have been possible to know more about the reasons that make family businesses outperformance non family businesses ones.

We truly hope this report would be of your interest.

Yours faithfully,



José Luis Jiménez Guajardo-Fajardo
Chief Executive Officer, March Asset Management

Corporate Governance in Publicly Traded Family Firms

MARCH A.M.
BancaMarch

MARCH ASSET MANAGEMENT

March Asset Management is Banca March's asset management division. With over €1.9 billion and a team of 25 professionals, its investment philosophy involves creating value while protecting wealth. Its main areas of expertise are global equity and asset allocation. MAM has received numerous awards for its management over recent years.

BancaMarch

BANCA MARCH

Banca March is one of Spain's leading financial groups, with one of the highest solvency ratios in Europe (26% of Core Capital). In 2010 and 2011, it was number 1 in the European banking stress tests, according to the Committee of European Banking Supervisors. It has also been named Best Private banking in Spain by World Finance in 2010, 2011 and 2012. Banca March is a family company specialized in private banking, corporate banking and asset management.

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IE BUSINESS SCHOOL

IE Business School trains leaders who go on to promote innovation and change in organizations. Recognized as one of the world's leading business schools, IE Business School has an urban campus in Madrid as well as centers on all five continents. It has a faculty of more than 400 professors who teach students from 93 countries on its masters, PhD and executive education programs. IE Business School develops online and classroom learning methods which benefit the School's network of communities, made up of 40,000 graduates holding positions of responsibility in more than 100 countries.

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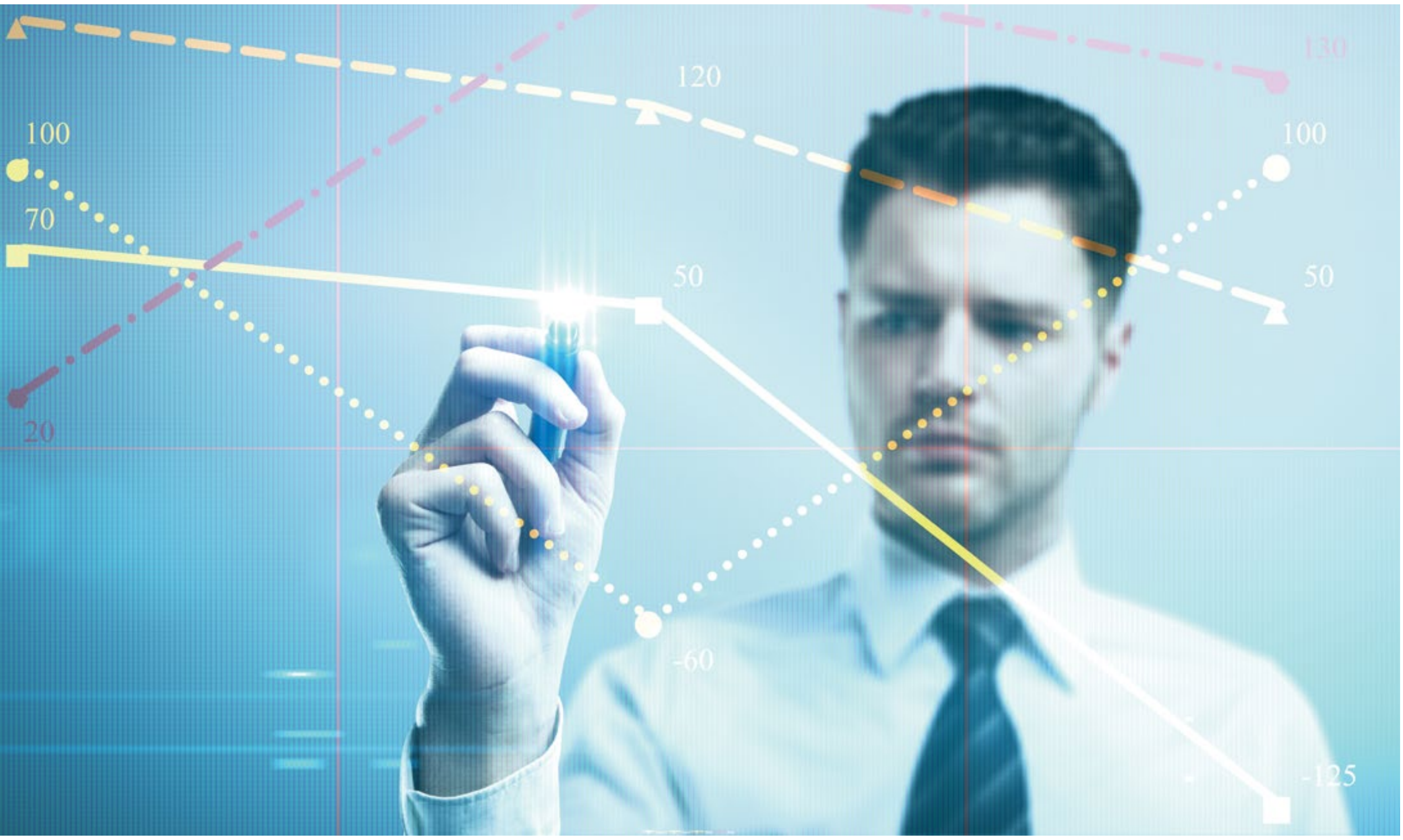
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Why a report on corporate governance in publicly traded family firms?

"There are two types of family businesses: those that recognize the need to implement mechanisms of internal governance to mitigate agency problems they face, and others that do not. The adoption of said mechanisms can explain why some companies prosper while others disappear."

W. Schulze 2001

The recent financial crisis has heightened awareness among stakeholders toward the importance of corporate governance in publicly traded companies. This is borne out by the proliferation of corporate governance initiatives in many countries, on the one hand prompted by obligatory compliance with company law, and on the other by recommendations contained in voluntary codes of good governance. All these initiatives are rooted in the belief that management of traded companies should be carried out responsibly, efficiently, and transparently with the aim of earning the trust of shareholders, as well as maximizing value creation, and that corporate governance is the key instrument to attaining this goal.

Family firms (FF) that are traded on stock exchanges cannot, nor should not, be immune to this trend. Regardless of their origin, corporate governance codes establish their area of activity as "the group of traded companies, independent of their size and level of capitalization[1]: thus making no distinction on the basis of the property structure of the company.

In previous Banca March-IE reports[2] we have highlighted the importance of family firms in the stock exchanges, as well as identifying the distinctive features that contribute to the existence of a "family premium", or to put it another way, the increased profitability of traded companies controlled by a family group. That said, we have also warned of the risks associated with family control that can damage the image of family firms and their competitiveness. The III Banca-March Report is born out of the belief that many of these risks could be mitigated by improving the corporate governance structures of listed FFs.

1 Código de Buen gobierno de las Sociedades Cotizadas. http://www.cnmv.es/DocPortal/Publicaciones/CodigoGov/Codigo_buen_gobierno.pdf
2 Cruz, C. and Letamendia, L. (2013). La creación de valor en la COMPANY Familiar Cotizada Europea. I Informe Banca March-IE
Cruz, C. and Letamendia, L. (2014). El "family Premium" en la COMPANY familiar cotizada. II Informe Banca March-IE

Figure 1 sums up the advantages and disadvantages of listed FFs in terms of corporate governance. Despite the positive effects of family control, the financial markets and different stakeholders are aware of the associated risks of less protection of minority shareholders and a management approach that on occasions can be overly personal and that is not always fully aligned with the objective of creating value. This is why family firms are required to be more transparent and to have higher corporate governance standards than other companies. If a family business wants to continue creating value in increasingly competitive and global stock markets, it needs to be able to respond to these demands through the implantation of efficient governance mechanisms and the adoption of many of the recommendations included in good governance codes.

