Ca' Foscari University of Venice

Master's Degree program

Global Development and Entrepreneurship

Curricula: Entrepreneurship

Final Thesis

The family firm leadership paradox: how to preserve family influence while hiring external managers. A VBM perspective.

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Academic Year

2018 / 2019

CONTENT

CHAPTER 1. INTRODUCTION **7**

1.1 Structure of the study 7

1.2 Evidence from data: family firms in Italy and the lack of external managers 9

CHAPTER 2. FAMILY RUN BUSINESSES **19**

2.1 Definition 19

2.2 The Top Management Team (TMT) of family firms 23

2.2.1 Definition of TMT 23

2.2.2 The impact of TMT composition on firm performance: *Upper Echelons Theory* 25

2.3 Professionalization of family firm's TMT 31

2.3.1 Definition of professionalization 31

2.3.2 Why to professionalize management in family firms? 37

2.3.3 How to professionalize management in family firms? 40

2.4 Diversity in family firms' TMTs 43

2.4.1 Definition of diversity: a double edge sword 43

2.4.2 The positive side of TMT diversity in detail: four types of Functional Diversity 47

2.4.2.1 TMT dominant functional diversity 48

2.4.2.2 TMT functional background diversity 49

2.4.2.3 TMT functional assignment diversity 50

2.4.2.4 TMT intrapersonal functional diversity 51

2.4.3 Diversity = Heterogeneity? 52

2.4.3.1 Diversity effects on TMT 53

2.4.4 TMT diversity within family firms 56

CHAPTER 3. THE INCLUSION OF NONFAMILY MANAGERS: OPPORTUNITIES AND THREATS **59**

3.1 TMT composition in family firms: focus on mixed solutions 59

3.2 Summary of the benefits deriving from the inclusion of nonfamily managers 60

3.2.1 The confirmation from scholars: the positive effects of external managers on family firms' performance, evidence from literature 62

3.3 Issues associated with the inclusion of nonfamily managers 65

3.3.1 Issue number one: Agency Theory 66

3.3.2 Issue number two: The loss of Socioemotional Wealth (SEW) 73

CHAPTER 4. "VALUE BASED MANAGEMENT" AS A WAY TO OVERCOME THE MISALIGNMENTS BETWEEN FAMILY AND NONFAMILY MANAGERS **79**

4.1 VBM: literature overview and history 80

4.2 The Value Creation Theory and its application to the family firm context 82

4.3 Value measurement: metrics, principles and models 87

4.3.1 A measure that captures the economic return of an investment: Discounted Cash Flow Method 93

4.4 The management geared to Value creation: VBM 102

4.4.1 The Performance measurement 105

4.4.2 The most popular VBM method for performance evaluation: Economic Value Added (EVA) 106

4.4.3 VBM: organizational model and operative implementation 111

4.4.4 Critics to VBM 119

4.5 Why should family firms use VBM? 123

4.6 VBM in (privately held) family firms 127

CHAPTER 5. CONCLUSIONS **145**

LIST OF TABLES 153

BIBLIOGRAPHY 154

INTERNET REFERENCES 160

CHAPTER 1. INTRODUCTION

1.1 Structure of the study

Family firms are undoubtedly one of the most popular form of business organization, worldwide. Their distinctive feature is, by definition, the involvement of the family in the business affairs, which concerns with potentially different extent two spheres of actions: ownership and leadership. While the owner status does not require the presence of neither specific skills nor abilities and merely impact the individual in economic terms (to benefit from profits or to cover losses), be manager is another story that calls for experience, training and talent to be successfully performed. That's why many family-run businesses choose to involve nonfamily managers in leadership, since the heirs often turn out to not be well suited for such a role. Despite the bulletproof validity of this logic, recent statistics evidence that in Italy, the openness of the management to outsiders is still ignorantly seen as a danger for the continuity of the family business rather than an opportunity to enhance the business and facilitate the generational turnover.

Nonfamily managers (also defined outsiders, externals or professional managers) are individuals who don't possess any parental relationship (of blood, marriage or adoption) with the family owning the business (Klein, 2007). They are generally regarded as a homogeneous group in contrast with the family managers, marked by a professional and experiential background, an objective approach aimed at economic maximization, no emotional involvement. In the light of the substantial discrepancies between the two groups, past studies have focused on defining pros and cons in the adoption of pure solutions (pure family and pure nonfamily management) and regarding with mistrust the possibility of a cooperation between the two groups (mixed management), due to the potential rise of conflicts that negatively impact the business performance. This study aims first at underlying the role of external

managers as positive contributors to *diversification and professionalization* of family firms' TMTs, with the backing of specific theories such as the Upper Echelons by Hambrick and Mason. A careful analysis will bring out the positive side of nonfamily members inclusion, with particular emphasis on the beneficial impact on the firm performance.

Even though the benefits deriving from the cooperation of family and nonfamily leaders are empirically proved, critics have recognized the emergence of several problems related to the inclusion of external managers. On one hand, *agency problem* occurs, defined as a conflict of interest between company's owners (in this case, the family) and company managers (who are nonfamily individuals). This type of conflict is common in almost every organizational structure in which ownership and management do not match, and derives from the fact that managers, acting as the agent for the principals, have the duty to make decisions for maximizing *the owners' wealth* instead of their own wealth, which is the natural vocation of every individual. On the other hand, the rise of a much more family firm-peculiar problem can be identified in the loss of Socioemotional Wealth (SEW), crucial feature of family organizations which represent the combination of all those "non-financial aspects of the firm that meet the family's affective needs, such as identity, the ability to exercise family influence, and the perpetuation of the family dynasty" (Gomez-Mejia and al., 2007). Indeed, family firms are characterized by a double purpose: the profitability of the business, but also the preservation of the business value and culture. This latter aspect is hardly communicable and understandable to nonfamily managers, and family firms, scared of the potential loss of the business core values, may refuse to engage outsiders in the management structure to avoid such loss.

Aware of the enormous advantages deriving from the introduction of professional outsiders within the management, scholars and practitioners have identified many ways to overcome the obstacles to integration (especially the agency conflicts). On one side, through the implementation of monetary incentives (wages and bonuses) and non-monetary incentives

(pleasant work atmosphere, stimulating work content, addictive management culture, good degree of freedom for action). On the other, through an effective monitoring activity carried out by family-ruled controlling bodies.

The final piece of this study is dedicated to the description of Value Based Management (VBM) as a further, possible solution to manage the misalignment of interests between owning family, likely to pursuit non-economic interests beside profit interest, and external professionals, accustomed and trained to a "financial profit maximization" perspective. Indeed, this managerial philosophy promotes clarity of goals to achieve, strict managing methodology, use of effective value assessment tools, accurate allocation of responsibilities. In this way, *a priori* the family is capable of detecting the "drivers" which foster value creation not only for the business activity itself, but for anything they consider important (family interests, social interests etc..), and directing the action of the management team in order to coordinate corporate objectives, techniques and processes in maximizing such value.

1.2 Evidence from data: family firms in Italy and the lack of external managers

Data indicates that over ⅔ of world enterprises are family run. In Italy, their presence exceeds 85% of the overall business population, in line with major EU Countries as France (80%), Germany (90%), Spain (83%) and UK (80%).[1]

Despite the similarity in terms of diffusion, latest statistics have pointed out few traits for which family businesses in Italy escape from the European standards.

[1] Data from the "Osservatorio AIDAF-EY" sponsored by Università Bocconi Milano, AIDAF (Associazione Italiana Delle Aziende Familiari), UniCredit and Angelini Foundation, with the collaboration of Borsa Italiana and Camera di Commercio di Milano Monza Brianza Lodi, X Report (2018), available on https://www.aidaf.it/aidaf/le-imprese-familiari/

A first distinction concerns family business size. By taking the Top 500[2] Companies of France, Germany and Italy (in terms of turnover), and focusing on those family-owned, important dimensional discrepancies emerge.

1. In the **High Class** (family firms with a turnover exceeding *€10 billion*), Italy has a clearly lower presence compared to Germany and France (2% while its competitors are both around 10%);
2. In the **Low Class** (family firms with a turnover lower than *€1 billion*), Italy has a significant higher presence compared to the other countries (56%, while Germany 1,7% and France 20,2%).

See Table 1 below.

	FRANCE		**GERMANY**		**ITALY**		
	N°	%	N°	%	N°	%	
> €10 bill	11	9,2%	18	10,2%	4	2%	**HIGH CLASS**
€5 - €10 bill	10	8,4%	16	9,1%	5	2,4%	
€2,5 - €5 bill	28	23,5%	36	20,5%	19	9,3%	
€1 - €2,5 bill	46	38,7%	103	58,5%	62	30,2%	
< €1 bill	24	20,2%	3	1,7%	115	56,1%	**LOW CLASS**
TOT	**119**		**176**		**205**		

Only **2%** of the Italian family firms is in the High Class

Over **56%** of the Italian family firms is in the Low Class

Table 1. Family Firms in the TOP 500 ranking of Italy, Germany and France. Source: AIDAF.

[2] XI Osservatorio AUB, "Le Imprese Familiari ed il Mondo", 25 Novembre 2019.

I conclude that Italian family firms, despite their population density in line with the major European economies, tend to be relatively smaller in terms of size.

The motivations behind the choice to keep a business within certain dimensional constraints may be multiple. The point is that, if the trend is national as in the Italian case, specific reasons should be probably traced back to macro-level attitudes. I happened to discuss about this topic with local entrepreneurs a bunch of times (I've been lucky enough to grow up in the Nord-East Italian region, where entrepreneurial spirit and family capitalism are daily bread), whose interpretations on the matter have been recurring: Italian family firms struggle to escape their small dimensions (anti-competitive, in a globalized economy) due to structural constraints such as over-bureaucratization, tedious legal system and out-of-date financing forms ("banks-centrism"), but also cultural barriers, such as lack of ambition, competition, merit, audacity, long-term vision, and fear of losing leadership.

As one of the most prominent managers of modern times, Sergio Marchionne, used to say, Italy has always been a land of "Gattopardi" (from the Italian novel "Il Gattopardo", written by Giuseppe Tomasi di Lampedusa in the Fifties): "*in words we want everything to change, but just to let it stay the same".* This reference is as simple as effective in outlining the business profile of the Italian entrepreneur: innovative and revolutionist, but extremely scared of escaping its comfort zone; desirous of enlarging the activity, but as long as retaining a full control over it.

Such wary attitude allows organizations to survive over time, but hardly gives the opportunity to coordinate capital and efforts to let the business grow. Concerning the leadership structure in the family business, family leaders tend to be skeptical about the inclusion of externals in positions of prominence as management and ownership, resulting in a lack of meritocracy and inability to trigger economic growth. It is therefore not surprising to discover that Italian family

firms fall short of nonfamily managers. According to European statistics, our Country stands out for the presence of Pure-Family Executive Teams (where 100% of the managers are family members): about 13% of the overall family run businesses, versus 3,7% and 7% of Germany and France respectively. [3]

See table 2 below.

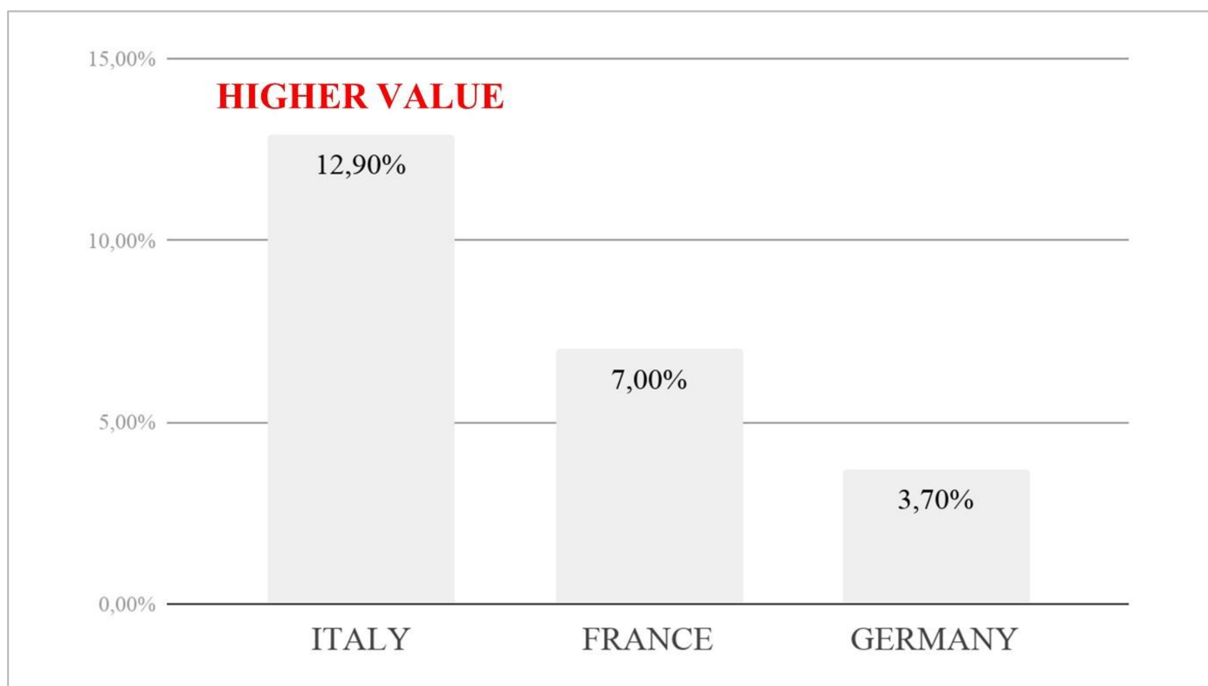

Table 2. Percentages of family firms with a Pure Family Leadership (100% family members) in Italy, Germany and France. Source: AIDAF.

