Family Firms versus Private Equity: A struggle of business models? The example of the German printing industry

By Dr. Ida BAGEL
Bagel Group
and Prof. Michael TROEGE
ESCP Europe

With the growth of the Private Equity (PE) industry an increasing number of firms remain for substantial periods in the ownership of PE companies. Today, PE owned companies are important and permanent competitors for many traditional Family Firms.
The financial and commercial strategies of both types of firms differ substantially. The paper analyses the differences in structure and strategy of PE-owned and Family-owned companies with a particular focus on the functioning of German Family owned Mittelstand firms. Using the German Printing Industry as a case study we try to assess 1) why PE backed firms are particularly dominant in shrinking industries, 2) in how far competition from PE owned companies reduces the viability of the stakeholder focused strategies that are the core of many family firms' success and 3) whether more widespread PE ownership will erode the institutional environment that has enabled the flourishing of the German Mittelstand.

Introduction

Many large family owned firms have over the last century been replaced by stock market listed corporations that are owned by anonymous investors and financial institutions (1). A similar dynamic seems to now be at play with small and midsized firms, as more and more firms are controlled by the strongly growing Private Equity (PE) industry (2).

Even if the ownership by a single fund rarely lasts longer than five years, the dominance of secondary exits implies that companies are being transferred from one PE investor to the next and remain for increasingly long time periods in the ownership of funds. Hence, PE ownership which has in the past been a transitory episode in the life of firms, is today evolving into a quasi-permanent ownership and governance system, mid-way between the traditional family firms and listed corporations.

(1) FRANKS J., MAYER C. & ROSSI S. (2005), "Spending less time with the family: The decline of family ownership in the United Kingdom", *A history of corporate governance around the world: Family business groups to professional managers*, University of Chicago Press, pp. 581-612.
(2) 2019 "Private markets come of age", McKinsey & Company.

PE ownership and governance could theoretically avoid the well-known shortcomings of both family and stock market ownership. Family firms face an important succession risk (3) and are sometimes viewed as not being sufficiently innovative and dynamic, whereas listed firms are perceived as being riddled with agency conflicts between management and the badly informed, passive and short-term oriented shareholders (4). PE shareholders are committed, usually well informed, have real decision power and unlike stock market investors hold their shares for several years. They should therefore provide more efficient governance. At the same time, the obligation to sell the firm before the expiry of the fund exposes PE backed firms to market scrutiny with market for corporate control ensuring that the most capable shareholders will acquire the company.

(3) BENNEDSEN, MORTEN *et al.* (2007), "Inside the family firm: The role of families in succession decisions and performance", *The Quarterly Journal of Economics* 122.2, pp. 647-691.
(4) E.g. LAZONICK W. (2013), "Profits without prosperity", *Harvard Business Review* 92.9 (2014), pp. 46-55. For a comprehensive discussion see ROE Mark J., "Corporate Short-Termism – In the Boardroom and in the Courtroom", *The Business Lawyer*, pp. 977-1006.

It is therefore not unconceivable that PE ownership will evolve into a new and more efficient permanent form of governance with long term benefits for innovation and economic growth.

Unfortunately, this is not how PE is perceived by much of the public. PE is largely demonized. For example, *Franz Müntefering,* the former chairman of the German Social Democrats famously labelled PE firms as "locusts". The US presidential candidate Elisabeth Warren, talks about "legalized looting" (5).

The criticism levelled at PE is often diffuse, which is not surprising given the diversity of PE funds and the heterogeneity of strategies. A certain number of recurring themes can, however, be recognized. A key accusation relates to the highly levered capital structures that are often the result of leveraged buyouts (LBOs,). This can weaken portfolio companies and creates incentives for value destroying risk shifting (6). To serve the massive amounts of debt companies allegedly need to slash costs, resulting in a lower product quality, layoffs and reduced long-term investments.

A related critique is that the threat of bankruptcy is used to extract concessions from stakeholders such as employees, suppliers, banks and bondholders, as well as the communities. This is perceived to violate implicit contracts and ethical norms. Potentially, the high leverage also contributes to maximize the protection provided by limited liability, making legally dangerous strategies viable for shareholders.