Figure 1. Advantages and disadvantages of family firms on corporate governance

POSITIVE ASPECTS	NEGATIVE ASPECTS
• Commitment to business project • Long-term vision • Separation of interests between owners and directors	• Nepotism • Lack of meritocracy • Primacy of control over meeting financial objectives
• Greater importance of extrinsic compensation systems, based on motivation • Greater efficiency of supervision mechanisms, due to less asymmetric information	• Less efficient internal control mechanisms due to family ties between parties • Less efficient external control mechanism due to family control over the company
• Less risk of conflicts of interest between shareholders and managers • Less risk of opportunism by managers	• Greater risk of conflict between family and minority shareholders • Greater risk of adverse hiring. Difficulty in attracting external talent and disciplining family executives

Source: IE, based on reports of corporate governance in family businesses

Objectives of the III Banca March-IE Report

Thus, the first objective of the III Banca March-IE Report is to analyze to what extent listed FFs are actually following good governance recommendations. At the same time, the report aims to analyze what sets these companies that have decided to adopt good governance codes, as well as how these recommendations are impacting on value creation in family firms. In short, the report aims to answer the following questions:

OBJECTIVE 1	Current state of corporate governance in FF compared to non-FF
OBJECTIVE 2	Why do FFs have lower corporate governance scores?
OBJECTIVE 3	What characteristics of listed FFs improve their corporate governance?
OBJECTIVE 4	Does good corporate governance increase the profitability of a FF?
OBJECTIVE 5	Which are the best FFs in terms of corporate governance?

Sample of III Banca March-IE Report

To meet these objectives, the III Banca March-IE Report carried out a quantitative analysis of corporate governance between 2008 and 2013 on a sample of 1,127 publicly traded companies in the United States and Europe:

2 GEOGRAPHIC ZONES / **7** COUNTRIES	**1127** LISTED COMPANIES	TIME FRAME **6 YEARS**
US, UK, France, Italy, Spain, Germany, Switzerland	**23,6% (265)** family firms **76,4% (861)** non-family firms	Period: **2008 - 2013**

How do we measure corporate governance?

The III Banca March-IE Report measures the good corporate governance of traded companies using indicators created by specialist companies that collected data on corporate governance, turning it into scales that allow for comparison between companies. In this case, both indices use a scale of 0 to 100. The indices also offer a corporate governance score of companies that analyze in subdimensions that reflect different aspects of corporate governance, as outlined below:

CSRHUB™

Overall level: CSRHub

CATEGORY

Board of directors: efficacy of a company in following the best practices in relation to corporate governance principles applicable to the board of directors.

Ethical leadership: This measures how a company manages its relationship with different interest groups, including investors, clients and regulators, as well as the efficiency of the company in treating shareholders and employees equitably.

Transparency: Policies and practices aligned with sustainability goals, including to what extent the management of the company is transparent for its stakeholders.

ASSET4

Overall level: ASSET4

CATEGORY

Functioning of board of directors: Whether a company's board has assigned the relevant committees with clearly defined tasks and responsibilities.

Composition of board of directors: Whether a company's decision-making processes are carried out by a board that is independent, diverse, and made up of members with proven professional experience.

Remuneration policies: Whether a company can attract and retain executives and board members by paying them the right amount.

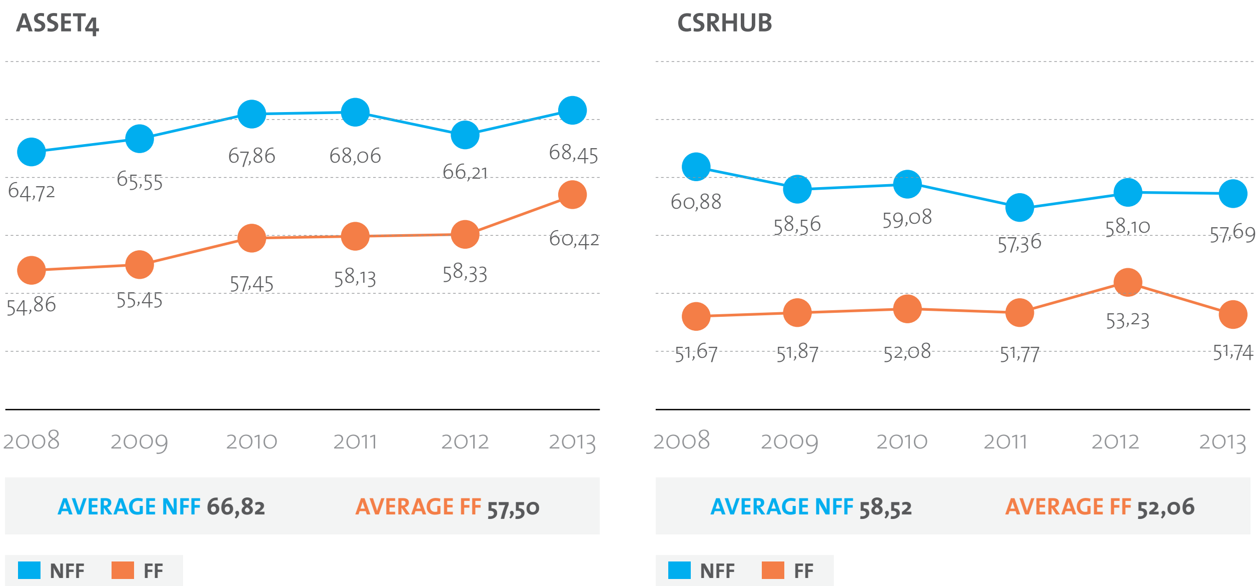
Shareholder rights: Whether a company can attract and retain minority shareholders, assuring them of equal rights, and limiting the presence of mechanisms to prevent takeover bids.

OBJECTIVE 1. Current situation of corporate governance in FFs compared to NFFs

FFs have lower overall corporate governance levels than NFFs over the period under review (2008-2013).

Nevertheless, FFs are evolving positively, and differences in levels have reduced over the six-year period, particularly in the case of ASSET4.

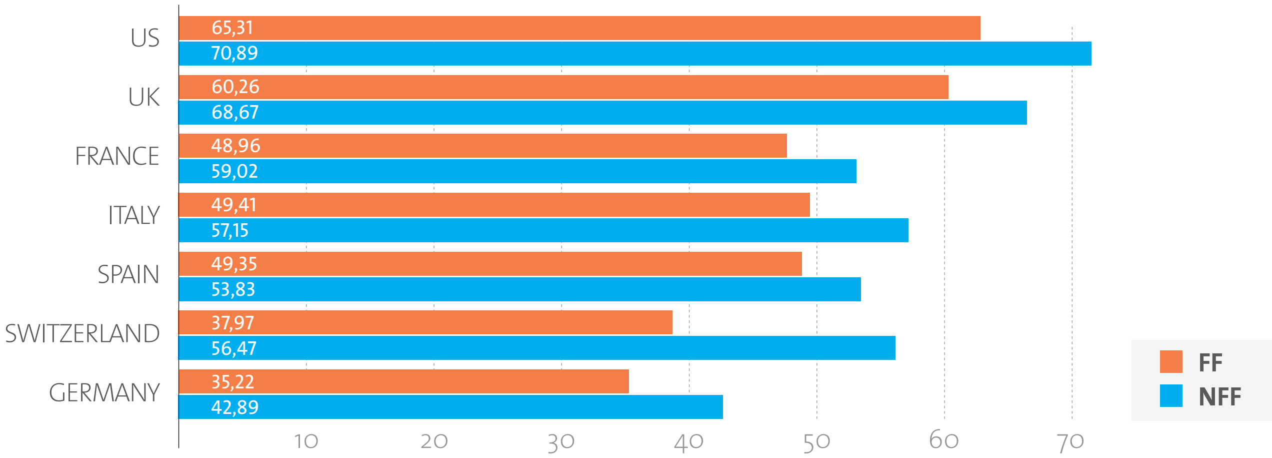
Graphic 1a and 1b. Evolution over time of corporate governance indices



The differences in overall corporate governance levels between family firms and non-family firms are much more striking in Europe than in the United States.

Except in the case of the United Kingdom, where corporate governance is better than in the rest of Europe, in all countries surveyed, the European family firms has lower corporate governance levels than in the United States.