The hypothesis of a correlation between the lack of nonfamily managers and the tendency to be smaller in terms of business size is supported by the fact that any business, to grow, requires managerial skills that increase in complexity as the organization expands. Family members may be self-sufficient in managing a family firm at early stages, however, when seeking business growth, the involvement of external managers is highly recommended due to the

[3] XI Osservatorio AUB, "Le Imprese Familiari ed il Mondo", 25 Novembre 2019.

professional support they can provide (in terms of academic and experiential background), as well as their neutral perspective on business affairs (not emotionally attached as family members).

Statistics reveal that Benchmark family firms[4] have leadership structures more opened to nonfamily members, which means, the presence of external managers in high performing organizations is above the average.

See Table 3 below.

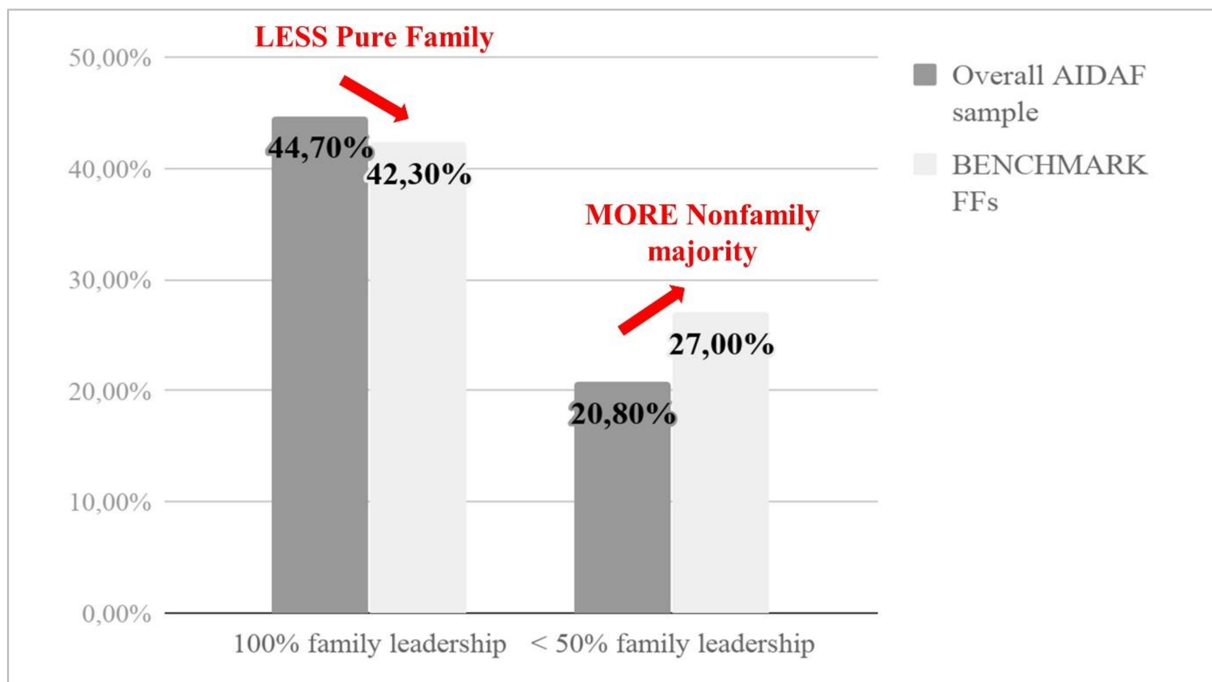

Table 3. Presence of Pure Family Leadership and Non-family Majority Leadership: a comparison between the average of the overall AIDAF sample, and the Benchmark Cluster (family firms outperforming the average).

[4] Within the sampled family firms, AIDAF identified the 300 Top class (named "Benchmark family firms") performing better than their competitors in the same size class. X Osservatorio AUB, "Dieci anni di Capitalismo Familiare", 2018.

Moreover, interesting discrepancies emerge by separating Benchmark family firms between newborn (*first generation*) and well-established organizations (*second and later generations*): after the second generation, they are even more likely to opt for a nonfamily leadership.

See Table 4 below.

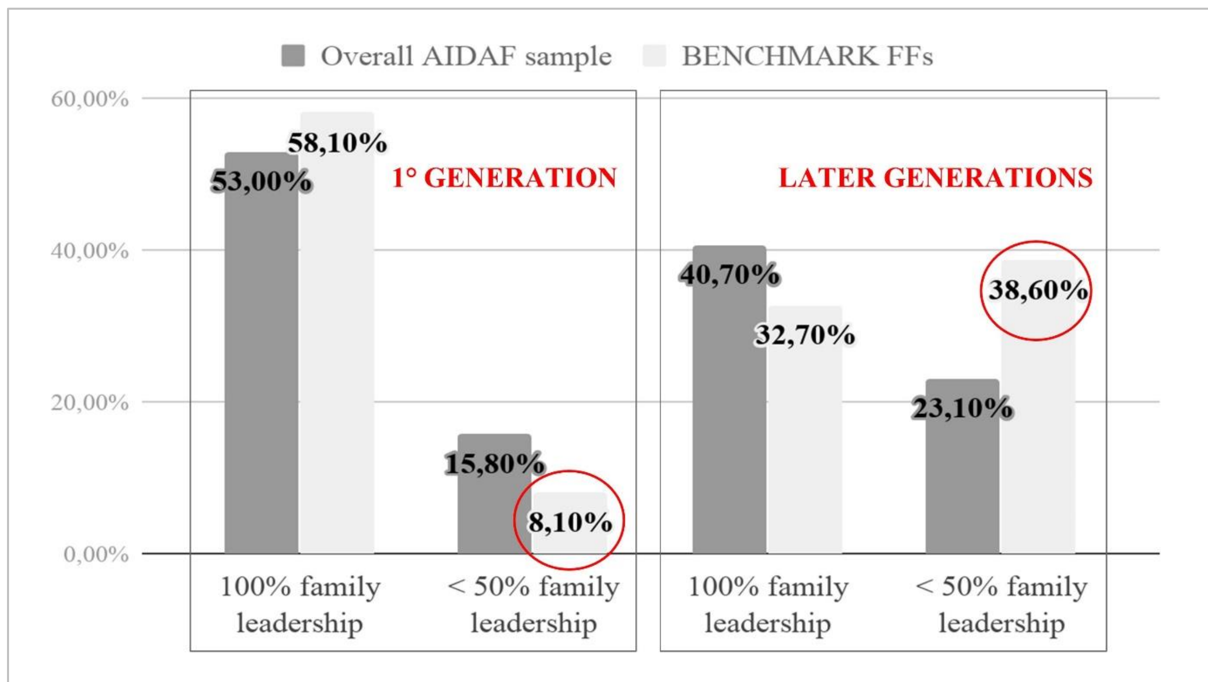

Table 4.In the Benchmark cluster, the amount of Non-family managers increases more sharply as generations go by. Source: AIDAF.

With the same rationale, the comparison with Centenary family firms[5] provides evidence of the business success ensured by a policy of openness over time, and the comparison with Elite family firms[6] reveals that a percentage reduction of the family members involved in leadership

[5] Within the family firms sampled by AIDAF, those remarkable for their longevity. IX Osservatorio AUB, 2017.

[6] Within the family firms sampled by AIDAF, those entered in the Management Education ELITE Program sponsored by Confindustria and Borsa Italiana. VIII Osservatorio AUB, 21 Novembre 2016.

To clarify, ELITE is the London Stock Exchange Group's international business support and capital raising programme for fast growing private companies. Basically, it is an ecosystem where the most ambitious private companies learn how to scale up, to structure for the next stages of growth and access capital, thanks to the support of other entrepreneurs, advisors, investors and key stakeholders.

roles is compulsory to aim at growth, not only dimensional but also cultural, and to promote the access to alternative-finance tools.

See Table 5 below.

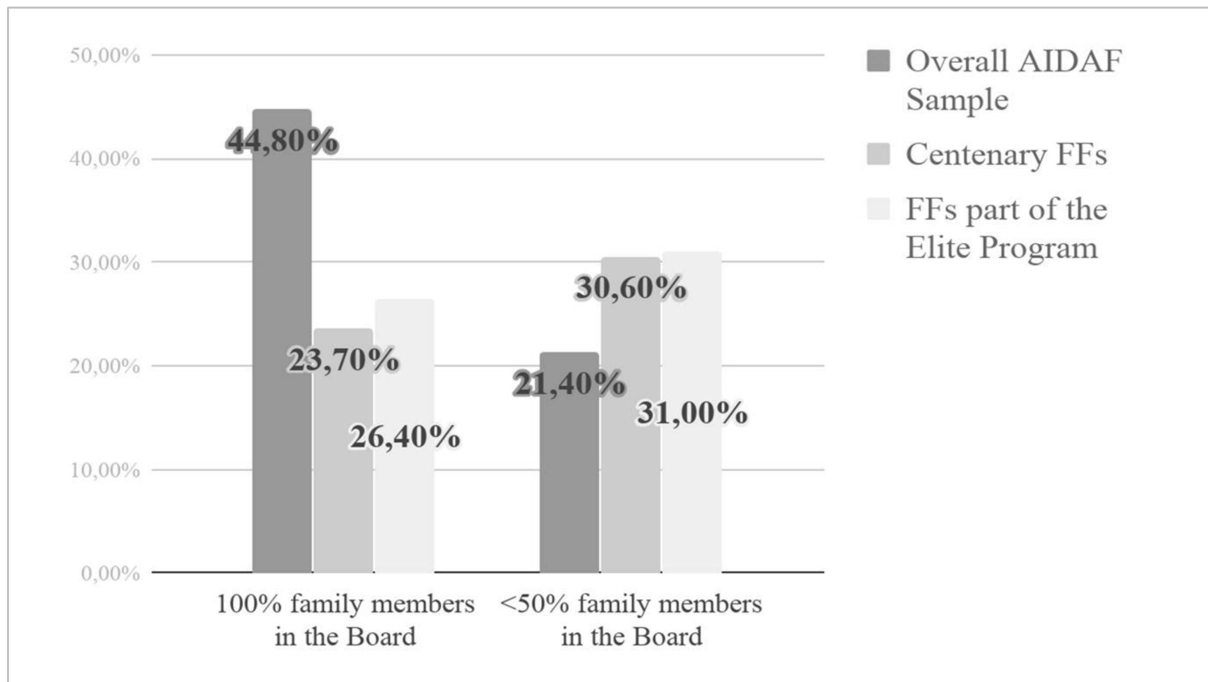

Table 5. The percentage of nonfamily managers involved in leadership positions is higher in Centenary family firms Cluster and in family firms that are part of the "Élite Programme", compared to the overall average. Source: AIDAF.

One of the major advantages associated to the inclusion of external managers in family firms concerns the rise of the survival rate along generations. There is a worldwide popular statistic claiming that only 30% of the family run companies survive after the founder's departure, while 10%-15% overcome the second generation. Even though the empirical evidence of such figure is much rarer than the mentioning, it is fair to say that having troubles after the first couple of generations is in line with the family business life cycle. So, not surprisingly, Italian family firms undergoing third generation experience a negative performance (measured in terms of ROI) on average. However, a look in detail demonstrates that the effect is mitigated under two

conditions: in family firms with *greater dimension*, and in family firms *opened to nonfamily managers*.[7]

See Table 6 below.

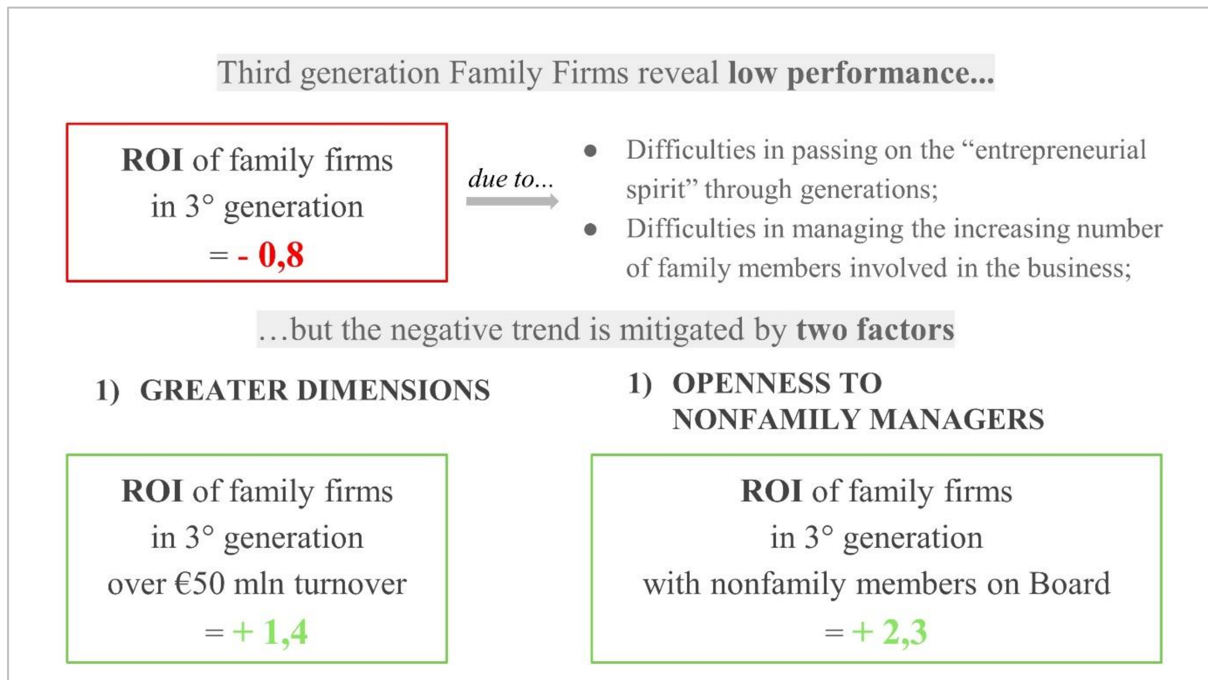

Table 6. Performance data reveals a positive effect triggered by the openness to nonfamily managers during the 3° generation (considered a critical phase of family firms' life cycle). Source: AIDAF.