Concerns have also arisen about the role of PE backed companies in the general decline in competition (7). PE companies often implement so called "platform" strategies, where price wars are triggered in order to acquire competitors for low values with a view of ultimately consolidating the industry and achieving higher pricing power. Competition authorities have started to react. In particular EU competition authorities have started to fine not only the portfolio companies but also the owning PE firms for an antitrust breach (8).

Last not least, this unpleasant view is reinforced by the fact that PE firms seem to play a major role in industry wide series of bankruptcies, such as in the retail and newspaper industries in the US, or as in our case the printing industry.

The Scientific Evidence: Strategies of PE Backed Firms

The accusations listed above are difficult to examine with scientific rigor. On the whole, they have not been confirmed by careful academic studies. While there is widespread agreement that PE funds do not, on average, beat a diversified stock market investment (9), they do not seem to massively underperform. This would be difficult to explain if these funds were systematically destroying the performance of their portfolio companies.

The few papers that have collected meaningful data on the performance of PE owned companies tend to show that, even if PE investors impose substantial default risk, performance on average increases, likely because of lower agency costs both through the disciplining effects of leverage as well as better governance and monitoring by the PE fund. PE firms have been demonstrated to play a very active role in defining the company strategy (Acharya *et al.,* 2009; Baker and Wruck, 1989; Cotter and Peck, 2001), implement strong incentive compensation plans, decentralise decision making, reduce board sizes (Cornelli and Karakas, 2008) and increase the turnover of management.

The evidence on the effect of PE investors on employment, one of the most controversial aspects is more mixed (10). The evidence points to buyouts triggering the unpleasant, but often necessary creative destruction process in the labour market. This leads to reallocation of resources, with job losses where inefficiencies exist, but at the same time job creations in areas of strategic importance. Overall the impact on employment seems to be weak (11).

The Financial and Non-financial Performance of Family Firms

The reputation of family firms is at the opposite of PE backed companies. Much of the management literature has adopted the view that family shareholders not only maximize financial wealth but have a larger objective function labelled "socioemotional wealth" that includes personal preferences such as a concern for the family's reputation.

Hence, family businesses are viewed as pursuing a long-term and intergenerational strategy, stick to implicit and explicit rules and norms, act more altruistically in their relations with employees and have stable employment relationships that allow for the accumulation of experience, leading to high quality and high productivity. Manager-shareholders generally have many years of expertise in the company and he market and a high level of social know-how. This results in stable firms that guarantee fulfilling jobs and contribute to the economy and a stable political environment.

There exists a considerable body of empirical research backing up these views. Family firms are indeed more sustainable, have high corporate social responsibility and

(5) https://www.warren.senate.gov/imo/media/doc/2019.7.17%20Stop%20Wall%20Street%20Looting%20Act%20Text.pdf

(6) EISDORFER A. (2008), "Empirical evidence of risk shifting in financially distressed firms", *The Journal of Finance* 63.2, pp. 609-637.

(7) GUTIÉRREZ G. & PHILIPPON T. (2017), *Declining Competition and Investment in the US* (No. w23583), National Bureau of Economic Research.

(8) For example, the EU commission imposed a 13.3 million fine on the German firm Arques Industries AG in 2009 and in 2019 a fine of 104.6 million euros was leveld at Prysmian, which included a joint fine of 37.3 million euros with Goldman Sachs.

(9) PHALIPPOU L. & GOTTSCHALG O. (2008), "The performance of private equity funds", *The Review of Financial Studies* 22.4, pp. 1747-1776.

(10) ACHLEITNER A. K. & KLÖCKNER O. (2005), "Employment contribution of private equity and venture capital in Europe", *Available at SSRN 1113782*.

(11) DAVIS S. J., HALTIWANGER J. C., JARMIN R. S., LERNER J. & MIRANDA J. (2011), *Private equity and employment* (No. w17399), National Bureau of Economic Research.

a long term perspective on profitability and the evolution of the society [12].

The literature does not omit potential downsides of family ownership. In particular, a closely knit family can develop values that are not aligned with the values of the larger society and therefore evolve at odds with social norms [13].

In general, family ownership seems to enhance performance. While there is no study comparing the respective efficiency of family held versus PE backed firms, we can compare family firms to widely held corporations. On continental European stock markets a substantial number of firms are still controlled by families and these firms seem to outperform widely held corporations [14]. One of the reasons seem to be their paternalistic management style that leads to lower wages even for skilled workers. As a counterparty family firms smooth industry shocks and guaranty a higher job security [15].