Graphic 2. Corporate governance index by country

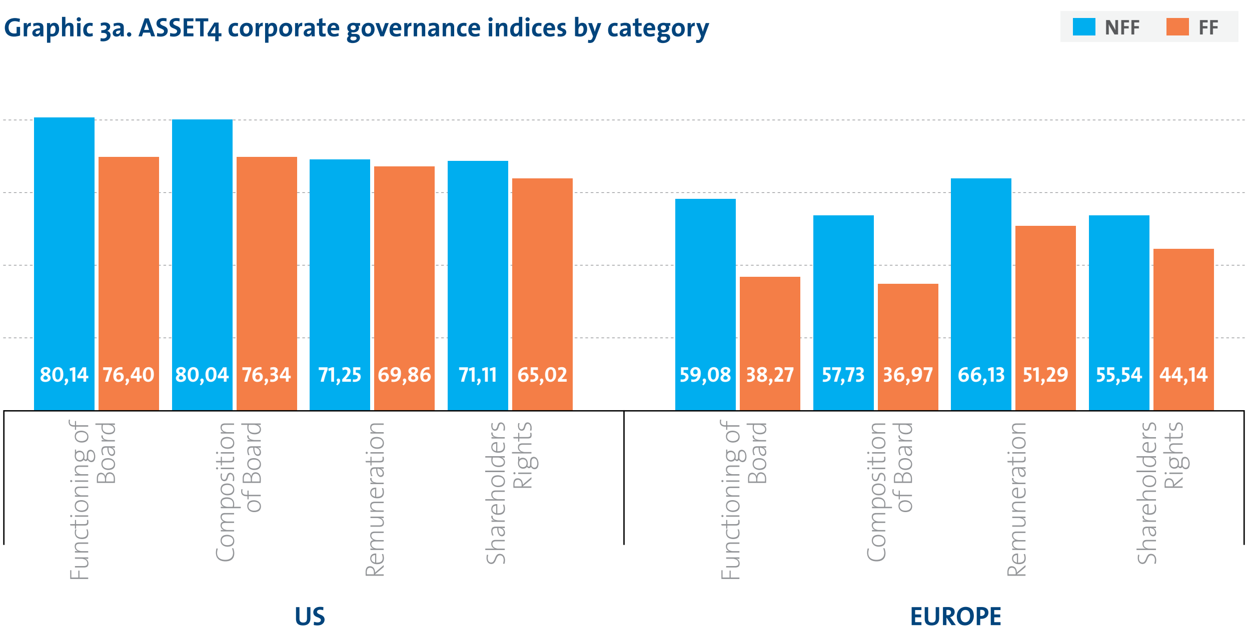


OBJECTIVE 2. Why do FFs have lower corporate governance levels?

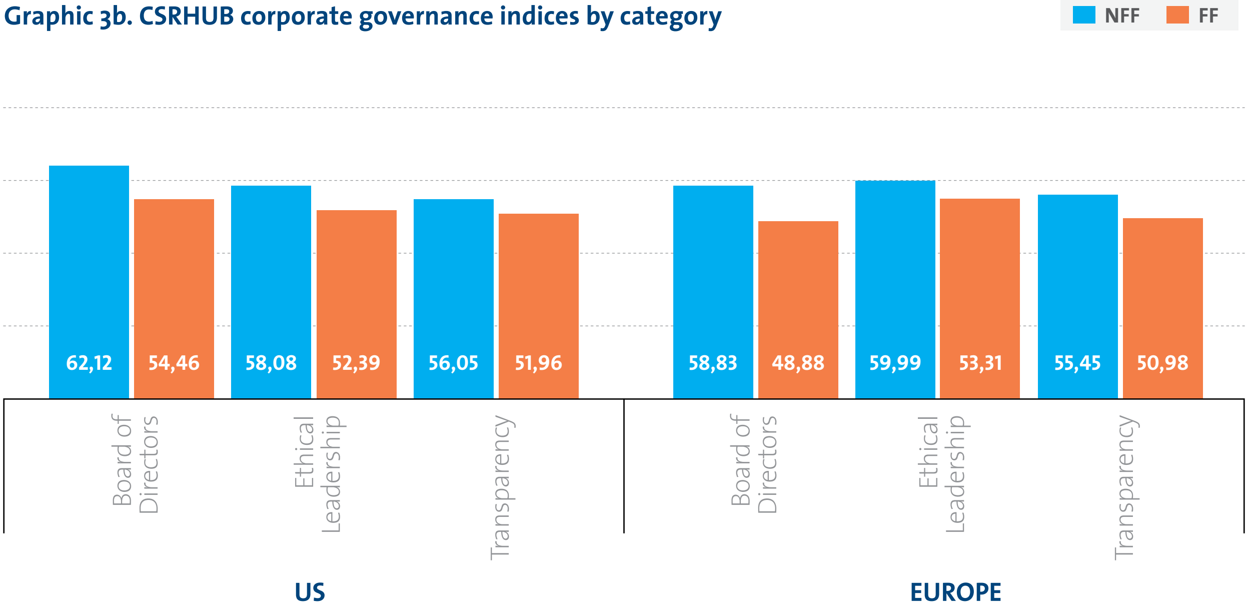
FFs have lower corporate governance levels to NFFs in all aspects, and once again, more strikingly in Europe.

In both cases, the main differences between FFs and NFFs are related to the functioning and composition of the board of directors, where FFs score lower.

Graphic 3a. ASSET4 corporate governance indices by category



Graphic 3b. CSRHUB corporate governance indices by category



Category 1. Recommendations relative to functioning of board of directors

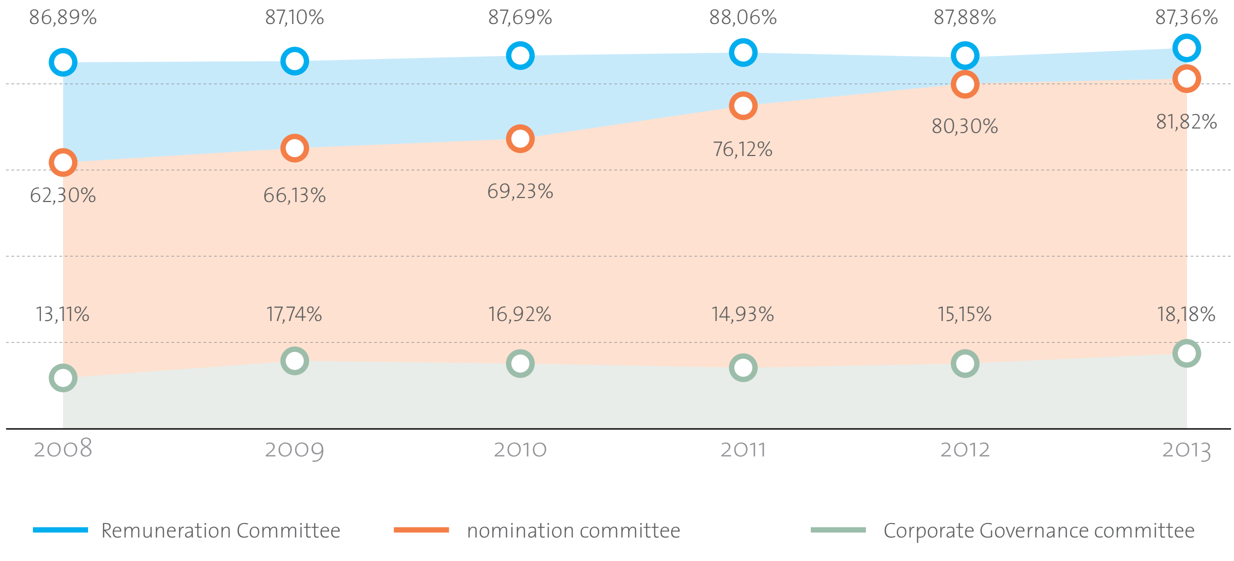
In FFs, the degree of compliance of good governance recommendations relating to the functioning of boards of directors is evolving favorably, although it continues to be lower than the levels reached by NFFs:

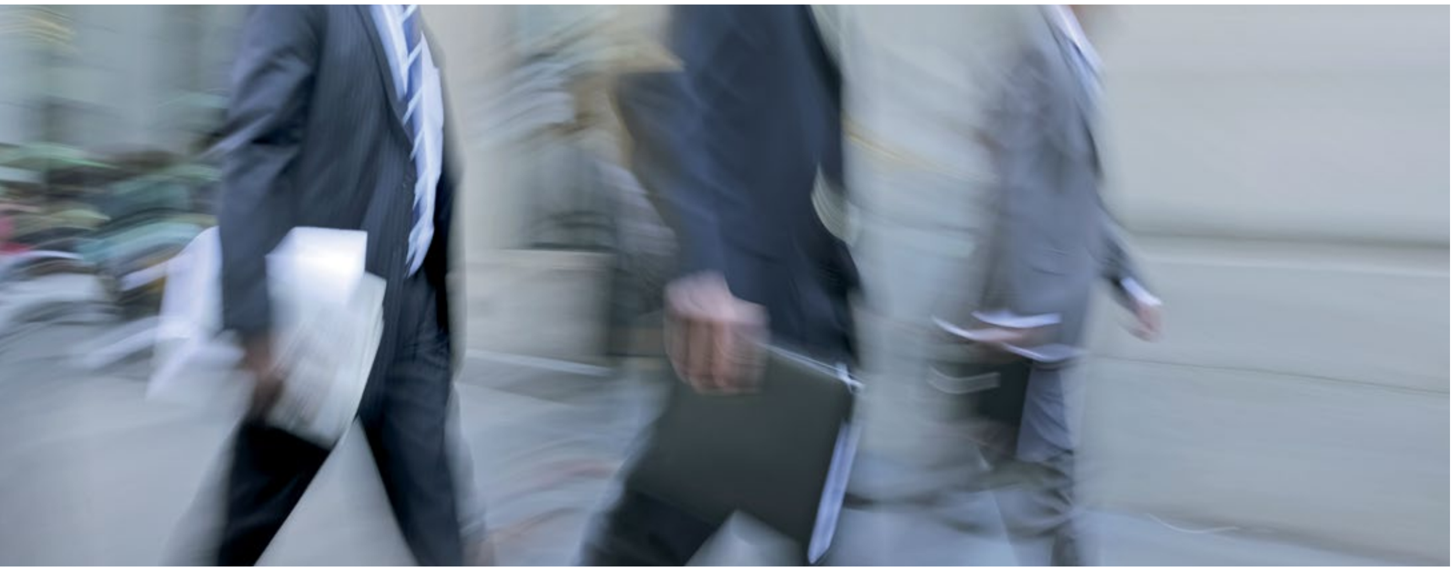
- The existence of corporate governance and nomination committees is less frequent in FFs. These differences are more striking in Europe.
- European FFs are making efforts in this regard, and greater numbers of FFs are choosing to set up these committees as part of their corporate governance.

Table 1. Firms with corporate governance nomination and remuneration committees by country

	FF EUROPE	NFF EUROPE	FF US	NFF US
Corporate Governance committee	16%	22%	92%	99%
Nomination committee	72%	95%	96%	99%
Remuneration Committee	87%	96%	100%	100%

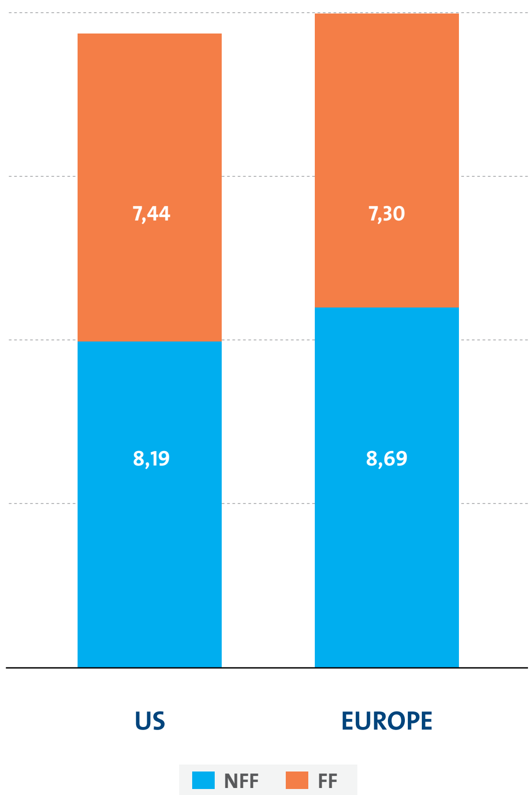
Graphic 4. Evolution of percentage of European FFs with nomination, remuneration and corporate governance committees



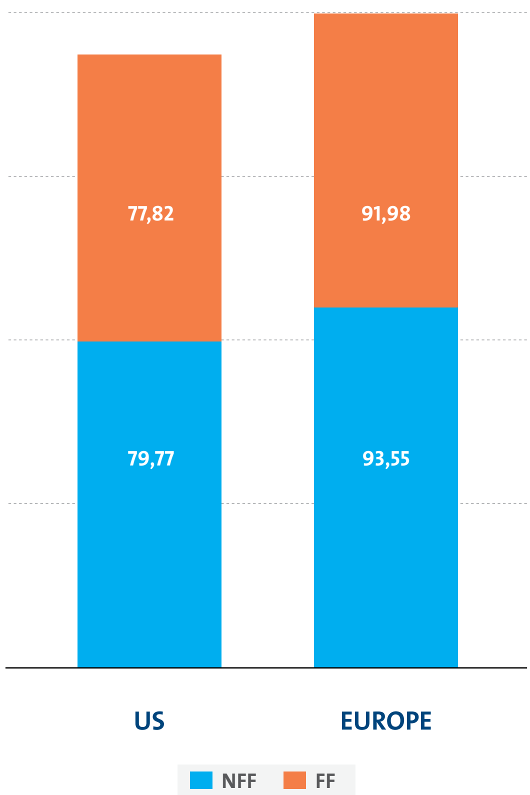


- The board meets on average 8.4 times in the case of NFFs, compared to 7.3 in the case of FFs. The differences between the United States and Europe in this case are not very significant.
- The average attendance of directors at board meetings is higher in the case of Europe than the United States, both for FFs and NFFs. Some 92% of directors attend board meetings of FFs in Europe, compared to 77% in the case of NFFs.

Graphic 5. Board meetings per year



Graphic 6. Average attendance at board meetings (%)

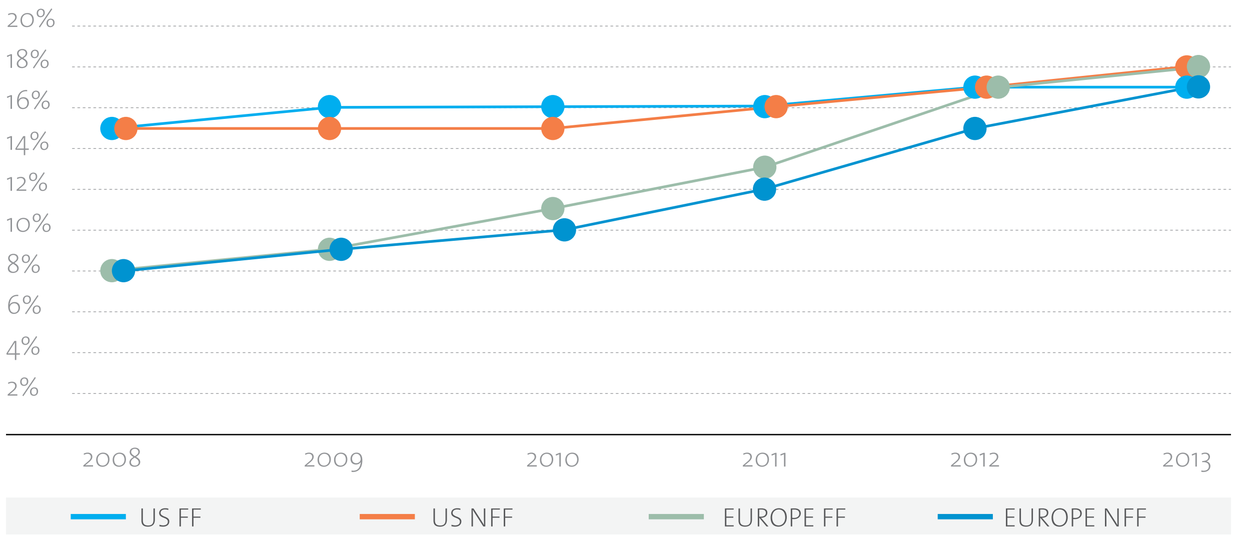


Category 2. Recommendations regarding the composition of the board of directors

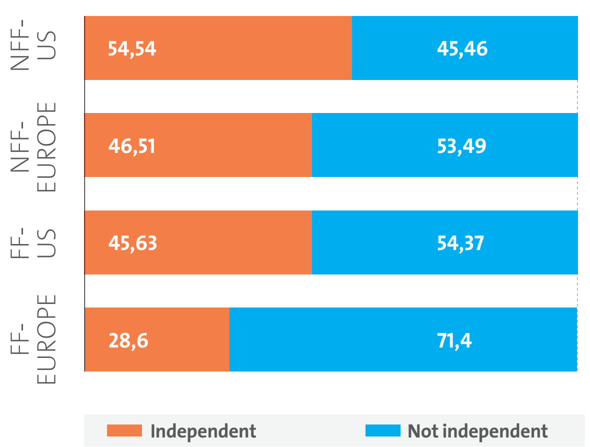
The level of compliance with good governance recommendations regarding boards of directors is also evolving positively, although at the same time, the level of European FFs is below the others.