It is also interesting to notice that nonfamily managers are more likely to be appointed as the business performance gets worse (when the ROA is lower compared to family successions) but are capable of getting the business up more effectively (sharper recovery).[8]

See Table 7 below.

[7] IX Osservatorio AUB, 2017.

[8] IX Osservatorio AUB, 2017.

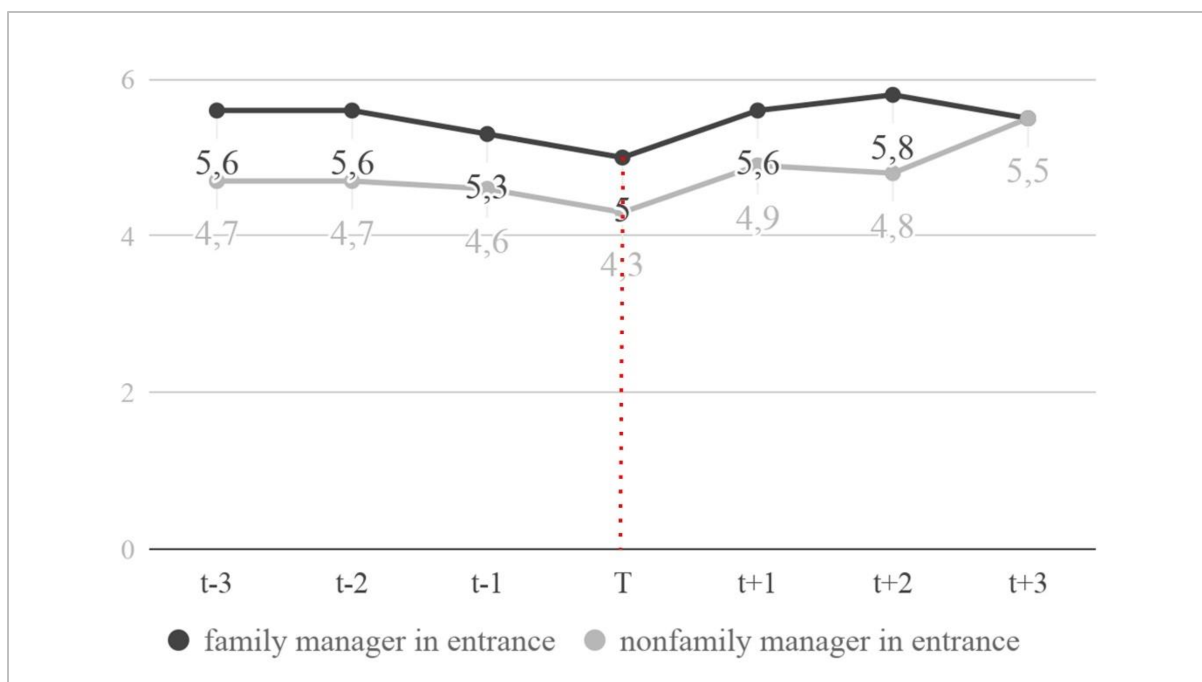

Table 7. Nonfamily managers are more likely to trigger sharper recoveries from worse performance scenarios, compared to family managers. Source: AIDAF.

Data citations and comparisons among statistics might continue, however, the above mentioned are enough to elucidate few starting points for this study.

- *Undergoing first generation, the success of a family firm has probably to do with maintaining the leadership within the family; however, during later generations, only the opening attitude of the Board and governance to external players encourages business growth. We assume a correlation between the tendency of Italian family firms to remain small in size, and their aversion towards involvement of nonfamily managers.*

- *The tendency to open to nonfamily managers should increase as time goes by, especially as way to overcome generational succession troubles and to recover from bad performance periods.*

The fact that Italian family firms appear to be more skeptical about opening the management to externals may be traced back to several reasons, both of structural nature (legislation, capital market, infrastructures, etc.) and cultural nature. However, the aim of this study is not that of explaining such triggers but rather to elucidate the importance of a change of direction in the future.

CHAPTER 2. FAMILY-RUN BUSINESSES

2.1 Definition

One of the most popular forms of company governance worldwide is the family one. As the name easily suggests, this type of business requires the presence of a fair number of family members that exert a certain degree of influence on the activity.

The origin of this organization form is impossible to place in time. We might adventure to say that family businesses have been the very first type of productive organization to be established, even before the advent of organizational structure and discipline themselves (i.e. Fordism and Taylorism in the early 20th century). In fact, prior to the modern age coming, the support tools on which companies could rely on in running their activity were extremely poor considering that financial assistance was unreliable, and legal support was barely existing. In this rudimental scenario it was easier to ask a relative to lend you money or to help you expanding the business, instead of involving an outsider, so that the family-run was the most common form of corporate government. Its relevance has kept its greatness even later during the pre-industrial period, when family firms counted as vast majority of business activities mainly in form of local artisan workshop, and also in the industrial revolution, giving birth to sophisticated merchant activities. In the late Nineties, they can be identified as crucial contributors to the advent of modern capitalism, based on private ownership, capital accumulation and profit orientation.

Nowadays, this organization type keeps being the backbone of both industrialized and developing Countries, in a variety of business sectors from the high-volume industry to the specialized niche, thanks to its greater virtue: the sense of ownership.

However, despite its popularity and the apparent immediacy of meaning, the family-run business is not a concept easy to delineate both in terms of boundaries and main features.

One of the trickier aspects of family firms, increasing the complexity of the case, is the *variance in terms of size*. Indeed, most of the worldwide family firms are small corner shops and small/medium enterprises, privately owned and in family's hands for generations. However, on the other hand, publicly traded family-run corporations as Exor Spa (Agnelli family), LG Corp. (Koo and Huh families), Roche (Hoffmann-La Roche family), Dell (Dell family), Ford Motor (Ford family), Volkswagen AG (Porsche family) do actually fall into this category as well, even if hardly considerable as family firms in the collective consciousness.

Despite the many forms that may assume, a family company is undoubtedly characterized by two key elements: there must be a family, owning a considerable part of the ownership and exerting a certain degree of influence over the main decisions of the management; and a succession between generations must have occurred in the past, be in place at the moment or, in case of funder-owned companies, be scheduled for the future.

By curbing the setting to the European Union, the Commission responsible for Entrepreneurship and SMEs has drawn up a more technical definition of a family business, based on few distinctive traits.

1. *"The majority of decision-making rights are in the possession of the natural person(s) who established the firm, or in the possession of the natural person(s) who has/have acquired the share capital of the firm, or in the possession of their spouses, parents, child, or children's direct heirs";*
2. *"The majority of decision-making rights are indirect or direct";*
3. *"At least one representative of the family or kin is formally involved in the governance of the firm";*

4. *"Listed companies meet the definition of family enterprise if the person who established or acquired the firm (share capital) or their families or descendants possess 25 percent of the decision-making rights mandated by their share capital".*

What is undoubtedly recognized is the greater prominence of certain traits over others, above all the family component and its interaction with the business environment. The Three Circle Model of family firms perfectly represent this scenario, in which three main spheres interact each other: Ownership, Management and Family. The first two circles are common to all business, while the Family dimension only appear in Family business.

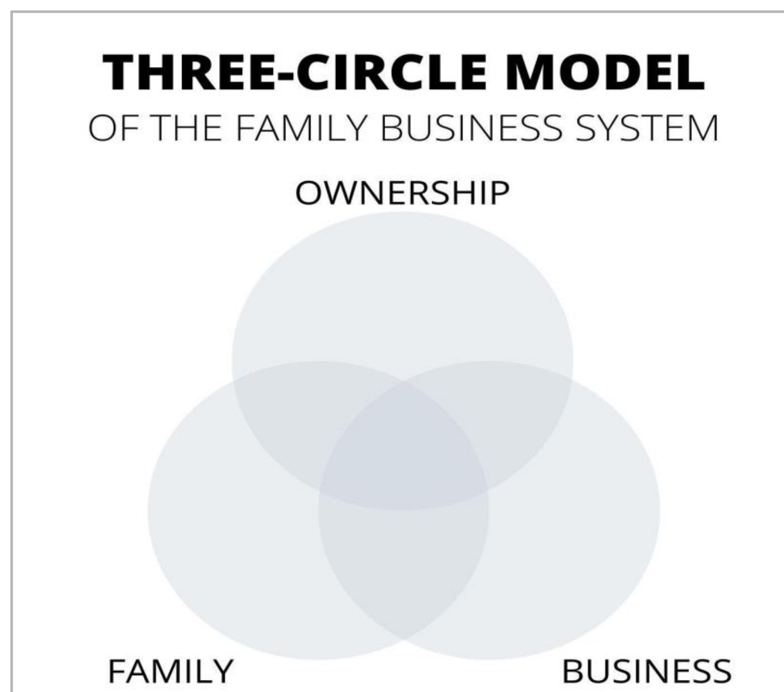

Table 8. The Three-circle model of the family business system.

Now, the extension of each sphere and the interaction among them determine the diversity of family-run companies' nature. Three are the main types of family companies that may be identified:

- Ownership and managerial authority generally lie all in family's hands inside small organizations, where a unified distribution of power allow the owner to take decisions, check the business activity and benefit from the returns. This is the classic form of family company: the little grocery store downstairs, or the small-town footwear manufacturer with a handful of employees.

- Moreover, when the complexity of the organization increases, this combination of ownership and control becomes harder to keep and a separation between the two dimensions generally occurs in order to ensure a successful governance of the system. As a consequence of that, a second scenario provides the family to end up retaining the majority of the ownership but giving up the managerial authority to professional outsiders.

- A third hypothesis concerns family businesses where the family keeps holding a small percentage of the ownership but maintains a key role in management.

The involvement of the family into the business generates positive advantages, but at the same time may trigger dangerous emotional pitfalls, especially if the concentration of ownership is such to exclude the involvement of neutral parties, the externals. In fact, outsiders might be seen as crucial moderators who help the family to focus on business improvement without falling into emotional distractions. As their presence in top positions increases (i.e. Ownership, Executive Team, the Board) in support of family members, the organization's stability is strengthened, and the chance of familiar disputes falls.

As it will be discussed in the next chapter, externals contribute to *professionalize* the system and to maintain a short-term economic orientation, while family members preserve the original values, keep the business long term vision and provide further support beyond a mere job duty

thanks to the emotional involvement they have (the so called "Familiness", Habbershon et al., 2003).

Moreover, nonfamily individuals may be introduced in the family business as agents of *diversification* in terms of competences and perspective. Diversification is one of the most popular risk management strategy, which in financial terms is based on the idea that the inclusion of various assets within a single portfolio of investments will limit exposure to the risk of a single asset downfall. Family firms might be interpreted in a similar way: the risks deriving from the involvement of family members is lowered by outsiders' moderating role.

Basically, the combination of internals and externals at Top positions is the key to the success of family-run businesses, as this study aims to claim.

2.2 The Top Management Team (TMT) of family businesses

The theoretical framework in which this research is placed concerns the Management structure of family businesses. With this regard, the choice to use the Top Management Team (TMT) as reference body has been made consistently with other similar researches on the family-run business field (Minichilli et al., 2010; Binacci, 2013).

2.2.1 Definition of TMT

The TMT is considered as the group formed by the Chief Executive Officer, the Chief Financial Officer, the Board Chairperson and, more generally, every other highly ranked member of the management board who operates closely with the Chief Executive. A review of the current literature on management reveals how the figure of CEO is generally taken as reference,

examining his/her interactions with the organizational environment with the purpose of extrapolating general remarks on the managerial behavior of companies. However, evidence has proposed that certain factors, values, and evolution affecting the Top Management Team as a whole, and all its members, turn out to be more reliable indices of organizational outcomes than if individually observed in the CEO figure (Bantel & Jackson, 1989; Gupta, 1988; Hambrick and Mason, 1984; Hage & Dewar, 1973).

The analysis of the Management Team is relevant under two perspectives. On one hand, it gives important information concerning management demography. Indeed, the observation of the top managers allows to evaluate if the prevalence of specific demographic traits over others do impact on the performance, and in which way. On the other hand, the variance of TMT demography is related to the homogeneity/heterogeneity of the group, the extent of which also impact on the business performance. Indeed, it is important to determine not solely which individual features increase team effectiveness, but also whether is preferable to have a homogeneous or heterogeneous group of demographic features.

In relation to family businesses, family and nonfamily managers are considered as part of two distinctive groups with demographic features that differ between the two groups, but match within the same one. This study is based on the idea that the introduction of external managers positively affects the performance of family business, because

a) it allows to select the demographic traits that improve team effectiveness, especially those related to *professionalization*;

b) it increases heterogeneity and *diversity* within the organization, triggering “positive conflicts” between the family and neutral parties.

Before venturing into the concepts of professionalization and diversification by means of nonfamily individuals, the next step consists of investigating how the composition of the management team and the demographic features of its members is capable of affect the performance results of an organization, and in which way.

2.2.2 The impact of TMT composition on firm performance: Upper Echelons Theory

The purpose to identify the elements influencing firm performance has always been one of the main focus for academics in the strategic management field. Generally speaking, two are the schools of thought: one argues that the environment affects the performance of a company (Porter, 1980; Weber, 1952; DiMaggio & Powell, 1983), while the other claims that the internal characteristics and resources of a firm affect its performance (Hambrick & Mason, 1984; Hiebi, 2017; Barney, 1991).