The German Family Owned Mittelstand Firms

Family-owned "Mittelstand" firms are today the backbone of the German economy having largely replaced the diversified conglomerates ("Konzerne") of the 80s and 90s. This success can be explained by a very specific economic and institutional ecosystem which might be endangered by the raise of PE backed firms. In this section, we briefly characterize this environment.

The traditional definition of the Mittelstand comprises not only SME's but also larger family owned companies. The typical Mittelstand company has been family-owned for several generations. Often these companies are highly specialized and achieve a dominant position in the world market for a specific range of "niche" products ("hidden champions").

The products themselves are often not new, but Mittelstand excel at incremental innovation, *i. e.* the continuous development and improvement of existing products to achieve high quality, reliability and functionality. A key component of this strategy is a close cooperation with suppliers and customers who provide active input in the product design. Another component is the high investment of Mittelstand companies in the qualification of their current and future employees. Mittelstand companies are the principal employers of apprentices who obtain a very thorough vocational training in Germany's "dual" system involving a vocational school and the company. These highly specialized workers ("Facharbeiter") are able to produce high quality products and contribute to process and product innovations. The vocational training system is also the first contact point of the company for a closer collaboration with more advanced academic institutions, such as universities and research centres, that can help the company to stay at the forefront of the technological evolution.

Many Mittelstand companies are located in small towns or villages. Living costs for employees are low and often employees are not mobile, which reduces competition for qualified workers and explains the companies' willingness to invest in their skills. Both employees and entrepreneurs actively participate in the social and associative life of their municipality or region, which increases the dialogue between stakeholders and contributes to the construction of compromises acceptable to all.

Mittelstand companies have typically low leverage. Unlike most corporate forms, the GmbH & Co KG structure (roughly similar to a limited liability partnership) used by many Mittelstand companies does not allow for tax shields of debt and hence there are no tax incentives to lever up a company. Most of the capital comes from retained earnings, banking services are often provided by local mutual banks ("Genossenshaftsbanken") and the publicly owned saving banks ("Sparkassen"). This helps Mittelstand companies to maintain another key strategic advantage: They disclose very little information. Competitors cannot identify profitable areas and the high uncertainty about the incumbent's costs base makes market entry highly risky.

The Bagel Group and the High Volume Printing Industry

In many respect the Bagel Group represents the typical family owned Mittelstand firm. Founded in 1801 by a descendant of French Huguenots, the Bagel Group has been run since its foundation by a member of the founding family, today in the 7th generation. The company is organized as a network of companies operating in various segments of the printing industry, publishing and the service sector. The administrative head office is located in Düsseldorf.

The company has not only French origins, but has also been active in the French market for more than 30 years. For example, it has been printing the catalogues for the mail order companies La Redoute and 3 Suisses. Today these catalogues have been displaced by the internet, but the company still prints advertising supplements and smaller catalogues for French clients.

As is typical for family owned Mittelstand firms, the company has low leverage, discloses little information about financials and has a loyal workforce with a very low turnover. Unlike for many Mittelstand companies, however, products are largely commoditized and the market is very competitive.

The Market for high volume print products

The market for high-volume commercial printing (catalogues, magazines and advertising supplements) has been in decline for more than a decade, most importantly because of the increase in internet based advertising and the decline of print based magazines. This has led to an

(12) DEEPHOUSE D. L. & JASKIEWICZ P. (2013), "Do family firms have better reputations than non-family firms? An integration of socioemotional wealth and social identity theories", *Journal of management Studies* 50.3, pp. 337-360.
(13) MARQUES P., PRESAS P. & SIMON A. (2014), "The heterogeneity of family firms in CSR engagement: The role of values", *Family Business Review* 27.3, pp. 206-227.
(14) SRAER D. & THESMAR D. (2007), "Performance and behavior of family firms: Evidence from the French stock market", *Journal of the european economic Association* 5.4, pp. 709-751.
(15) ELLUL A., PAGANO M. & SCHIVARDI F. (2017), "Employment and wage insurance within firms: Worldwide evidence", *The Review of Financial Studies* 31.4, pp. 1298-1340.

overcapacity for high volume printing, resulting in fierce competition and several market exits.

