Family Ownership Channels to Innovation

Family companies may have a conservative heritage, but new research suggests they can teach us a lot about innovation

Family firms are generally characterised by their lack of social capital and trust in an economy. It's said they rely too much on familial ties; are often conservative in outlook; and are reluctant to take on additional debt or other external financing measures fearing the dilution of control. All attributes which are thought to hinder innovation.

Another train of thought however suggests businesses under family ownership are less motivated by short-term profits and show greater alignment between ownership and management; characteristics which are known to stimulate innovative behaviour.

All of which paints a particularly paradoxical picture, and raises the question does the family-owned business model stifle or enhance a company's capacity to innovate?

Latest research supports the latter suggesting family-ownership boosts both the quantity and quality of innovation as evidenced by the number and substance of its firm level patents.

To test the strengths of opposing theories associating family ownership and innovation, my study, **The New Lyrics of the Old Folks: The Role of Family Ownership in Corporate Innovation**, co-authored with Po-Hsuan Hsu Associate Professor of Finance at the University of Hong Kong, Sterling Huang, Assistant Professor of Accounting at Singapore Management University and Hong Zhang, Assistant Professor of Finance at INSEAD, researched a comprehensive sample of U.S. public companies between 2000 and 2010.

The results were illuminating. We found family firms were associated with 11 percent more patents filed and 12 percent more citations of filed patents received. They scored 14 percent higher in originality (innovation output which considers the creativity of the firm's patents) and 30 percent higher in generality (which considers the patents' versatility), indicating that not only is there more innovation happening in these organisations, but it is of a higher quality than non-family companies.

Surprisingly, family firms spent less on research and development (we observed a negative relationship between family ownership and R&D input) but were significantly more efficient with what they did invest in this area, when measuring R&D spending against patent output. That is, they produced more and better patents.

So what are family firms doing right?

A closer look at the data identified three channels which promoted innovation.

Focus on long-term value. By sheltering managers from the short-term pressures of irrational and myopic investors, the family ownership model encouraged them to pursue technological advantages with long-term value.

Reduced financial constraints One train of thought suggests that in their efforts to retain control, families may be less willing to resort to capital markets, investment partners or other external financing methods. However we found that lenders had a tendency to trust family firms more, thus reducing financial constraints that hinder innovation.

Improved governance Based on the widely-accepted assumption that the presence of institutional investors indicates better governance and encourages innovation, we found family ownership serves as a substitute for these investors and replaces other governance mechanisms in spurring innovation by lowering agency costs and strengthening monitoring.

The role of family ownership in corporate innovation changes over time. Innovation efficiencies in the firms studied were found to improve with the reduction of the estate tax, suggesting family-owned firms adapt to their institutional environment.

Family firms account for a significant portion of business activities and constitute the backbone of economic development worldwide. But their link to innovation is less obvious. While family ownership can hamper a firm's innovation – conservatism and nepotism can result in family businesses adopting suboptimal investment policies and there may be higher capital costs due to under-diversification or exacerbating agency issues - family firms can also stimulate innovation. By taking advantage of economic channels that focus on long-term value, alleviating financial constraints and improving governance, family firms can make up for these negative characteristics - and through a balance of tradition and modernity- adapt to survive change.

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