Undoubtedly the Top Management Team is considered as part of a firm's internal features, and the theory concerning how its composition influences the organizational outcome is known as Upper Echelons Theory (UET). Upper echelons theory claims that organizational outcomes, in terms of strategy and effectiveness, may be interpreted as reflections of the values, knowledge and experiential background of its most powerful actors (i.e. the managers). In particular the theory argues that top managers' perception and interpretation of the corporate environment affect the strategic decisions they take, that in turn influences the performance of the organization.

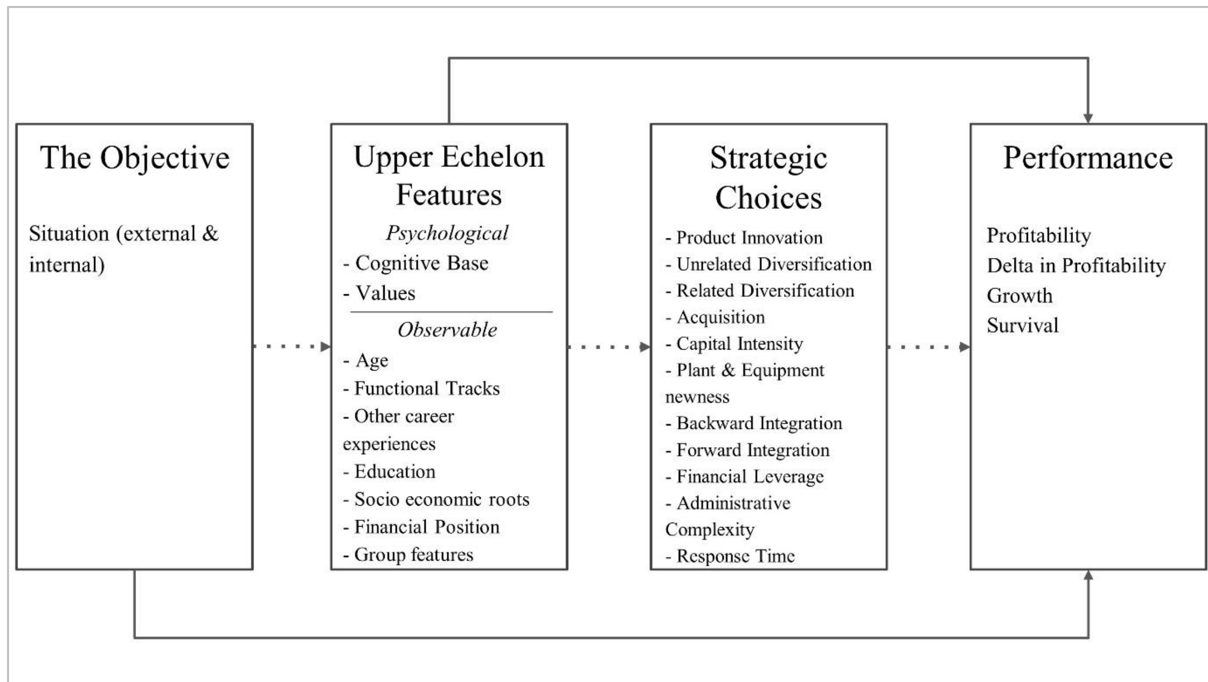

Table 9. The Upper Echelons Theory by Hambrick and Mason, published in the 1984.

The personal cognitive base of each manager is so decisive in shaping his/her managerial behavior, because the human capacity for information processing is limited, and because our assessment capacity to select what elements of the environment should be considered is determined by our character, education and personal tendencies. Put another way, the personal traits of top executives control the environmental features that they can “see”, what they see affects the strategic choices they take, which lastly affects the outcome of the firm in terms of productivity and financial results.

With the aim of investigating this theory, academics have approached the topic of whether and how top managers affect their organizations’ outcomes under two perspectives. On one hand, evaluating the top Executives’ demographic traits and the corresponding results in terms of business performance. On the other, evaluating the psychological features of top executives and the corresponding results in terms of performance. Both the perspectives are adopted with the aim of determining recurring trends, and whether specific personality configurations of

TMT members are related to specific financial results. However, it must be noticed that most of the UE studies adopts the ‘demographic’ method instead of the ‘psychographic’ as much more objective and easier to assess.

According to this perspective, the demographic features of the management group can be interpreted as proxies of the cognitive and methodological base of its members, so that the strategy they will adopt can be forecasted and so the consequent firm’s performance.

The original model was introduced for the first time by Hambrick and Mason (1984), and it put pen to paper a two-step reasoning: managers make strategic decisions based on their personal opinions on the situation they face, and their personal opinions are built on their physical and personality traits, their norms and values, their experience (Hambrick & Mason, 1984). This implies that personal characteristics of Executives such as the age, the personality, the academic background, the work experience contribute to shape their own perception and their actions.

Considering that the Management Team is formed by a collective of individuals, the sum of these characteristics is crucial in defining the way TMTs interpret situations and take decisions affecting the business organization.

UET model suggests that detectable managerial characteristics like age, origin and education should be adopted as viable proxies rather than psychological features, much more difficult to measure. The sum of all these measurable factors varying among the members, form the so-called *demography* of the TMT.

Hambrick and Mason (1984) specifically identify 7 observable features as determinants of strategic choices and so, of organizational performance: Age, Functional tracks, Other career experiences, Education, Socioeconomic roots, Financial position, Group characteristics.

Age	Firms with young managers will be more inclined to pursue risky strategies than will firms with older managers.
	Firms with young managers will experience greater growth and variability in profitability from industry averages than will firms with older managers.
Functional Track	There will be a positive association between the degree of output-function experience of top managers and the extent to which the firm emphasizes outputs in its strategy. Indicators of an output emphasis include product innovation, related diversification, advertising, and forward integration.
	There will be a positive association between the degree of throughput-function experience of top managers and the extent to which the firm emphasizes throughputs in its strategy. Indicators of a throughput emphasis include automation, plant and equipment newness, and backward integration.
	The degree of output-function experience of top managers will be positively associated with growth.
	In stable, commodity-like industries, throughput-function experience will be positively associated with profitability.
	In turbulent, differentiable industries, output function experience will be positively associated with profitability.
	The degree of peripheral-function experience of top managers will be positively related to the degree of unrelated diversification in the firm.
	The extent of peripheral-function experience of top managers will be positively related to administrative complexity, including thoroughness of formal planning systems, complexity of structures and coordination devices, budgeting detail and thoroughness, and complexity of incentive compensation schemes.
Other Career Experiences	Years of inside service by top managers will be negatively related to strategic choices involving new terrain, for example, product innovation and unrelated diversification.
	For an organization in a stable environment, years of inside service will be positively associated with profitability and growth.
	For an organization facing a severe environmental discontinuity, years of inside service will be negatively associated with profitability and growth.

Formal Education	The amount, but not the type, of formal education of a management team will be positively associated with innovation.
	There is no relationship between the amount of formal management education of top managers and the average performance (either profitability or growth) of their firms. However, firms whose managers have had little formal management education will show greater variation from industry performance averages than will firms whose managers are highly educated in management.
	Firms whose top managers have had substantial formal management education will be more complex administratively than will firms whose managers have had less such training. Specific forms of administrative complexity include thoroughness of formal planning systems, complexity of structures and coordination devices, budgeting detail and thoroughness, and complexity of incentive-compensation schemes.
Socio-economic Background	Firms whose top managers come disproportionately from lower socioeconomic groups will tend to pursue strategies of acquisition and unrelated diversification.
	Such firms will experience greater growth and profit variability than will firms whose top managers come from higher socioeconomic groups.
Financial Position	Corporate profitability is not related to the percent of shares owned by top managers but is positively related to the percent of their total income that top managers derive from the firm through salaries, bonuses, options, dividends, and so on.
Group Heterogeneity	Homogeneous top management teams will make strategic decisions more quickly than will heterogeneous teams.
	In stable environments, team homogeneity will be positively associated with profitability.
	In turbulent, especially discontinuous, environments, team heterogeneity will be positively associated with profitability

Table 10. The seven observable characteristics described by Hambrick and Mason (1984), and the relative hypothesis drafted by the author according to the research and reasoning laid out.

The perspective proposed by the two authors has the great limitation of not having been empirically tested; however, following studies have taken charge of the empirical applications, confirming the linkage between top management team structure and organizational

performance. By measuring performance in terms of economic profits, research has amply demonstrated a positive correlation between financial indicators as Return on Assets (ROA) or revenues growth, and few TMT demographic traits as group heterogeneity (Carpenter, 2002) and past experiences (Kor, 2003).

By the way, finance measures are not the only way to assess firm's performance. For instance, innovation has been proved to be stronger in organizations leaded by more educated managers coming from different functional backgrounds: to confirm that both level and diversity of expertise positively affect strategic decision-making ability (Bantel and Jackson, 1989). Some studies have seen as positive relation between performance, measured as firm internationalization capacity, and TMT size (Carpenter, 1998).

On the same wave, others proved international diversification to be positively linked to average tenure, academic background, experiences abroad, and tenure heterogeneity (Tihanyi et al., 2000), while negatively related to TMT average age. With respect to family firms and the introduction of external managers in the TMT, UET provides us with two main points for reflection:

a) Hiring nonfamily members allows the family to select those demographic traits that positively impact on firm performance, especially the experiential background and the academic training. See paragraph 2.3 “Professionalization”;

b) Hiring nonfamily members increases the heterogeneity of the management team by mixing family and nonfamily individuals, that positively impact on firm performance by triggering “constructive conflicts” among the members. See paragraph 2.4 “Diversification”.

2.3 Professionalization of a family firm's TMT

A wide amount of research confirms that with the increase of the family firm size, which generally occurs as generations go by, the necessity to include professionals into the corporate structure increases as well.

When a family firm attempts to professionalize its management team, it means that the family leaders start a process of integration of professional managers into the organization. On one hand, family members may be professionalized through a training process so that the management is kept within the family; on the other, hiring professional managers allows to gain the skills of professional management from the outside.

When does professional knowledge need to be incorporated into the management of a family business from the outside, and under which conditions can this integration process be successful?

2.3.1 Definition of professionalization

In the last half-century, the world of business has seen the refinement of management science followed by the inexorable growth among the population of the "professional manager" figure (Chandler, 1977; Meek, Woodworth, and Dyer, 1988).

Professionalism as education

Almost everybody agree that a professional manager is typically who has received formal training in a business school and subsequently has undertaken a leadership carrier in a company. Indeed, Shein (1968) sees the presence of a proper education as *conditio sine qua*

non to distinguish a Professional Manager from a Technical Expert (provided of technical background and experience only).

Following this perspective, academic education enriches managers' skills by shaping specific professional behaviors as:

(a) their choices are prompted by a set of general principles independent and not influenced by the circumstances;

(b) they are considered "experts" in management topics;

(c) their relations with the other organizational actors are objective and appropriate;

(d) they reached the role "climbing the ladder".

Education is at the base of many modern theories seeking to determine the essential conditions to classify an individual as a professional manager. Many have been the academics proposing the establishment of a "closed system", able to control who belongs to the profession and fitted with an ethical code that would allow managers to decide the appropriate behavior to adopt. In this scenario, one of the more spontaneous criteria would be, not by chance, the academic qualification of an individual:

"a (...) system, in which management positions would be attainable by individuals with varying credentials, depending on the job responsibility: none; experience only; experience plus education; MBA only; MBA plus CBP; CBP only. (...) We believe that the added confidence in the intellectual capabilities of certified professionals (that they have mastered a body of knowledge and are current in their knowledge of new ideas in business) would enable them to command a premium." (Khurana & Nohria 2008)

In the light of that, management education is considered as a fundamental prerequisite which ensures a certified level of leadership, skill, etc., higher than non-educated managers, and

produces significant differences in the ethical behavior of the individuals. Managerial ethic in particular is seen as one of the hottest topics of modern economy. With this regard, worldwide business universities gradually raised awareness concerning the responsibilities of management in modern society, and the crucial role they play in educating and qualifying those professional managers.

Professionalism as Experience

Another stream of literature focuses on the role played by *practical experience and technical knowhow* in the formation of a manager "expertise", contributing to the completion of his/her professionalization process together with the acquisition of a solid academic background.

In fact, literature tend to interpret the concept of "expertise" under a double perspective: on one hand, a cognitive-based view defines expertise as the "possession of an organized body of conceptual and procedural knowledge than can be readily accessed and used with superior monitoring and self-regulation skills" (Glaser et al., 1988), while on the other, a performance-based view defines expertise as the "ability, acquired by practice, to perform qualitatively well in a particular task domain" (Frensch & Stemberg, 1989).

Transcending which perspective to adopt, experience is undoubtedly crucial in the formation of the manager figure, since it allows to socially contextualize the theory learned during the academic training.

If management expertise is intended as the ability to perform management tasks properly in practice, a fundamental issue to be investigated first is the *nature of the managerial tasks*. Thus, our first consideration concerns the context-specificity of management experience, intended as its tendency to vary among different situations. A clarifying example is necessary:

“(...) project management expertise in the R&D group of a biotechnology firm is likely to differ significantly from project management expertise in the Information Systems group of a bank. Although project managers in the two situations may use similar techniques (for example, PERT charts), they will need a detailed understanding of different organizations, technologies and environments in order to make effective judgements and decisions.” (Reuber, 1997)

In other words, while, on one hand, the academic background provides the generic conceptual framework to exercise the managerial role, the working experience transfers to the manager all the specific tasks related to a specific sector. It means that management experience is sector-specific and may not be generalizable beyond the context(s) investigated.

Many studies have attempted to derive a list of relevant experiences in the manager education, through empirical evidence. For instance, the entrepreneurial literature has widely discussed to derive a relationship between the experience of the founder before to start the firm, and the subsequent firm performance (Sandberg & Hofer, 1987; Bates, 1990; Keeley & Roure, 1990; Stuart & Abetti, 1990; Van de Ven et al., 1984). In the attempt to do so, firm performance is considered in these researches as a proxy to weight the managerial skill of the business owner, and so to select the effectiveness of certain prior experiences rather than others.