Products are similar in terms of features and quality, but transportation costs create certain geographical differentiation.

The Technology

High volume printing is characterized by large capital expenditures, which to a large fraction are non-recoverable. In addition, there are high fixed costs, in particular labour costs. In certain countries capacity reduction is also associated with huge exit costs. For example, after closing their print shop, the German Bauer Group had to pay around 38 million euros to compensate 340 employees for the loss of their jobs [16].

Input prices make up for a very large fraction of the final product. In particular, the price of paper can reach up to 80% of the final product price. Costs are very similar, given that competitors use similar machines and inputs. Differences in salaries can generate small advantages in marginal costs, but given the large block of fixed costs, this will rarely be decisive for the competitive outcome. Together with the overcapacity in the market, this creates conditions where competitive prices will frequently not cover fixed costs and might, given the high exit costs, even fall below marginal costs.

Suppliers and Customers

Suppliers and in particular paper producers also have very capital-intensive production, but a more oligopolistic market structure. This creates cost advantages for similarly dominant players in the print industry, who are able to drive a tougher bargain and obtain better prices.

Customers are mostly large retailers that are self-financing through suppliers with long payment. Together with the high input costs and short payment delays for inputs, this results in high working capital requirements. Given the risk inherent in a consolidating industry, banks as well as accounts receivable insurers hesitate to finance this working capital. As a consequence, even profitable companies can face liquidity problems.

Major players

The printing industry in Germany has long been dominated by classic German Mittelstand businesses similar to the Bagel Group. Other traditional players include in-house print facilities of media groups such as Bauer Druck, Burda Druck and the Bertelsmann Printing Group (BPG).

PE financed companies have only recently started to acquire printing plants and companies form the traditional players. Given the low prices of these assets, the strong fragmentation of the European market and the homogenous cost structure, the market seemed right for implementing a classic platform strategy.

A typical example is the UK based Walstead Group, which was founded only in 2008. The company is controlled by the PE fund Rutland Partners through a 53% stake. Senior management retained the other 47% [17]. Under PR ownership Walstead has engaged in rapid expansion through M&A-driven external growth and has now become the largest web offset printer in Europe. Its explicit strategy of consolidating the European market starts to pay off [18]. In particular its dominant position in the UK has allowed it to substantially increase prices, after commercial exchanges became disrupted due to Brexit negotiations.

The same strategy has been tried by CMG (formerly Circle Media Group) an Amsterdam-based player that is not controlled by a traditional PE fund but has been set up by anonymous shareholders based in Cyprus and Luxembourg. The CMG Group was founded in 2017 and expanded quickly through a series of mergers. With the acquisition of CPI in July 2018, CMG had reached sales of approximately – 900 million, more than 5,000 employees and 26 production sites in ten European countries as well as in the United States.

The strategy has, however, failed. Declining market size and increasing paper costs have forced CMG subsidiaries into bankruptcy and Circle Media has announced its exit from the printing industry.

The Competitive Dynamics

A war of attrition

The cost characteristics in this industry, together with the shrinking market produce a strategic setting that is known in game theory as “war of attrition” (sometimes also called “game of chicken” or “all pay auction”). The basic choices are simple: If none of the players react, everyone will suffer, but if a sufficient number of players exit the markets, the remaining players will reap large gains in an oligopolistic market.

Winning a war of attrition

Game theorists know that wars of attrition only end well if players are asymmetric and information is symmetric. In other words, if some players are obviously weak and this is known, the weaker players understand that they cannot win and exit immediately. Neither the leaving players nor the remaining stronger players will suffer substantial losses.

Asymmetric information can destroy these efficient equilibria, however, because weaker players could be tempted to bluff. In this case competitors will test each other’s capacity to absorb losses which can lead to highly destructive outcomes.

In the next sections we will list factors, which could contribute to determine a winner in the game played between family firms and PE backed companies in a shrinking market with high fixed costs.

Deep Pockets

Capital constraints are always bad in a war of attrition.

(16) https://wirstehenauf.wordpress.com/2010/12/08/mit-hoch-erhobenem-haupt/

(17) https://www.printweek.com/print-week/news/1164624/walstead-appoints-rothschild-to-advise-on-next-phase
(18) https://www.printweek.com/print-week/news/1164624/walstead-appoints-rothschild-to-advise-on-next-phase

If unconstrained competitors know that a firm can only finance a certain amount of losses, they can force the exit of the constrained firm. Normally the game will not reach this stage, however, as all players understand this situation and the weaker ones withdraw immediately to avoid accumulating useless losses.