- The percentage of women on boards is evolving favorably, above all in the case of European FFs and is around 17 percent for 2013.
- The percentage of independent directors is much lower in European family firms than in the United States (28.6 compared to 45.63 percent).
- The duration of a director's mandate is longer in FFs. On average, a director sits on a board for 10 years in an FFs compared to seven years in an NFFs. The differences between Europe and the United States are no significant in this area.

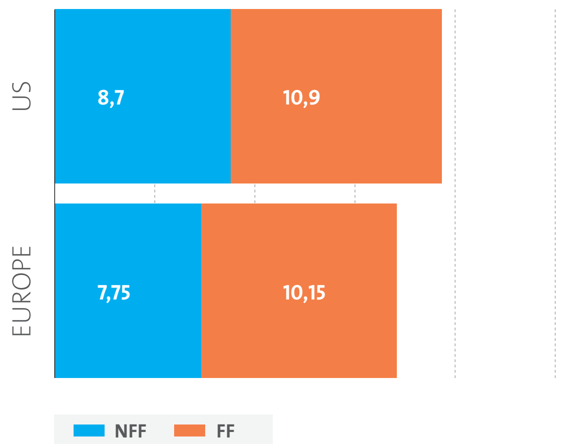
Graphic 7. Evolution of the percentage of women on boards of directors



Graphic 8. Independent board directors (%)



Graphic 9. Board of directors tenure

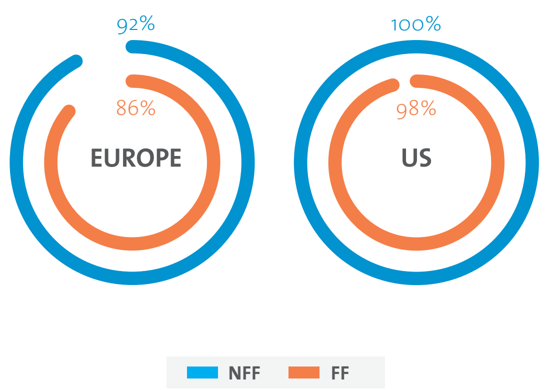


Category 3. Corporate governance recommendations in relation to remuneration policies

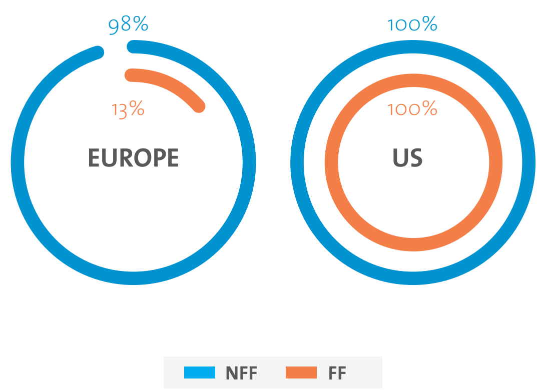
- **The degree of compliance in relation to remuneration in European FFs is lower than the rest of the firms in the sample, although the tendency here is positive as well:**

- Only 13 percent of European FFs report on the implementation of director remuneration policies, compared to 100 percent of US firms. This percentage has improved by 3% over the period under survey.
- The number of European FFs with performance oriented remuneration policies also increases by 8% (from 81% in 2008 to 89% in 2013), although the average (86%) continues to be much lower than the rest.

Graphic 10. Percentage of firms with performance oriented remuneration



Graphic 11. Percentage of firms that report on implementation of director remuneration policies



Category 4. Corporate governance recommendations in relation to shareholder rights

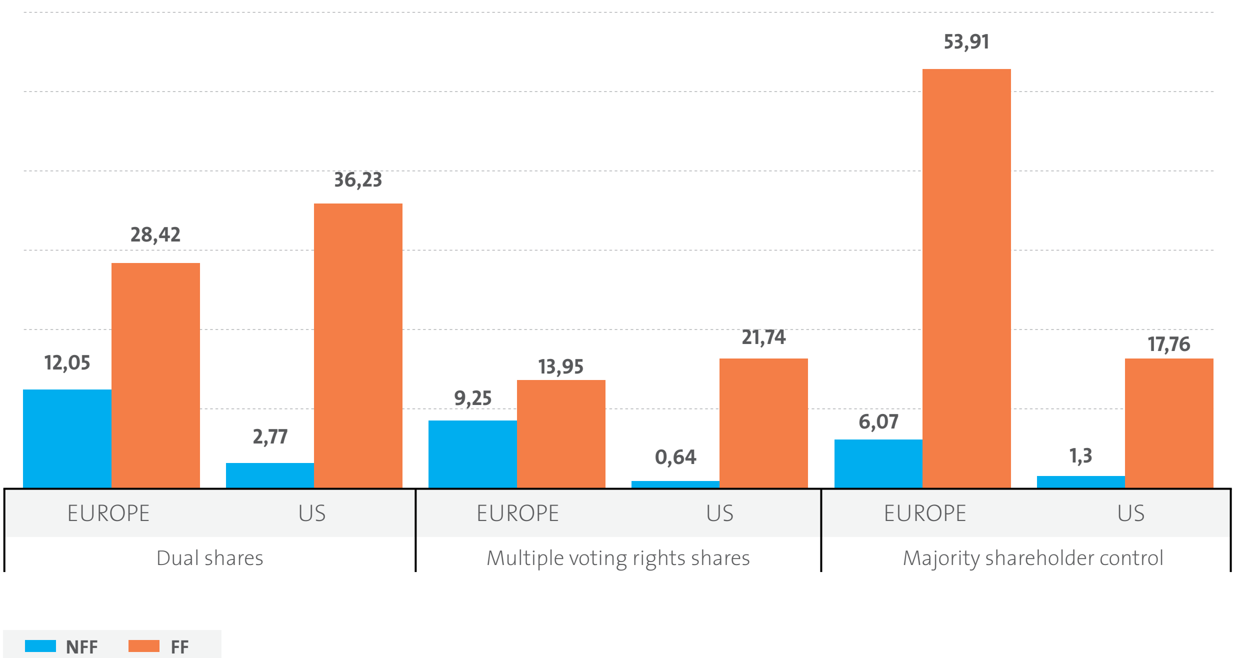
The evolution of compliance levels relating to shareholder rights is not consistent:

On the one hand, there is an increase in the number of family firms that show they have policies to guarantee the application of the principle of one share one vote, although the percentage is lower in NFFs (75% of FFs vs. 94% of NFFs). At the same time, the use of shares with different voting rights by the FFs increases during the years being surveyed, and is common in both US and European FFs.

Table 2. Percentage of firms with a one-share, one vote policy.

	TOTAL	EUROPE	US
FF	75,29	75,19	75,36
NFF	94,6	87,8	99,1

Graphic 12. Firms with dual shares, shares with multiple voting rights, and veto rights of main shareholder (%)

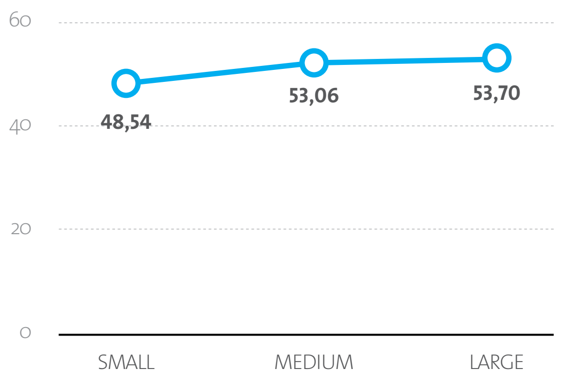


OBJECTIVE 3. What characteristics of listed family firms improve their corporate governance?