The explanation lies in the fact that managerial work is innately difficult and ambiguous to measure, since its interlinked nature with the entire organization makes it hard to (a) separate performance results among different activities and (b) separate performance merits among different individuals: the measures of a manager’s competences through the evaluation of firm performance avoid these difficulties.

By the way, the whole of results of this line of literature is heterogeneous and contradictory, mainly because different notions of experience and business performance have been adopted in each study. However, it’s particularly interesting to note that there is recurring evidence of

a substantial positive linkage between firm performance and few typologies of prior experience: supervisory, industry and start-up experience. This may be interpreted as a confirm to the fact that the most relevant types of experience turn out to be industry-specific and job-specific, and that the formulation of a list of experiences necessary to form the manager figure should be specifically formulated for each management context studied.

After having determined that different types of experience bring to capture different types of managerial expertise, which, in turn, may have different consequences on the business performance, the next issue concern *the extent of each experience.*

There's a maximum and minimum repetition a typical manager can have with respect to a single action, which basically means that for every experience it should be possible to calculate a certain average extent. This has been demonstrated to be valid in different fields: for instance, master chess players have typically spent 30,000 hours playing chess (Simon & Chase, 1973) and radiologists have seen about 10,000 X-rays during their training and 200,000 over a career (Lesgold et al., 1988).

Of course, the tasks played by a manager are countless, of different significance and varied in terms of frequency, not to mention the specificity related to every single case, so that the compilation of a ranking of extent for each managerial experience is impracticable. However, an interest alternative question could be the following: in shaping management expertise, are large quantities of many small diversified experiences more effective than small quantities of few selected major experiences? The results of a study concerning managerial learning through experience ("Lessons of Experience: How Successful Executives Develop on the Job", 1988) demonstrate that the answer is 'yes'. One of the key findings of the study was that the most intense managerial learning comes from diversified experiences happening on the job.

The multitude of these routine matters fell into one of three major categories:

(a) challenging assignments, the major category which comprehends “ground breaking” situations of high stress and high stakes but followed by success, as to handle adverse economic conditions and escape from it, to turn upside-down the business and to start from scratch, or to create something new within the organization;

(b) hardship, which comprehends negative situations dealing with adversity and personal failures, as to repair a business mistake, to fire someone, to recover from a major carrier setback;

(c) relationships with specific individuals playing different roles within the organization (generally other executives and bosses), in terms of positive experiences of mutual esteem and support, but also negative experiences (showing to those individuals what they didn’t want to be like as a leader).

According to the authors, there’s also another category of minor relevance but however present, personal life events, which comprehends experiences happening outside the workplace and marking an individual’s personality, like being part of a sport team, living abroad or do charity work.

Diversification is a topic that will be discussed and deepened in the next chapter, but for now, suffice to say that applied to experiences it ensures exposure to a wide variety of situations, both positive and negative, and it is through surviving those situations and learning a new morale that executives’ learning and professionalization is built. Moreover, high degree of repetition and routinization have been proved to be dysfunctional in terms of innovation and creativity, essential elements in most of the managerial contexts requiring flexibility in thinking. In the light of that, the exposure to many different situations rather than the repetition of few in-depth experiences is best to professionalize managers. In fact, there are empirical studies confirming that benefits from mere exposure are higher than a sustained activity on the

same situation, in several managerial areas. For instance, negotiation skills, which are unanimously recognized as key management skills, can be significantly improved after a single negotiation experience (Thompson, 1990).

2.3.2 Why to professionalize management in family firms?

There are several reasons why a family firm should decide to launch a professionalization process of the Management team, bringing in professional managers from the outside or adopting educational trainings to professionalize the currently active management team.

(A) The most intensively investigated is probably the lack of proper managerial skills and talent among the family members. This is more likely to happen as the business grow, the family hardly keep being able to fill all the key roles and rarely possess all the required skills. The 2019 PwC report on Family Business specifically underlines the recent trend concerning the widening of skill sets required to managers, especially about technology:

"(...) we're seeing rising interest for board candidates who have had responsibility over large-scale information technology (IT) implementations or knowledge of cybersecurity and other IT risks. This isn't surprising. Firms are making substantial investments in technology. Over half (52%) of family business leaders expect to have made 'significant' strides in digital capabilities in the next two years. At the same time, concerns are growing over vulnerabilities to digital disruption and risks, particularly in cybersecurity. Having someone on the management who is knowledgeable about these risks is crucial." (2019 Family Business Survey by PwC)

Moreover, considering that family companies are increasing in size, expanding internationally or moving into different product areas, the inclusion of professional managers with knowledge of those markets or industries definitely means to gain a higher gear.

(B) A second cause triggering management professionalization is the need of a change in the organizational culture. Indeed, the family provides to the business specific “emotional” values, such as devotion and commitment, often in conflict with “economic” values, such as profitability and efficiency. In the attempt to fill the family's lack of professionalism, or the employees' lack of direction to value and profit creation, some family firms’ leaders may opt for a shift to sounder business practices. The urgency of including externals has been observed to increase as generations pass by, and heirs start to be open to changes with respect to organization’s values and culture, in a perspective of progress and profit.

(C) A third reason for launching a professionalization of the management within a family firm is to overcome leadership succession troubles. The transition from a generation to another (especially the first one, involving the founder) is a very delicate moment in which the family leader has to identify the manager/s who is worthy of assuming the future leadership of the firm. A further professionalization training might be required to family members or non-family employees who are believed to not be ready yet, or the active leader may be bound to search outside if none of them is deemed suited for such a role. Moreover, in numerous families many descendants may claim for a role in the business, so that the selection of a small managerial elite is challenged by numbers and externals may be called to appease conflicts. On contrary, in cases where no successors exist for many reasons, like a lack of interest on the business or because they’re not properly qualified, the involvement of professional outsiders may be forced by circumstances.

(D) A further reason to launch a professionalization of the TMT might be recognized in another recent trend demonstrated by family firms: the increasing willingness to explore alternative sources for financing outside of the family heritage. Historically speaking, family run firms have always demonstrated to be skeptical with respect to forms of funding involving externals (i.e. private equity), who tend to break the equilibrium of the closed familiar system, requiring

the separation of ownership and management and a professionalization of the latter as insurance of well-managed administration. Recent trends demonstrate that things are changing. On a hand, Private Equity investors are increasingly interested in family firms. On the other, family firms are opening their capital to Private Equity investors, especially as way to overcome ownership transitions due to demographic trends and the retirement of the baby boomer generation[9] (Neckebrouck et al., 2017; Dawson, 2018).

When the target is a family firm, a PE firm is more likely to invest if there are well qualified family successors (Upton and Petty, 2000), experienced family members, non–family managers, and family members wanting to exit the firm's ownership (Dawson, 2011). These family firms are preferred as investment targets because they do not require significant strategic changes after the investment (Achleitner et al., 2010; Scholes et al., 2009) and because they are already somewhat professionalized (Dawson, 2011).

(E) One last reason for launching a professionalization of the management within a family firm is related to the growing interest in achieving management diversity. As a matter of fact, recent studies have revealed the benefits deriving from a heterogeneous TMT structure (see next chapter), where diversity is intended in terms of gender, origin, personality, professional qualification, etc. With respect to family firms, the shift from entrepreneurial start-up to a well-structured business with long-term growth perspectives implies a formalization of management structures and processes, and a consequent specialization of managerial tasks. A multitude of specialized, diversified roles requires a multitude of professional, diversified managers.

[9] According to the author: "As the baby boomer generation (born between 1946 and 1964) retires, countries will experience the largest volume of business transfers ever seen. For example, in the United States, 60 percent of the country's 30 million small businesses, worth over $10 trillion, are owned by baby boomers, one of whom is turning 65 every 57 seconds (Forbes, 2012). Although keeping the business in the family remains the preferred exit route for business owners, an alternative exit route for family business owners – especially relevant for cases in which there is a lack of adequate financial resources for growth or of potential heirs – consists of selling all or part of the equity to an external investor such as a PE firm. (Watson 2018)

2.3.3 How to professionalize management in family firms?

Three are the basic available options to introduce professional individuals into the family firm TMT:

(a) to professionalize family members;

(b) to professionalize employees;

(c) to bring in outside professional managers.

The Professionalization through externals

Hiring external professional managers is one method to bring into the family business the expertise of professional management.

The majority of obstacles faced by the family firm during this professionalization process rises because of the divergence of education and values between family and professional managers. Indeed, family members and professional executives tend to possess different perspectives through which they make choices, exert authority and establish relationships. The apex of this personality divergence is reached between the figure of the entrepreneur, and so the first generation of a family firm, and the figure of the professional manager.

"For example, founders of family businesses tend to be driven by their particular vision of their product or service. They tend to be intuitive in their decision making, their power is based on ownership, and they motivate their followers through their charismatic behavior. Conversely, those trained as professional managers generally derive their power not from ownership but from positions of authority. They tend to make decisions based more on logic and rational analysis than on intuition. Furthermore, these managers tend to be rather impersonal in their interactions with others, in contrast to the more personal style of the founder." (Dyer, 1989)

The cultural conflict between Family and Professional Externals is generally kept alive among generations as part of the emotional sphere involved in this type of organizations, which is partially in contrast with the formality of the business sphere. This is due to the fact that past family firm literature had the tendency to categorize Externals Managers as "professional inducers" and "competences providers", characterized by objectivity, emotional detachment and mere economic/opportunistic orientation.

"Such "Professional" managers are usually identified as non-family and as non-owners and, therefore, as less "invested" in the company. Often, they have been specifically educated to be managers rather than experts in whatever Is the company's particular product or market. They are perceived, by virtue of these facts, as being less loyal to the original values and assumptions which guided the company, and as being more concerned with short-run financial performance. They are typically welcomed for bringing in much needed organizational and functional skills, but they are often mistrusted because they are not loyal to the founding assumptions." (Schein 1983).

In fact, the main line of literature concerning the topic tended to equate professional managers to external, nonfamily individuals providing "objectivity" and "rationality" to the family TMT, but lacking the understanding of "human issues" in organizations and focusing too much on short-term financial performance. Hence, the Agency problems associated with the inclusion of externals into family businesses. Not by chance, it is commonly believed that the entry of nonfamily professional managers is likely to generate tensions within the management team, as new skills and values are introduced into the system.

Recent critics observe that past research addressed the topic in a too simplistic way, and that results downgrading the role of external managers in family firms are outdated and incomplete. For instance, Hall and Nordqvist (2008) criticize the dominant view of professional family business management, purely focused on formal competences, stressing the role of a second component: cultural competences. The authors claim that nonfamily managers may reveal great

sensitivity and comprehension with respect to family culture and values, proving to be capable of assimilating family behaviors and goals. A point that the author stresses.

"The culture of a family business is to a large extent the result of values and norms of a founder and rooted in the family and its history. These values and norms manifest themselves in a rather stable way of thinking. (...) in order to be effective in the family firm, top management must be sensitive to the owner family's values and norms as well as to their goals and meanings of being in business. (...) Management is, thus, processual and deeply embedded in the social and cultural contexts in which it is enacted." (Hall & Nordvisq, 2008).

When the owners hire nonfamily CEOs looking for formal competences, they must be sure to select candidates who are capable of understanding and be sensitive to the family-influenced cultural and social processes (so called "*cultural competence*").

The recruitment of an external manager who does not possess or is incapable of developing cultural competence can trigger serious structural problems, especially concerning corporate identity: defining the nature of the business, its future direction, the goals to reach and the strategies to adopt, the actions to pursue them. It might be argued that the requirement of this "cultural boundary" affects the extent of actions of nonfamily executives and set up a managerial environment hostile to change. However, family culture has to be interpreted by external professionals as a guiding principle remaining on the background of action rather than a driving force for every choice.

The objective of external inclusion is basically to let original culture and family values survive under the guise of a new "hybrid management style": the family is able to impose the organizational culture guidelines through the retention of the ownership (or at least, of a majority stake according to the essential requirements of a family business to be defined such),

but the external executives are responsible for developing a range of new initiatives based on their background.

The new paths undertaken will be consistent with part of the core values of the original family culture but will also add innovative traits affirmed by their experience. These new initiatives will prove to benefit the family business performance, since they keep the TMT updated to the evolution of the management techniques and will be the expression of a *super partes* position in facing problems' change as the company mature and grow.

2.4 Diversity in family firms' TMT

2.4.1 Definition of diversity: a double edge sword

Diversity is generally defined as the property of a social group to be formed by members with objective and subjective differences among each other. In the management context, this term refers to the heterogeneity degree a TMT can assume under a functional or educational backgrounds' perspective.

In the last years, the growing awareness of scholars on the topic of TMT diversity has gone hand in hand with the increasing spread of the phenomenon: the competitive and dynamic nature of the market landscape has made difficult for firms to rely solely on the capabilities of a single manager. Hence the need to create management teams that are wider and more competent, to stand the pace of an ever-changing competitive environment and to satisfy the specificities of each corporate's field of expertise. Indeed, empirical studies demonstrated that the combined capacity of top management teams is responsible for the long-term success of a business.

How do we measure diversity?

Under a theoretical perspective, diversity refers to any possible dimension of differentiation within a group, since the introduction of subjective parameters can potentially identify endless possible combinations of human characteristics, and so of differences among individuals. What is perceived as diverse among the members of a group really depends on what social similarities have been adopted as reference in the judgement, which consequently determines the classification of similar and dissimilar.