Family firms often have important own resources, but access to external finance is normally easier for large PE firms. These firms are important customers of large banks and also generate substantial fees with their M&A activity. They can therefore negotiate loan terms that are not available for smaller companies [19]. PE firms are also more experienced in structuring a loan in a way that makes it easy for the now heavily regulated banks to fulfil the regulatory requirements.

Leverage

Leverage will generally make firms more aggressive, simply because the controlling equity holders care less about potential downsides of an aggressive strategy. On the other hand, highly levered firms also have a lower capacity to finance losses. If there is no uncertainty, they may therefore decide to pull out earlier. This is likely what has happened to CMG which was not backed up by a PE investor with deep pockets.

Risk aversion

Risk aversion is a big disadvantage in "war of attrition" games and this factor makes it more difficult for family firms to compete. Family shareholders are not diversified intermediaries investing other peoples' money. The concern about their reputation add to this risk aversion and explains why many family firms decide to withdraw in war of attrition situations.

Operational Efficiency

Efficiency reduces the losses in the "war of attrition" phase and increases the value of the price in case the war of attrition is won. Again with symmetric information this should give more efficient companies an advantage. However, with high uncertainty efficiency is likely to only have a marginal impact and it is by no means sure that the most efficient player wins the competition.

Customer support for competition

An important factor might be the support of certain customers. Large customers who understand the danger generated for them by "platform strategies" might intentionally disadvantage certain more powerful players to maintain a certain level of competition in the market. This is for example the case for the media groups with in house printing shops. They might outsource some of their activity but might try to maintain even a loss making activity in the print industry to avoid being held up by dominant players.

Levelling the Playing field

The above discussion shows that family firms have a number of serious disadvantages in a war of attrition. Risk aversion and potentially limited access to finance make it difficult to sustain and survive cut-throat price wars. Better and cheaper production, in particular because of better labour relations and more committed employees could play in favour of family firms, but these factors are not determinant in a war of attrition. The traditional opacity of family firms makes it difficult to credibly signal low cost to the competitors and the excellent relations of PE firms to banks imply that an advantage in operating costs for family firms can be outbalanced by lower financing costs for PE backed competitors.

This could explain why PE backed firms are making strong inroads in declining markets where risk taking, deep pockets and the capacity to reduce competition, rather than long term strategies and operating efficiency are the key success factors.

It is likely that long term ownership by private equity companies will erode the institutional ecosystem that helped support Mittelstand companies. Whereas Family firms could be relied on to actively support this environment, PE backed firms are likely to free ride. Even if they do not violate social norms and use limited liability to escape from legal constraints, as is sometimes alleged, anonymous decision makers without local roots will have no incentives to invest in the local communities or a long term strategy. This might add to the current polarization of society and the increasingly dysfunctional political process.

The decline of family firms is not a fatality, however. Rules can make a difference, re-establish the competitive balance and maintain a diversity of ownership formats. We discussed in the introduction that many family firms have been replaced by listed firms with fragmented ownership, but this has happened to a much lower extend in continental Europe, where unlike in the US and UK, family controlled firms still make for a substantial fraction of listed companies.

Discussing the detailed reforms that could achieve this goal is beyond the scope of this paper but eliminating the tax shield of debt, and reducing the scope for strategies that exploit limited liability should be high on the agenda. More flexible banking regulation and more stringent competition control.

Conclusion

PE firms have an important role as short-term owners of firms with specific restructuring needs, but this paper argues that much of the current competitive advantage of PE backed companies derives from other factors such as low risk aversion, a preferential access to cheap finance, the exploitation of limited liability and possibly a willingness to neglect societal norms and test legal boundaries. In particular, in shrinking industries these factors tilt the competitive playing field in the direction of PE based corporations. This creates the danger of eroding the institutional and societal ecosystem that is necessary for maintaining competitive markets and a balanced and inclusive political system. Careful regulation is necessary to level again the playing field between different ownership formats.

(19) https://dealbook.nytimes.com/2012/07/11/16-million-reams-of-paper-please/