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Family Firms: How Much Cash is Enough?

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For years, corporate governance scholars and activists have assumed that cash-rich companies are less vigorous about using resources, leading to the loss of shareholder value. In line with this view, regulators and shareholder activists have increasingly scrutinized corporate cash holdings, pushing firms to redistribute profits back to the shareholders. As a result of this "payout and prosper" movement, the pre-pandemic years were marked by a substantial increase in dividends and share buybacks by listed corporations. Against this backdrop, family firms that tended to hold hefty financial cushions were under mounting pressure to trim their cash reserves.

However, since the pandemic hit in early 2020, things have gone into reverse. Cash-rich family businesses have become the investors' darlings; their sizable cash reserves have insulated them from cash flow volatility and to allowed them to take advantage of attractive investment opportunities.

In our recent study (https://www.sciencedirect.com/science/article/pii/S1877858521000474) published in the *Journal of Family Business Strategy,* we study 1) Whether family firms use their cash more effectively than their non-family counterparts; and 2) The conditions that allow family firms to derive the maximum value from their cash holdings.

What We Found

Based on the data from 195 Italian-listed firms between 2003 and 2015, our findings illustrate that too much and too little cash can hurt the financial performance of all firms. In other words, each firm has a certain optimal level of cash holdings where the performance benefits are the highest; accumulating cash beyond this optimal level will result in a performance decrease. Yet the optimal level of cash holdings is higher in family firms than in nonfamily firms, allowing family firms to derive *greater* financial benefits from holding more cash.

We attribute this finding to two key reasons. First, family firms rely more on their own cash reserves because they generally rely less on external financing. Second, due to their incentive structure, family firms tend to use their cash more efficiently and are less prone to overspending than non-family firms. In sum, the greater importance of cash holdings and their more cautious use means that accumulating cash resources provides more benefits for family firms than for non-family firms.

Along with these differences between family and non-family firms regarding the use of cash holdings, the degree of family involvement in the firm also has an impact on cash's benefits. For example, some family firms are run by non-family executives with family owners overseeing strategic decisions, whereas other family firms are both owned and managed by family members. In our study, we distinguished between family firms with a high percentage of family ownership and a family board chair (which we term as "high family control and influence") and family firms with a non-family board chair (termed "low family control and influence").

We found that family firms with high family control and influence enjoy more significant performance benefits than those with low family control and influence. However, these benefits mainly occur when cash resources are scarce. In such situations, firm survival is the highest priority for family owners, and greater control over the firm enables them to use the cash stock to contribute to the long-term value creation.

In contrast, in situations when cash resources are abundant, high family control and influence implies that the family's needs matter more than the firm's financial priorities, resulting in performance decrease. Taken together, under high family control and influence the optimal level of cash holdings will be higher; however, accumulating additional cash beyond this optimal level will lead to a steeper decrease in firm performance.

We then tested whether strong corporate governance might limit the adverse effects of the family having too much control over cash holdings. Our study found that good oversight by a board of directors (in firms where the CEO and board chair are two separate roles) can create the most benefits. Our data indicates that the benefits of hoarding cash are the *highest* in firms with a high level of family control and influence, and when this control is coupled with more robust monitoring by the board.

Key Takeaways

Our research offers three key takeaways for investors, family business managers, and their advisors in assessing the level of cash holdings in a firm:

- Both too little and too much cash holdings hurt firm performance
- The optimal level of cash holdings is higher in family firms than in their non-family counterparts.
- Accumulation of their cash holdings creates the highest value for shareholders when the family has high control and influence in a firm and when the board of directors is in a solid position to protect the interests of non-family shareholders

We encourage non-family investors to take advantage of family control and influence over the business while carefully considering firm governance design. For family owners, we highlight the importance of the board of directors in helping the firm reconcile the interests of diverse groups of shareholders.

Explore the Research

Strings Attached: Socioemotional Wealth Mixed Gambles in the Cash Management Choices of Family Firms (https://www.sciencedirect.com/science/article/pii/S1877858521000474) , Journal of Family Business Strategy, October 2021

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