Organizational diversity extends along two dimensions, primary and secondary. The primary dimension of diversity comprehends the characteristics that affect and differentiate individual identities, such as gender, ethnic group, sexual orientation, age, mental and physical distinctive traits. This is the category that mostly influence the formation of groups in the workplace and within the society. The secondary dimension of diversity is the one comprehending the less evident characteristics, that tend to exert a less predictable impact on personal identity. Academic background, religious belief, geographic location, spoken languages, family situation, work experience, other experiences, income level are examples of characteristics included in this category. Some academics proposed the addition of a tertiary category, related to past experiences.

With particular reference to TMT diversity, the point is how to estimate the impact on coopetition among managers. Under a social psychology and cognitive perspective, Bengtsson et al. (2018) suggest that TMT diversity arises from two distinct characteristics of the team's individuals: surface-level attributes (age, gender, nationality) and deep level attributes (knowledge and experience). Similarly, Pelled (1996) distinguishes diversity features between more visible but not job-related attributes (like age, gender, and nationality) and less visible but highly job-related attributes (like. educational background and job experience). Likewise,

Milliken and Martins (1996) classify in two separated groups diversity generated from observable attributes and diversity generated from underlying attributes. In short, along the same line, other academics have grouped diversity features into surface level (much more observable characteristics) and deep level (less clear characteristics) diversity.

How do TMT diversity affect group process and performance?

Traditionally, literature has addressed the matter of diversity focusing on a "individual perspective": in the wake of the Hambrick and Mason's (1984) UET model, the characteristics of TMTs have been identified as a collectivity of independent characteristics deriving from each member as human being, with personal skills, experience and talents. However, recent studies have started to notice that a focus on individual executives tends to neglect the fact that each manager is only one building block of the team, and team members complement each other's knowledge and expertise thanks to their heterogeneity. The investigation of TMTs' characteristics reveals sharper relations between certain corporate decisions and resulting outcomes, if compared to the investigation of a single top manager. So, aware of the crucial role played by TMT as a group on the establishment of management practices, does diversity among the members advantage or disadvantage its effectiveness?

Management diversity is commonly defined as a "two-edged sword" because theory predicts both positive and negative implications on the quality of the decisions. These findings suggest that diversity can provide great opportunities as well as tough challenges for organizations. Indeed, diversity can generate conflict of different nature and so cause diverging effects on the group performance. Specifically, to address the matter of the effects caused by the multiple shades of diversity within TMT, two streams of perspectives may be adopted: the social categorization perspective, and the information decision-making perspective.

(a) **Social categorization perspective - the negative perspective of diversity:** according to this stance, the presence of dissimilarities among the members of a work group led to label everyone as either ingroup/similar or outgroup/dissimilar. Considering that people are much more inclined to favor ingroup members over outgroup members, to trust them more, and to be more willing to cooperate with them, the identification of sub-groups may disrupt the effectiveness of the major group, harming communication, cohesion and collaborative problem solving. This means that individuals with similar attributes like age, sex, and nationality are attracted to each other and tend to categorize themselves as part of the same social group, generating a more effective and efficient exchange of information. Not only demographic features can associate two individuals: for instance, personal linkages among top managers that are originated from common education (if they got the same degree or attended the same university) or common work experience (whether they had the same career path, or worked for the same company) are capable of improving communication within the TMT.

In this perspective, negative aspects that have been identified as consequences of diversity among members include slower decision-making and communication breakdowns.

(b) **Functional perspective - the positive perspective of diversity:** according to this stance, diversity may introduce differences in knowledge, expertise, and perspectives useful in the establishment of a higher quality, creativity and innovation of the outcomes. Diversity implies greater availability of job-related technical knowledge and expertise within the TMT, crucial for the TMT effectiveness in each management department (creative, financial, operation and production, human resources, marketing, strategic). The main argument in favor of this approach is that heterogeneity gives to the team a larger pool of resources and skills, helpful in dealing with non-routine issues. Studies have widely claimed that TMTs featuring a wider

range of knowledge and different perspectives are better capable of interpreting, evaluating, predicting, and reacting to market changes. Moreover, a varied TMT may also be the scene of constructive conflicts, where the integration of diverse information and perspectives reconcile and stimulate a much more creative and dynamic thinking.

2.4.2 The positive side of TMT diversity in detail: four types of Functional Diversity

The type of diversity which positively affect TMT effectiveness (i.e. Functional Diversity, where diversity is intended as trigger for "positive conflicts") may be traced back to four scenarios:

(1) diversity in the different functional areas within which team members have spent majority of their careers (dominant function diversity);

(2) diversity in the functional backgrounds of team members (functional background diversity);

(3) diversity in team member functional assignments (functional assignment diversity);

(4) the diversity represented in the functional backgrounds of individual team members (intra-personal functional diversity)

Each of these conceptualizations focuses on a different expression of functional diversity and is based on different assumptions concerning which form of functional diversity matters the most.

2.4.2.1 TMT dominant functional diversity

It refers to the functional area of specialization of each TMT member, i.e. the one within which he/she has spent most of the career. TMT dominant functional diversity basically stands for the diversified “dominant functions” available within the team. When the degree of dominant functional diversity increases, it means that team members possess a wide range of different functional specializations, gained through experiences on a specific field. The fundamental issue to address within a certain group is whether the different dominant perspectives possessed by the members cover a wide range of functional categories, or they are confined to only few categories. Indeed, when the dominant functions of team members are well distributed across all the relevant functions required by the organization to the team, the team is considered well balance in terms of knowledge and expertise.

Empirical studies adopting this measure of functional diversity reached important achievements: some have proved that diverse teams can generate more options during the brainstorming process, so that to creatively solve complex issues and increase the quality of decisions taken (Bunderson & Sutcliffe, 2002; Carpenter et al., 2004; Doz & Kosonen, 2007; Wiersema & Bantel, 1993). Others associate dominant function diversity with an increasing level of innovation (Bantel & Jackson, 1989). Other scholars demonstrate that a varied range of experiences and perspectives is linked to an improvement in the process of evaluation of alternatives, increasing decision effectiveness and strategic clarity (Smith et al., 1994; Bantel, 1993). Others, an increasement in TMT dominant functional diversity has been proved to increase the group’s capacity to foresee, interpret, and respond to environmental changes (Carpenter, 2002; Keck, 1997). For all the positive aspects mentioned above, dominant functional diversity results in better firm performance, especially concerning the long-term.

2.4.2.2 TMT functional background diversity

It refers to the degree of difference in the functional experiences each member has. The background of an individual is built through experiences, and while "dominant function diversity" concerns the distribution of the prevailing functions of each member, "functional background diversity" concerns the extent to which team members differ in their functional backgrounds thanks to the unique combination of experiences they live. Basically, functional background diversity is evaluated by examining the professional experience of each team member, with the aim of determining the time spent in each of the different functional areas.

Functional backgrounds' heterogeneity is positively evaluated as provider of non-overlapping knowledge, broader expertise, and wider pool of resources from which to draw in making choices and in taking action. It has been positively associated with increasing levels of diversity of beliefs and perspectives, and with an improvement in the communication exchanges, in terms of quality and speed.

Concerning how to measure functional background diversity, academics advance the idea of computing it as "the average Euclidean distance between the time-in-function scores of each team member and every other team member across all relevant functions" according to the following logic:

"(...) teams composed of individuals whose dominant functions cover all of the functional bases (dominant function diversity) are more likely to be composed of individuals with different functional backgrounds (functional background diversity). The two measures clearly provide unique information, however, since it is possible to have a team whose members have generally similar functional backgrounds but very different "dominant functions". This suggests that the choice between dominant function diversity and functional background diversity is an important research design decision that

may influence the results that are obtained and the way in which those results should be interpreted. Furthermore, we suspect that in most cases, researchers will want to select one or the other conceptualization rather than employ both in order to avoid problems of construct overlap and multicollinearity." (Bunderson, 2001)

2.4.2.3 TMT functional assignment diversity

It refers to the degree of difference in the functional assignments that have been allocated to each team member. The main difference from the previous forms of functional diversity is that it doesn't concern the past experiences and backgrounds of an individual, but the current assignments.

The point is to evaluate their current extension among the different functional areas of an organization, and to understand if the members are covering many functional categories or if they are concentrated in just a few.

Studies in this field attempted to investigate how the extension and the variety of functional assignments within a team may be related to the effectiveness of team processes and outcomes. Few scholars demonstrate that functional assignment diversity is associated with an improvement in communication (Ancona & Caldwell, 1992), and positively affect the capacity of a team to reorient its strategy (Lant et al., 1992).

In terms of performance, high degrees of functional assignment diversity are proved to lead to better performance in turbulent environments (Keck, 1997) and, generally speaking, to a much more sustained performance over time (Keck & Tushman, 1993), as well as an increase of firm profitability when sustained by open dialogue (Simons et al., 1999).

2.4.2.4 TMT intrapersonal functional diversity

It refers to the diversity of functional experiences of each team member. This dimension of functional diversity focuses on the degree to which an individual may have had experience in a limited range of functional areas (and so, be a narrow functional specialist) or in a much wider number of functional domains (be a broad generalist).

The main problem arising in this context is that no study has attempted to empirically investigate the significance of intra-personal functional diversity in management teams yet. So that, we have no chance but to consider the few empirical researches examining its significance for individual managers, and the theoretical assumptions made with regard to its significance for management teams. For instance, Campion et al. (1994) discovered that experience in a wide range of functional areas is positively associated with wages level, career opportunities, positive affect, perceptions of skill acquisition and other career benefits (Campion et al., 1994). Further, Hitt and Tyler (1991) stress the change of perspective through which strategic acquisitions are evaluated, between managers with broad functional backgrounds and managers with narrower functional backgrounds (Hitt and Tyler, 1991). Shifting the attention to the group effect, Burke and Steensma (1998) advance the hypothesis that the intra-personal functional diversity of members exerts massive effects on the dynamic of the TMT too, not only on the actions of the single manager. According to their study, executive teams formed by individuals with wide-ranging functional backgrounds turn out to show a broader "dominant logic" and to be less sensitive to decision-making behaviors like rigidity and overconfidence (Burke and Steensma, 1998). Moreover, executives who have experience in many functional areas are supposed to be more likely to have both larger and more structurally sparse networks (Monge & Eisenberg, 1987), and to gain more awareness of “where the knowledge is and how to tap into it” (Bunderson, 2003), facilitating the decision-making process of the TMT. Further,

managers with a high degree of intrapersonal functional diversity are more likely to become the nerve center of the management team, and to exert a massive influence in the decision-making process (Bunderson, 2003).

2.4.3 Diversity = Heterogeneity?

When describing the potential divergence of demographic traits among TMT members, as well as the positive effects triggered by mixed compositions of family and nonfamily managers, I referred to the concept of diversity. However, it might be the case of spending few considerations on a second terminology: heterogeneity. Indeed, despite the fact that a shallow approach may induce to consider them synonymous, they actually hide important shades of meaning for the purpose of this study.

We claim that referring to something as heterogeneous, implies emphasizing the integration of reciprocal interactions among different organisms all part of the same collectivity, while instead, referring to a collection of objects or entities by using the term diversity implies neither interactions nor a common collectivity. An etymological analysis confirms the observation. "Diversity" focuses on the diverging dimensions of a difference, while 'heterogeneous' indicate something quite the contrary: the integration of many other (from Greek, *hetero*) kinds (from Greek, *genus*) within a single whole. In other words, heterogeneity indicates a collective entity that dynamically integrates different units, while diversity refers to divergence rather than integration. A heterogeneous body may be formed physically of entities that differ in some ways, but as a group, it implies multiple direct and indirect engagements, reactions and exchanges among these individuals.

In the light of these observations, when dealing with TMT and referring to the demographic discrepancies among its members, the attribute of diversity may turn out to not be precise since its meaning and significance are much broader than the notion of heterogeneity. Aiming for TMT diversity in the strict sense may effectively suggest an increased likelihood of conflicts and incompatibility among its members, reducing the effectiveness of the group and having a negative impact on the outcomes.

However, since most of the past and current literature refers to a group's dissimilarity of its members by bringing up the term "diversity", and in the attempt to recall relevant economic foundations as the Portfolio Diversification[10], I chose to keep referring to TMT pluralism with the term diversity, bearing in mind the limitations that it implies and the intrinsic reference to the more appropriate notion of heterogeneity (sometimes used as synonym).

The next paragraph is dedicated to the evaluation of the effects caused by TMT diversity on leadership effectiveness.

2.4.3.1 Diversity effects on TMT

The TMT can be deemed as the informational and decisional conglomerate, through which the competitive moves of a business are made. Such moves are influenced by how the team analyses the environment, recognizes risks and opportunities, interprets external stimuli: in the light of that, the team proceeds with designing strategies, and implementing decisions. The way

[10] Diversification is a risk management strategy that mixes a wide variety of investments within a portfolio. A diversified portfolio contains a mix of distinct asset types and investment vehicles in an attempt at limiting exposure to any single asset or risk. The rationale behind this technique is that a portfolio constructed of different kinds of assets will, on average, yield higher long-term returns and lower the risk of any individual holding or security.

TMT diversity affects leadership effectiveness, intended as its capacity to act and react to events, may be traced back to three aspects:

(1) "The competitive appetite", intended as the willingness to engage on actions and react to competitors' actions. A heterogeneous team has access to wider intellectual resources, embraces a broader set of vision and exploits far more external contacts than does a homogeneous group. Moreover, thanks to their miscellaneous backgrounds and perspectives, diversified TMT can catch more opportunities and at the same time detect threats more easily, which means to have a greatest potential for engaging in "healthy" actions. Not by chance, management heterogeneity is associated with positive effects especially in creative, unstructured and innovative tasks.

(2) "The competitive magnitude", intended as the magnitude of the actions and reactions undertaken by the leadership team. The significance of an action is measured in multiple ways, for instance in terms of strategic impact, goals achieved, optimization capacity, amount of attention received from industry and analysts, extent of the firm's operations that have been affected by the move. Competitive magnitude can be calibrated according to the tactical initiative that has been chosen, and TMT diversity contributes in defining such strategy. However, there's no evidence of whether such contribution generates a positive or negative effect on leadership effectiveness when done by a heterogeneous group, rather than a homogeneous.