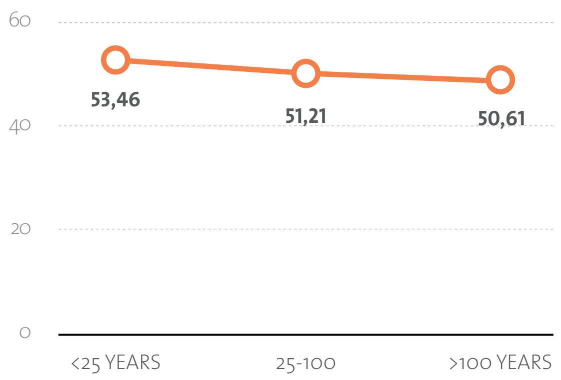
EFFECT on corporate governance

SIZE	+	The biggest FFs have better levels of corporate governance (Graphic 13)
AGE	–	The oldest FFs have the worst corporate governance levels (Graphic 14)
PRESENCE OF FOUNDER	+	FFs where founder is present have better corporate governance levels (Graphic 15). Of these, companies where there is no other family member on the board have better levels.
% FAMILY CONTROL	–	FFs where the family owns more than 60% of the capital have the lowest levels of corporate governance (Graphic 16)
FAMILY LEADERSHIP	–	FFs where the CEO is a family member have lower levels of corporate governance compared to those where the CEO is a non-family member (Graphic 17)

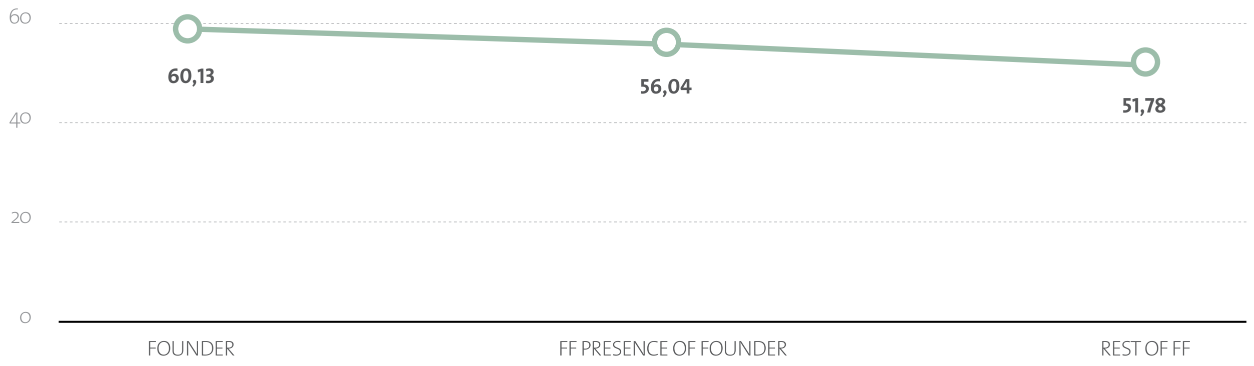
Graphic 13. Index of corporate governance by size



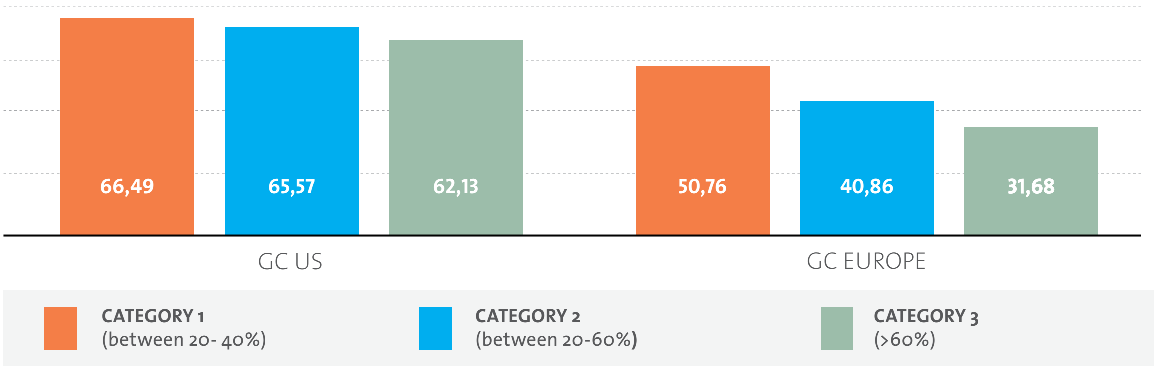
Graphic 14. Index of corporate governance by age



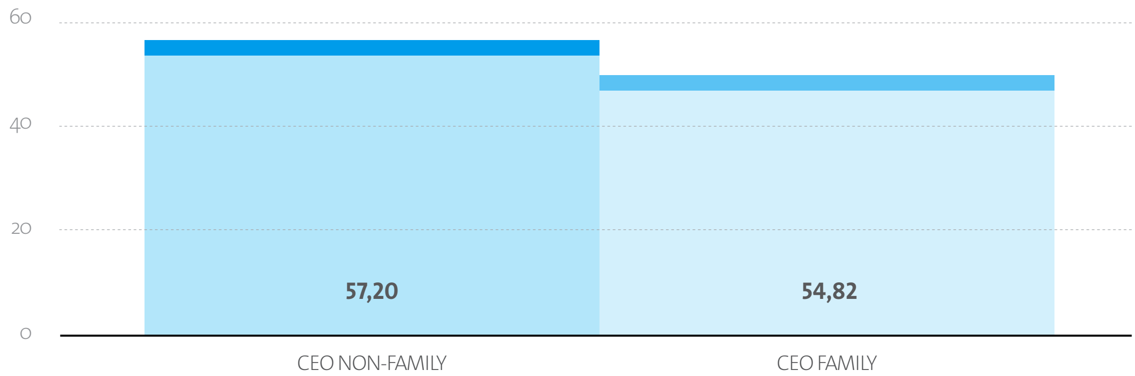
Graphic 15. Index of corporate governance by presence of the founder



Graphic 16. Index of corporate governance by family ownership



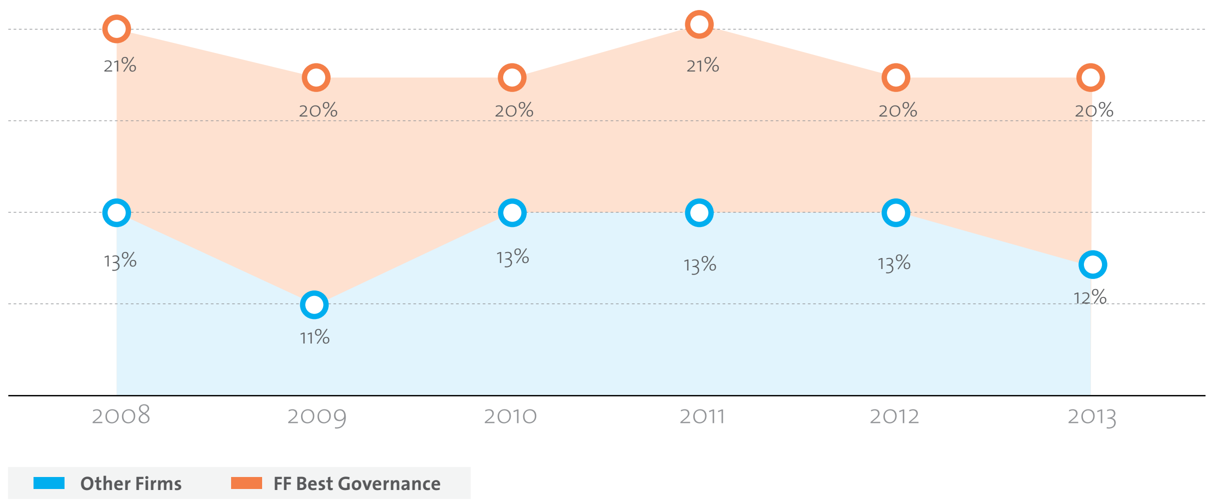
Graphic 17. Index of corporate governance: CEO family and non-family CEO



