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Are financing decisions of family-owned SMEs different? Empirical evidence using panel data

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Abstract

This paper analyses if ownership structure is an important determinant of capital structure decisions, on the basis of two sub-samples of family-owned and non-family owned SMEs, and using panel data models. The results suggest that family ownership is an important determinant for: i) the variations of short and long-term debt stimulated by financial deficit; ii) the speed of adjustment of short and long-term debt towards the respective target levels; and iii) the relationships between determinants and short-term debt and long-term debt. In general, the capital structure decisions of family-owned SMEs are closer to what is forecast by trade-off theory than those of non-family owned SMEs, whereas the capital structure decisions of non-family owned SMEs are closer to the forecasts of pecking order theory than those of family-owned SMEs.

Keywords: family-owned SMEs, long-term debt, non-family owned SMEs, panel data models, short-term debt

Introduction

In the literature on Corporate Finance, one of the most debated questions is if firms' capital structure decisions follow trade-off theory (Faulkender & Petersen, 2006; Graham, 1996; Graham, Lemmon, & Schallheim, 1998; Hovakimian, Opler, & Titman, 2001; Rajan & Zingales, 1995; Titman & Wessels, 1988) or, on the contrary, if they follow pecking order theory (Myers, 1984; Myers & Majluf, 1984).

According to trade-off theory, firms balance the costs and benefits of debt to reach an optimal capital structure that corresponds to the existence of an optimal or target debt ratio, where the marginal benefits of debt (i.e., debt tax shields) are equal to the marginal costs of debt (i.e., costs of bankruptcy).

Pecking order theory states that firms follow a hierarchical order in the selection of financing sources. The first preference is to use internal finance (retained earnings) before resorting to any external financing source. Internal financing incurs no flotation costs, and does not require additional disclosure of financial information that could lead to more severe market discipline. If firms must use external funds to fund their needs, which occurs in the situation of financial deficit[1] caused by the exhaustion of internal financing, they select risk-free debt, followed by risky debt, and lastly, they resort to external equity (Myers, 1984). This hierarchical order reflects the motivations of managers/owners to retain control of the firm, and avoid the apparently inevitable negative market reaction to an announcement of a new equity issue (Myers & Majluf, 1984). Implicit in pecking order theory is the asymmetric information, or the likelihood that a firm's managers/owners know more about the firm's current earnings and future growth opportunities than external investors do.

Myers (1984) argues that the key prediction of pecking order theory is the hierarchical order followed by firms in selecting financing sources, while the main conclusion of trade-off theory is that firms have a target debt ratio, and therefore firms adjust their actual debt level towards a target debt ratio. Central to separating these theories is the question of whether firms move towards a target capital structure, when adjusting their debt ratios: according to trade-off theory, firms take positive steps to offset deviations from their target

[1] Financial deficit corresponds to situations where internal finance is clearly insufficient to meet firms' expenses.