(3) "The competitive speed", intended as how quickly the leadership teams is capable of implementing its actions and reactions to competitors' moves. This capacity is extremely important since it allows the business to achieve early advantages in its initiatives, forcing its competitors on the defensive. This is probably the field where diversity might reveal its worst

influence: indeed, communications and decision making in a heterogeneous team tend to be obstructed due to the dissimilar perspectives, outlooks and information among the members.

In the attempt to take stock of the effects considered so far and investigating whether TMT diversity is something to strive for or not, we end up with two reflections.

First, recurring is the opinion that diversified groups are well disposed towards adaptation, and so led to better economic performance those businesses under conditions of environmental change and intense competition markets; on the other hand, homogeneous top executives' groups tend to engage more easily and therefore to be preferable within stable environments. This logic can be easily translated into the family firm context as follow: by considering the increasing complexity of a family run organization undergoing its path from micro to medium/big size, the adaptability and dynamism offered by a diversified TMT where family and nonfamily members coexist, appear far more suited than the stability and cohesion ensured by a pure family leadership. Under these terms, the performance-improvement utility provided by external managers to family firms appears to be not universally fair. Indeed, family firms can be successfully managed by family members as long as the business size is stationary and the market competition is under control. However, in front of the will to change the organizational structure, to grow in business dimensions, to expand the market boundaries, the choice of increasing TMT diversity by introducing externals becomes a crucial move to be done by the family.

Secondly, TMT heterogeneity led to a *strategic improvement*, which consequently turns into performance benefits. This logic is built on the common idea that strategic improvements, intended as decision quality, consensus and acceptance, are encouraged by constructive conflicts among its members. With respect to this, an effective TMT should prefer "cognitive conflict" while limiting "affective conflict": the first typology includes task-oriented

disagreements caused by divergent perspectives, while the second category includes individual-oriented conflicts deriving from personal hostilities. In other words, TMT demographics which trigger cognitive conflicts generate a beneficial effect on the performance (i.e. team size and openness are positively related to this kind of disagreements), while those triggering affective conflicts tend to harm the company outcomes. Nonfamily members are characterized by professional detachment and no emotional involvement with the business, so that their presence within the leadership team is more likely to generate cognitive conflict due to their heterogeneous background, rather than affective conflict.

2.4.4 TMT Diversity within family firms

The adoption of the Upper Echelons perspective in the family firm context calls for the assessment of one specific aspect in estimating TMT demography, which is the origin of individuals intended as family members or nonfamily members.

In fact, it is important to point out that in literature concerning TMT composition in family firm context and the way it influences firm performance (UET applied to family firms), family managers and nonfamily managers are considered two mutually exclusive, homogeneous groups formed by individuals who shares values, background, culture, experiences. Moreover, the internal or external origin of managers have been proved to entail specific, distinctive configurations of the above-mentioned features, so that the prevailing homogeneity of family managers influence the TMT behavior in a certain way and a nonfamily majority in another.

As widely said above, despite the variety of features on which diversity can be considered, academics tend to evaluate group's diversity focusing on few, precise human characteristics: on one hand, *surface diversity attributes* as age, nationality, gender, on the other *deep-level*

diversity attributes such as those based on education (level and specialization) and work experience (functional, technological environment and industry environment). The presence of aligned characteristics creates homogeneity within a group, while the presence of diverging characteristics creates heterogeneity, with all the positive and negative consequences already mentioned.

The degree of heterogeneity of a TMT in a family firm is generated by the variance of the said characteristics among its members (managers), as it is generated in any other type of business. Nevertheless, we can identify *two unique sources of diversity* within the family firms' TMTs that are peculiar for the family business case, and so untraceable in any other organization form: the presence of family and nonfamily members, and the presence of different active generations of family members.

In which way and to what extent family executives may differ from nonfamily executives, enough to talk about TMT diversity?

The answer is related to the hiring mechanisms adopted. As a matter of fact, family members are potentially victim of privileged recruitment procedures in which their competences and skills are not impartially judged based on their professional background, as with externals, but rather taken for granted due to the family name. The adoption of such nepotistic behavior is quite dangerous for the formation of an effective TMT, since it may not guarantee the presence of the appropriate managerial expertise. Hence, besides not necessarily having the proper high-level academic training, a wide work experience background and the right mix of talent, personality and attitudes (deep-level diversity attributes), family managers may diverge in terms of surface diversity attributes too (i.e. be younger or female). In short, the two categories of diversity attributes described by the theoretical authorities of the field (in depth and surface features) may modulate among individuals, within the family as well as within the nonfamily

managers' groups. However, there's a peculiar source of diversity that distinguish family executives from nonfamily executives: the controllability of the said attributes. In fact, while nonfamily managers who are hired on the base of an impartial thorough assessment are specifically chosen for that combination of skills and backgrounds, which are therefore "controllable", family managers who are hired through a fast line may be relieved from some curriculum standards, and so be less controllable in terms of skills and backgrounds.

From this reflection, it appears clear that the introduction of the group "external managers" within the TMT of a family firm can be read as an act of diversification, in the sense that provides to the management team a configuration of deep-level and surface features other than those provided by the group "family managers".

CHAPTER 3. THE INCLUSION OF NONFAMILY MANAGERS: OPPORTUNITIES AND THREATS

3.1 TMT composition in family firm: focus on mixed solutions

Let's now discuss the different compositions a TMT can assume in the family business context. The composition of a Management Team in this kind of company exert a stronger impact on the entire organization if compared to other business forms, since the governance structure has to face the interactions with a non-institutional organism: the family. Three are the potential compositions a TMT can assume in a family-run company:

1. Pure Family Management Structure
2. Mixed Structure, comprehending Family and Nonfamily Managers
3. Pure Nonfamily Management Structure, with a complete separation of ownership and management

Among all, this thesis strongly encourages the adoption of mixed managerial configurations as the best solution through which family firms can make their governance more effective. A mixed management structure provides that external professionals should be introduced into the family business, to whom part of the authority is delegated. The advantage of this hybrid system is the establishment of an equilibrium between the entrepreneurial direction and the managerial direction. Indeed, the presence of external managers is fundamental in family companies to let the family members cure the operational level of the core business, while nonfamily members deal with the managerial issues, providing their professionalism, competence and experience.

"(...), the creative-intuitive behavior of entrepreneurs works in tandem with the more rational and planned behavior of managers, a strategic synergy that ensures the success of the firm. Overall, under

these circumstances, the extended family business undergoes a "managerialization process" while continuing to maintain its decision-making power, most of the times held by the founder and his/her successors." (De Falco 2016)

Although the Pure nonfamily Management solution may seem to be even more indicated for initiating a family company professionalization process, it actually hides some danger for which it is not as suitable as the mixed one. In the Pure nonfamily Management scenario, the family retains only the ownership while the management authority is totally entrusted to externals. This is the top level of professionalization a Family-run Business can aim at, as well as the configuration that makes them more like other business forms. This form of management is generally much more popular in family business with higher age and more past generations behind (Miller and Le Breton, 2006). The higher risk of this model has been recognized in the higher likelihood to lose the distinctive family values and culture, and so reducing the competitive advantage family firms have. Moreover, a total disposal of family involvement in manager duties led to a reduction in the company performance.

3.2 Summary of the benefits deriving from the inclusion of nonfamily managers

By taking up the incipit of this work, the family business Italian context has been recognized to suffer from significant closure in terms of leadership, allowing the family to maintain full control of the business but excluding a substantial active participation of externals in the management. Aware of the crucial role played by the executive team in determining the success or failure of a business, the pursuit of competent individuals to hire should bring very often families to look outside the household rather than persist in a restrictive approach. In fact, this

detrimental behavior precludes the possibility to launch two important processes, the professionalization and the diversification (intended as heterogeneity growth) of the TMT.

To professionalize the management team means to recruit experts capable of diligently apply their specialized knowledge to solve complex problems of great impact on the business (namely, the organization of employees and resources for the production of goods and services that generates societal welfare). This selection process is impartial and based on merit when the candidates are not involved in the family circle, ensuring "to the best man to win" thanks to his/her educational and experiential backgrounds. Not by chance, the recruitment of professional externals is the best choice in many scenarios: to fill the knowledge gaps of family managers, to trigger a change of direction of the business (in terms of corporate culture and future prospects), to overcome generational turnovers and family diatribes, and to facilitate the inclusion of outside capital investors (more inclined to cooperate with family businesses lead by *"super partes"* professionals). Of course, it is pertinent to note that a professionalization of the TMT may be carried out potentially through few selected family members who, once verified their aptitude for the work, may be trained (in both academic and experience perspectives) properly. However, the presence of a finite family circle with a limited number of members does not always ensure the existence of a suitable candidate over time. Hence, rather than a family designation prompted by dynastic pride which doesn't effectively professionalize the TMT, the inclusion of externals (already employed, or ex novo) turn out to be the best solution to implement within the family business context.

With respect to the diversification process of TMT instead, scholars claim that the coexistence of diverse individuals within the same group generates divergence of opinions, and so repeated opportunities for "constructive discussions". The personal features in which the members of a team may diverge are generally grouped into two main categories: surface attributes (age, gender etc.…) and deep level attributes (knowledge and experience). With respect to these

characteristics, the introduction of external managers within the family TMT generates an increase in the heterogeneity of the managerial system due to: (a) nonfamily managers can be selected among an endless pool of professional candidates, each one diverse from the other in terms of the said personal features, on the base of the current needs of the organization; (b) the personal traits inherent in the figure of the professional manager (large experience, high quality academic education, top-class skills), without which he/she would never be hired, may get to significantly diverge from those of the family managers, for whom rules imposing certain standards are quite often bended (lower educational and experiential background). The benefits deriving from a group's diversity are triggered by conflict of positive nature, called tasks conflicts: according to the functional diversity theory, that pursuits the aim of investigating this type of disputes, diversity of cognitive resources promotes creativity and innovation among the members, problem solving capacity, and organizational flexibility, with a resulting improvement of the TMT performance.

In short, the secret of success for family firms is likely attributable to the recruitment of external managers, firstly due to the ensure of professionalization they provide, customizable on the base of the organization needs, and secondly due to degree of heterogeneity they generate, stimulus for the creativity and the effectiveness of the management team.

3.2.1 The confirmation from scholars: the positive effects of external managers on family firms' performance, evidence from literature

The introduction of external managers within the family firm is an important step towards the *professionalization* of the organization and the *diversification* of the management team, with all the benefits of the case theoretically discussed up to this point. Now it's time to move to practice. The matter is the following:

Is there any empirical evidence in support of this solution? Are there studies demonstrating that family firms that incorporate outside managers within their TMT improve their performance?

What I noticed during the data gathering phase, is that the topic of external executives involved in family firms has been widely discussed under a theoretical perspective, both at academic and informal level, but very poorly addressed in practice. The main reason can be identified in the hard-to-source nature of data concerning the kinship of the managers to the family. On one hand, the few databases providing information on the managerial structure of family firms have been drawn up adopting approximate criteria: for instance, the identification of a manager as a family or nonfamily member is based on the matching of the surname with the family owner's surname (unfair measure if the family business is in the mother' side of the family).

As a consequence of that, most of the studies are based on surveys personally carried out by the author on a limited sample of local firms, providing a sharp subjectivity to each case. On the other, since the availability of data especially concerning the performance results of the small family firms is very little, most of the studies focuses on the context of large, listed family companies, which results are hardly generalizable and referable to family SMEs too.

Aware of the fact that most of the family businesses falls within the small-mid size range, this approximation proves to be quite misleading. Conscious of the limited availability of practical evidences, I summarized the major findings of the few studies directly focusing on the figures of nonfamily professionals, which aim at demonstrating the economic benefits of their inclusion within the family firm's TMT (Table 11).

Author(s):	Title of the study:	Year of publication:	Results:
Cucculelli & Micucci	“Family succession and firm performance: evidence from Italian family firm”	2008	Family firms positively perform as long as the founder retains the managerial powers. When he/she leaves, heirs’ leadership turns out to be detrimental for business success, while external executives’ leadership enhance the performance.
Perez-Gonzalez	“Inherited Control and Firm Performance”	2004	
Villalonga & Amit	“How Do Family Ownership, Control and Management Affect Firm Value?”	2006	
Minichilli et al.	“Top Management Teams in Family-Controlled Companies: ‘Familiness’, ‘Faultlines’, and Their Impact on Financial Performance”	2010	The co-presence of family and nonfamily managers within a family firm’s TMT positively affects the company performance: family members, through the so called “familiness”, determine the business’ resource-building and value creation, while nonfamily members contribute with their competence to a well-administration practice.
Bhattacharya & Ravikumar	“From Cronies to Professionals: The Evolution of Family Firms”	1997	Family companies initially grow by accumulating capital and then, only after the achievement of a critical size, professionalize their TMT hiring external professionals.
D’Angelo et al.	“External managers, family ownership and the scope of SME internationalization”	2016	The benefits on the international scope of family companies deriving from hiring external managers are evident when the ownership structure of the company is open to external capital. Internationalization can only be maximized if both the

			management team and the ownership structure are open to outside influence: unless both equity capital and the management team are opened to outsiders, the full positive effects of external managers will not be enjoyed.
Bloom & Van Reenen	"Measuring and explaining management practices across firms and countries"	2006	Heirs (eldest generation) tend to damage management effectiveness and performance due to the maintenance of inferior managerial practices, while on contrary the better management practice ensured by professional nonfamily executives is strongly associated with superior firm performance in terms of productivity, profitability, Tobin's Q, sales growth and survival. The authors claim that this correlation justify the American advantage over Europe in terms of management practice.