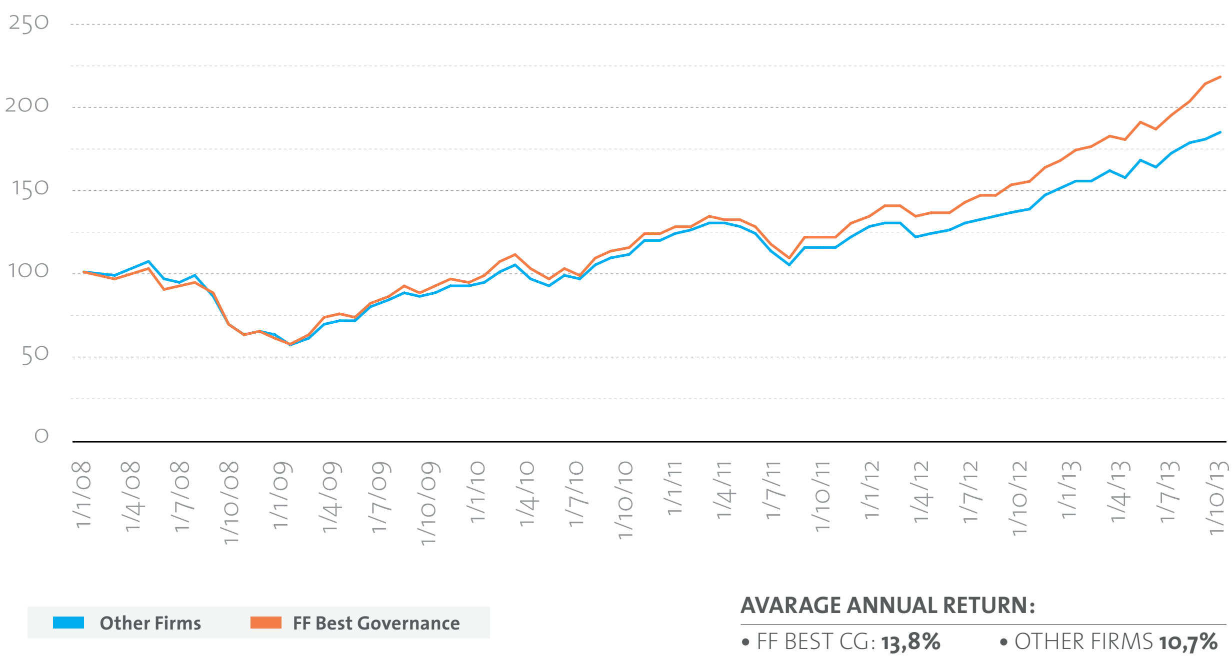
OBJECTIVE 4. Does good corporate governance influence profitability in a family firm?

Good corporate governance contributes to increasing the "family premium". FFs with the best governance attained higher returns than the rest of the firms in the sample (stock market profitability of 13.8% compared to 10.7%; ROA of 20% compared to 12%).

Graphic 18. ROA in FFs with best governance compared to others



Graphic 19. Stock market profitability in FFs with best governance compared to others

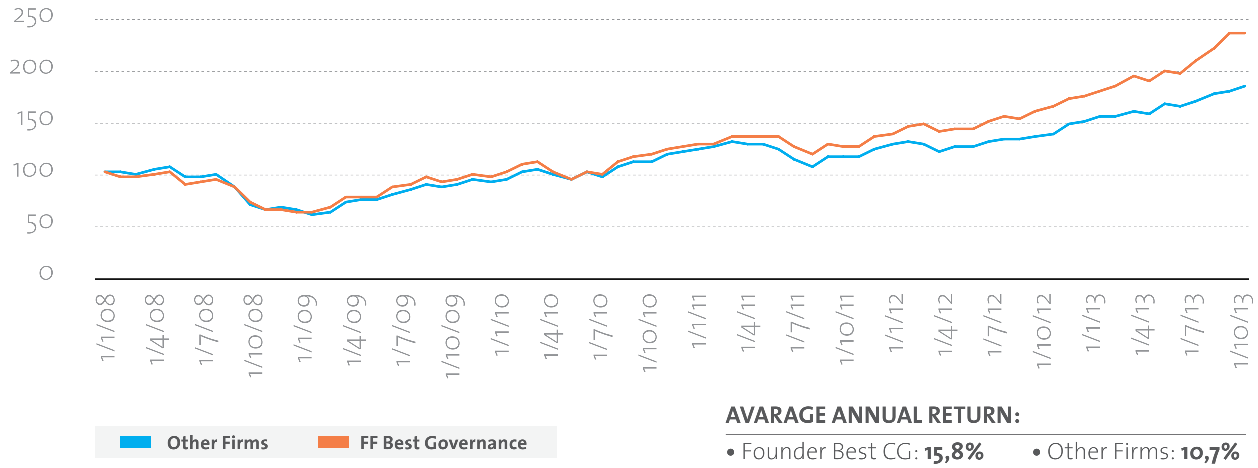


AVARAGE ANNUAL RETURN:

• FF BEST CG: **13,8%** • OTHER FIRMS **10,7%**

Good corporate governance helps boost the "founder premium". Companies still run by their founder were 5.6 points more profitable than the rest of the companies in the sample (15.8% vs. 10.7%).

Graphic 20. Founder premium and corporate governance

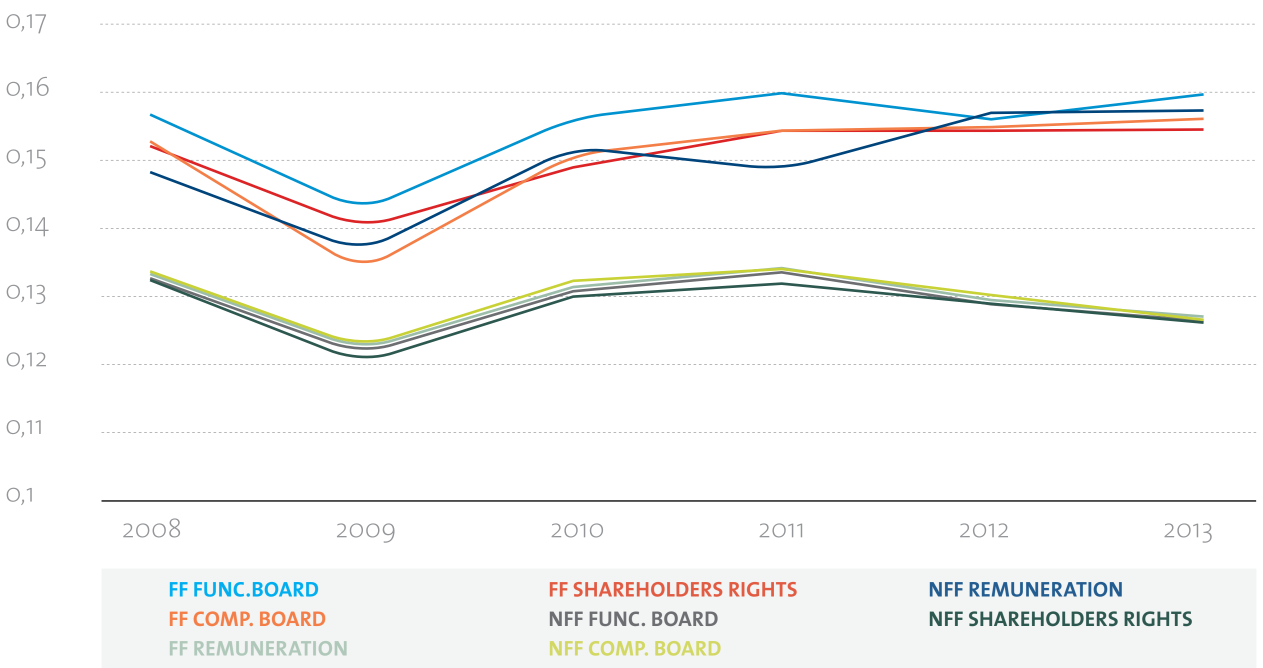


AVARAGE ANNUAL RETURN:

- Founder Best CG: **15,8%**
- Other Firms: **10,7%**

In the case of FFs, a high score in each of the corporate governance categories is related to profitability. That said, the composition of the board of directors has the greatest impact on FFs.

Graphic 21. Evolution of ROA of FFs with best governance by category



OBJECTIVE 5. Which are the best companies in terms of corporate governance?

Several family firms are among the top 15 companies ranked in terms of corporate governance. These companies, found in both indexes, have the best corporate governance among the companies in the sample.

Table 3. Founder companies with best corporate governance

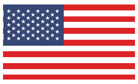
		COUNTRY	LEVEL	MARKET RETURN	ROA
	MICROSOFT	US	87,51	5%	28%
	STARBUCKS	US	87,36	29%	26%
	Average		**87,43**	**17%**	**27%**
	COMPUTACENTER	UK	62,95	30%	10%
	INDITEX	Spain	54,66	26%	29%
	Average		**58,81**	**28%**	**20%**

Table 4. Family firms with best corporate governance

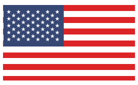
		COUNTRY	LEVEL	MARKET RETURN	ROA
	HORMEL FOODs	US	83,55	17%	19%
	GAP INC	US	82,26	15%	31%
	CAMPBELL SOUP	US	81,66	9%	24%
	KELLOGG CO	US	78,94	7%	21%
	MARRIOTT CORP	US	77,47	8%	14%
	Average		**80,78**	**11%**	**22%**
	HOLCIM LTD.	Suiza	78,00	-4%	10%
	STAGECOACH GROUP	UK	72,86	10%	18%
	ASSOCIATED BRITISH FOODS	UK	69,65	21%	13%
	ACCIONA S.A.	Spain	68,51	-18%	7%
	PIRELLI	Italia	67,34	15%	11%
	Average		**71,27**	**5%**	**12%**

Table 5. Ranking of family firms in US and Europe with best levels in each category

COMPANY	FUNC. BOARD
LOEWS CORP	89,22
FEDEX CORP	89,51
AVERAGE US	**66,91**
HOLCIM	83,04
PIRELLI	88,02
AVERAGE EUROPE	**37,30**

COMPANY	COMP. BOARD
PAYCHEX INC	89,64
NORDSTROM INC	88,81
AVERAGE US	**63,30**
FIAT SPA	84,56
LUXOTTICA	82,62
AVERAGE EUROPA	**58,35**

COMPANY	REMUNERATION
STARBUCKS	87,08
BROADCOM	85,99
AVERAGE US	**62,73**
ASSOCIATED BRITISH FOODS	85,10
THYSSENKRUPP AG	83,23
AVERAGE EUROPE	**61,12**

COMPANY	SHAREHOLDERS RIGHTS
BERKSHIRE HATHAWAY	92,85
CAMPBELL SOUP CO	92,70
AVERAGE US	**57,02**
PIRELLI	93,46
HOLCIM	86,11
AVERAGE EUROPE	**55,55**

COMPANY	TRANSPARENCY
SWIFT TRANSP.	73,09
ANIXTER	70,90
AVERAGE US	**51,30**
CARL ZEISS	79,52
PIRELLI	73,58
AVERAGE EUROPE	**51,76**

Conclusions

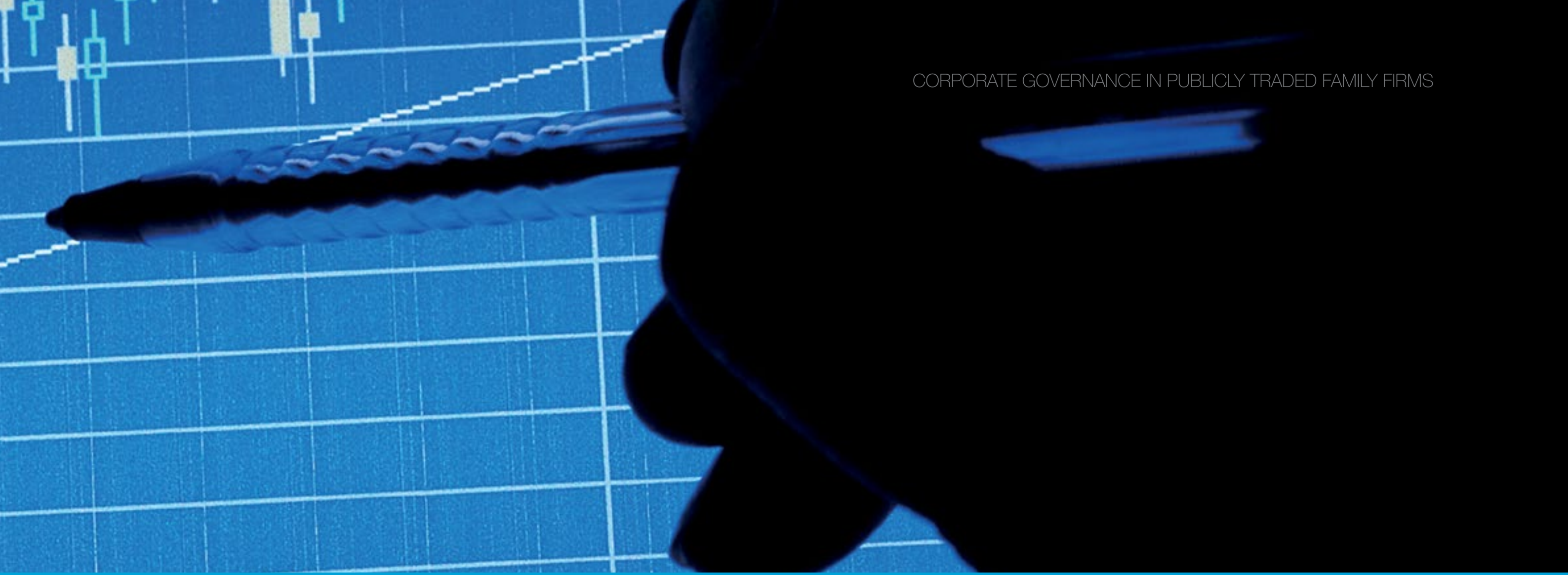
- The results of the III Banca March-IE Report show that family companies comply to a lesser extent with the good governance recommendations outlined in the governance codes of publicly traded companies. The fact that the same results are obtained using two widely indexes of corporate governance reinforces the validity of this conclusion.

- The surveys show the superiority of the corporate Anglo Saxon governance model compared to its continental counterpart when it comes to meeting good corporate governance practices. The US and UK family firms continue to lag behind non-family firms in terms of governance, but their situation is much better than their peers in the rest of Europe that were surveyed.

- Despite the results suggesting that European family companies are headed in the right direction, they still have some way to go to reduce the corporate governance gap. It is true that part of this gap can be explained by differences in the ownership structure of traded companies in both models, but it is also true that in an increasingly global market, investors are looking for profitable companies that meet universal good governance criteria, regardless of their origin or their capital structure.

- The results of the report also show that improving corporate governance is a profitable investment for family firms, given that those companies whose corporate governance is above the average are more profitable than the others surveyed. If in earlier reports we showed that the “family firm + listed company” combined the best of both worlds, this III report shows that adding “company with good governance” to the equation substantially improves the “family premium”.

- The analysis we have carried out provides family firms with indications as to which aspects of corporate governance improvement efforts should be directed. The data shows that family firms, above all in Europe, lag behind non-family firms in terms of the working and composition of the board of directors. At the same time, our report shows that scoring well in these areas has a positive impact on the profitability of family firms. The conclusion, therefore, is that an efficient board, with the required committees and a balanced composition in terms of independent directors, non-executive directors, and members with proven professional experience, helps family firms to mitigate the negative aspects of family control, maximizing their capacity to create value for shareholders.



- Another conclusion is that while it is generally a good idea to follow corporate good governance recommendations regardless of a company's structure, some recommendations should be adapated to the reality of a FF. The analysis of the relationship between the percentage of independent and non-executive directors is very revealing in this sense.

- The data shows that a larger percentage of independent board members improves the profitability of both types of companies. That said, while increasing the percentage of non-executives improves the profitability of NFFs in line with good governance recommendations, the effect is negative on FFs. Therefore, it is not just a question of balancing proportions of the types of directors, but also of assuring that those who occupy a seat on the board are able to bring maximum value to the company.

- In the same way, the conclusions of the data analysis regarding policies and mechanisms to guarantee the protection of the rights of shareholders should bear in mind the idiosyncrasies of family companies, which are distinguished by the presence of a majority shareholder whose objective is to maintain control of the company over the generations. The data shows that to achieve this, FFs in both Europe and the United States implant mechanisms that sidetrack the principle of one share one vote (contrary to good governance recommendations).

- As shown by a range of previous studies, the market "punishes" companies that give special rights to controlling shareholders by reducing their valuation. It is therefore necessary for family shareholders to decide whether to comply with good governance recommendations in this sense, weighing up the potential benefits to their image against the possible losses associated with less control over the decision-making process. The data shows that the presence of these mechanisms has a negative impact on the profitability of NFFs over FFs, which could be interpreted as meaning that in the case of FFs, these mechanisms do not necessarily mean that shareholder value creation is being avoided.

- Finally, the results highlight differences within FFs in relation to corporate governance. A snapshot of the listed FFs with better corporate governance would be a large and relatively young company in which the founder was still present, where the family has less than 40 percent of the shares, and a CEO who is not a family member. An example of this would be Spain's Inditex, which sits among the top ranked companies in both global indices in the report.

Notes

Complete Report: www.ie.edu/business-school/faculty-research/centers-of-excellence
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