Table 11. Summary of the major observations by academics in the last decade, concerning nonfamily management in family firms.

3.3 Issues associated with the inclusion of nonfamily managers

When a family firm decides to hire an outside professional to place within the management team, for the many advantages we've seen, the classic theory wants the arising issues to be associate with the *principal-agent problem*: distinctive of any type of organization where ownership and management are separated, it refers to any divergence of opinion, priority and interest that may arise between the two parties, generally of economic nature. Nevertheless, the new SEW theory reveals a second type of issues, deriving from the inclusion of external

managers: the loss of the affect-related values a family derives from its controlling position in the business.

3.3.1 Issue number one: Agency Theory

The fact that a company engages a wide variety of actors in its activity, each group of which has different roles and contracting relationships within the organization, unavoidably triggers multiple conflicts of interests among the stakeholders. One of the most popular in economics, finance and accounting literature is the conflict of interest between management and owners, triggered by the natural tendency of the agents (the managers) to pursuit their own interest.

This type of corporate conflict is generally defined as Type I agency problem. Moreover, research concerning agency conflict also showed that conflict may arise between majority shareholders and minority shareholders, leading to the identification of a second category of agency problems called Type II. This type of corporate conflict describes a scenario in which large shareholders exploit their position in the organization to take the reins of the business and overpower small shareholders, with the aim of enhancing their own wealth.

To limit the effect of agency conflicts, some specific costs, defined as “agency costs”, must be bear. Agency costs can be considered as the sum of:

1. the monitoring expenditures of the principal;

2. the bonding expenditures by the agent;

3. the residual loss (“Residual loss is the reduction in the value of the firm that arises when the entrepreneur dilutes his ownership” (Jerzemovska, 2006)).

As noted by scholars, the extent of agency problems differs according to the type of organization involved, especially to the degree with which the TMT is influenced by shareholders in the decision-making process and the capital structure diversification. By intuition, family firms might appear less exposed to Type I agency problems at least if the owning family retain the leadership power in full. On the other hand, the risk of Type II emergence is very high as most of the equity is held (per definition) by the family, and it takes place as soon as an external investor get into the capital structure of the business. The truth is that not all family companies are subject to agency problems with the same intensity, since they may have very different organizational structures.

Leaving aside the ownership structure that a business of this kind may assume, matter that lies out of this study, we automatically exclude Type II agency problems from our analysis. The issue now is to understand how Type I agency problems modulate among family firms, and how the inclusion of nonfamily professional managers may affect the extent of the said.

By definition, Type I agency problems occur at the time when the principal/owner (in this case the family) renounce to management tasks and engage a non-owner agent/manager, who is expected to act in the owners' best interests and to make decisions that maximize owners' wealth, even if it is in the managers' best interest to maximize their own wealth. Why do agency problems occur? In general terms, agency problems are recognized as the result of information asymmetries, triggered by the fact that agent/managers always have wider knowledge and more information on the business, in operative terms, than the owners.

The asymmetry of information between the two groups of actors generate the so called "moral hazard", namely when an individual or team that is excluded from risk chose to behave differently from what it would do if were fully exposed to the risk.

"For example, the company is considering a new investment that is risky but can contribute to increasing shareholder value. The investment is in the interest of shareholders but not to managers who may lose their jobs if the activity does not take place as planned. Precisely because of the existence of different objectives managers may decide not to implement this kind of investment even though it would bring harm to the owners of the company." (Boshkoska, 2015).

By approaching the family firm context, it can be observed that the separation of ownership and management, engine of Type I A.P., becomes an option rather than an organizational certainty. In fact, considering the two extreme scenarios, we can distinguish between:

(a) "Family-managed firms", characterized by the concentration of both management and ownership in the family's hands. In this scenario, Type I agency problems are quite limited.

(b) "Professionally-managed family firms", characterized by a separation of management and ownership spheres, respectively handled by outside professionals and household members. In this scenario, Type I agency problems can be significant.

Observation 1: Type I A.P. tend to aggravate within family firms as the owning structure is diluted and the shares of nonfamily managers within the TMT increases.

It must be noticed that the only case where the chance of agency conflict occurrence is averted, is with the 100% of TMT and ownership consisting of family members and affiliates. At the very moment in which even only one external manager is hire, or an external investor joins the capital, the exposure to Type I risk grows. The more heterogeneous the two groups become, the more complicated is to manage the divergence of interests, until to reach a maximum in correspondence of a pure professional management structure and a widely diversified capital structure (dominated by the family).

TMT	OWNERSHIP	TYPE I A.P?
F	F	NO
F+NF	F	SI
F+NF	F+NF	SI
NF	F	SI
NF	F+NF	SI

Table 12. Possible configurations of family/nonfamily ownership and management within family firms, and the resulting presence or absence of Type 1 Agency Problems.
Legenda: F = family member; NF = nonfamily member.

There's no evidence from studies of the variation of intensity by which family organizations are afflicted by Type I A.P. in each structural scenario illustrated in Table 12. Nevertheless, we might hypothesize a hierarchical distribution such that, as long as the family maintains a partial control of the TMT through several family managers, agency problems are moderate. Further, the complete entrustment of the TMT to external managers cause a complete separation of the two groups of interests and makes it harder for the family to prevail, even more when the capital structure is opened and diluted.

Observation 2: Type I A.P. tends to be moderated in family firms due to the interest of the owning family to preserve the business' welfare on a long-term perspective.

A reflection on the topic led me to perceive the conflicts of interest between managers and owners as belonging to two different categories.

On one hand, the “classic” perspective acknowledges the divergence of interests as a consequence of the managers’ propensity to pursue their personal wealth and not the owner/principal ones. This might be attributed to the “human instinct” for survival and characterizes every principal-agent relationship, the one between corporate managers and shareholders but also between elected officials and citizens, or brokers and markets’ buyers and sellers. The said classification of Type I A.P. has been widely discussed by academics and practitioners, who have identified several means of persuasion through which the principals may encourage agents to act in their interest: monetary incentives (for instance, high wages, bonuses, profit sharing, stock options, holiday time etc.), non-monetary incentives (healthcare benefits, life insurance, promotions, vehicle or vehicle disposal) and monitoring actions.

However, several studies reveal the existence of a second typology of conflicts of interest, arising from the managers’ propensity (with the right incentives above mentioned) to pursue business welfare rather than the personal benefits of each shareholder. As a matter of fact, professional executives are hired to run the business successfully and profitably, and this organizational goal is even reinforced by the fact that their remuneration and prestige tend to be positively correlated with company health. In the light of this, quite often managers have to make choices which value the organization as a whole but may be potentially harmful for the interest of the shareholders, who are only interested in the maximization of their shares’ value. Moreover, considering the highly volatile permanence of an investor within the shareholders team, it is likely that short-term sacrifice to promote future business prosperity would not be justifiable for shareholders, who may sell their shares in any moment.

This prior observation paves the way to stress a crucial peculiarity of family businesses, namely their lack of shareholders in the traditional sense. Generally speaking, agency theory refers to business organizations where equity is dispersed and shareholders act as investors, more than owners. The difference is slight, but crucial: owners feel a sort of connection with the firm and

focus on the improvement of business performance beside their personal wealth; in contrast, investors see a firm as a mean, as many others, to capitalize a monetary investment and to generate more income, focusing solely on the risk and return of their stock portfolios. Owners tend to establish a long-term relationship with the organization, for the maintenance of which are willing to sacrifice their own economic benefits in the short term and to give priority to the firm wealth.

This means that, by taking back the two categories above described, the risk of conflicts of interests due to the managers' self-interest, in family firms is the same as in any other organizations, since this type of agency problems is triggered by the human natural attitude towards personal gain. However, if conflicts of interest are intended as those generated by the managers' proclivity for business' wealth even at the expense of shareholders' wealth, family firms may be considered as less affected by Agency Problems. This because the owning family has a much stronger and more lasting link with the organization, such that the interest of the owning family to preserve the business health and the managers' interest on business maximization (for which they're remunerated, indeed) match much more easily.

Observation 3: Type I A.P. tends to be moderated in family firms due to the family's majority position in the ownership structure, which allows an effective implementation of control mechanisms over the management.

Even though its legal definition changes among legislations, as we've seen in the introductory chapter of this study, the family firm status inherently requires the family at stake to own majority of the shares. This *conditio sine qua non* significantly reduces the potential dilution of the capital structure in this type of organization. Ergo, the control mechanisms adopted by the family to moderate the effects of a managers' divergence of interests are more likely to be

effective, since the cohesion of the family members is strong and their influence takes precedence over anybody else (assumed that any other shareholder is joining the capital structure). Agency cost control mechanisms are defined in agency theory as those mechanisms overseeing, monitoring and tempering the effects of choices and actions made by the actors not in the principals' interest. The set of control mechanisms that an organization may implement to reduce the likelihood of self-interested activities by managers, harmful for shareholders' welfare, is part of a wider organizational structure defined as "corporate governance". The capacity of the said practices to align the interests of managers to those of the shareholders confirms, for its part, the corporate governance effectiveness. Leaving aside the various management control techniques adopted by each organization, the choice of which is deeply related to the contextual and operational contingencies that apply, for this section it is important to understand that the poor capital dilution featuring family firms allows the owning family to exert a strong power of persuasion over the TMT and so to mitigate Type I agency problems.

Observation 4: Type I A.P. tends to aggravate in family firms due to the cognitive, emotional, cultural and social interests of the family, that go beyond the purpose of economic maintenance prompted by professional managers.

If Ob. 2 and 3 have supported a positive perspective, by which Agency Problems between nonfamily TMT and owning family should be reduced in family firms, the last observation actually distances itself from this outlook. It is based on the idea that the mismatch between professional manager and owning family in terms of interests is even more striking than in other business organizations, due to a double component of family's interest: economic and affective. Let's consider it in detail. The economic interest is inherent in any principal-agent relationship and is based on the idea that shareholders seek for profit maximization through the

action of agents, which, on their part, not always do so. But the fact that the professional managers do not always choose to meet the shareholders' interests doesn't mean that they do not understand it. Managers and shareholders speak the same language of economy, so that managers do know what shareholders' profit looks like, how to achieve it, but eventually chose to not take that path. Even though company-value maximization is typically assumed to be the primary and only goal for professionally managed organizations, the case of family firms is peculiar since it involves another category of interests, of intangible, unmeasurable, affective nature. What does these non-economic goals concern? For instance, the employment of family members may be considered as a distinctive non-economic goal of the owning family, as well as the maintenance of business control, of the socio-emotional wealth (see next paragraph), of family harmony and the insurance of career opportunities within the business for family members as other family-specific interests.

The point of interest is that these non-economic goals are hardly communicable to managers, behaving and reasoning in accordance with the rationality of the *homo economicus.* In fact, mainly due to their professionalization, executives are characterized by "perfect rationality" reasoning process such that their tendency is to act in a perspective of utility and profit maximization. This prevents them from understanding the real value of the family non-economic interests, and drives them to always chose the good of the company rather than any other family-centric interest, with on turn exacerbate the Agency Problems of Type I.

3.3.2 Issue number two: the loss of Socioemotional Wealth (SEW)

About 10 years ago, a group of scholars suggested a new theoretical formulation within the family firms' field, in response to the lack of doctrine concerning the effects of the family-control over the business. The Socio Emotional Wealth (SEW) Model is based on the idea that

family run companies are traditionally inspired by, and dedicated to, the preservation of their SEW, intended as the whole of nonfinancial features or "affective endowments" of the owning family. From this perspective, gains or losses occurred in SEW correspond to the pivotal framework inspiring family-controlled firms when making all the major strategic choices and setting policy goals. SEW logic suggests that family members are propelled by the preservation of SEW in their strategic decision-making, where the term SEW refers to the non-financial goals and utilities which benefit the owning family, and not necessarily the business. SEW embraces the whole range of feelings solely attributable to the family, as the family's will of exercising authority, the enjoyment of family influence, the preservation of clan membership, the assignment of important positions and role to loyal family members, the maintenance of an intense family identity, the perpetuation of the dynasty and so on. In the attempt to simplify the comprehension of such behaviors, we can identify five major dimensions through which SEW manifest itself:

(a) *Family control and influence:* The family's ability to exercise authority, to control and to influence the direction of the business is inherent in the family organizational style, due to the strong ownership position it has. In fact, family members generally express the desire to assume multiple active roles in the firms, especially in the management, as a way of exerting formal and informal control. Basically, to achieve the goal of maintaining SEW, family members need for constant monitoring of the firm.

(b) *Family members' identification with the firm:* it is well known that family members tend to closely identify themselves with the family business, giving birth to an innately unique organizational identity. This leads the firm to be seen from both internal and external parties involved as a continuation of the family itself. In an internal perspective, this generates a significant impact on the attitudes of the employees, on the internal processes and on the quality of the output provided (i.e. family firms exhibit higher levels of corporate social responsibility

(Berrone et al., 2010)). In an external perspective, this makes family members pretty susceptible to the external image perceived by the outside actors as customers, suppliers, retailers, and other outside stakeholders in terms of image and reputation.

(c) Binding social ties: SEW provides family members with interpersonal ties presenting some of the collective benefits typical of closed networks, such as joint social capital, relationship trust, sentiments of closeness and mutual solidarity. The said bonds involving family firms are not exclusively limited to relatives, but tend to be widespread to external actors too: it is the case of time-honored providers and suppliers, who may be considered by the family as integral part of the family, or the case of nonfamily employees who may assimilate the family' feeling of belonging and start perceiving a sense of commitment to the firm. Or again, family firms may extend their strong social bonds to the surrounding community, especially family SMEs which tend to pursue the prosperity of the locals.

(d) *Emotional attachment:* the role played by emotions in the family firm context must not be underestimated, since it is actually one of the major distinctive features of this organization typology. Even if there's no doubt that any human choice (also those of the most qualified professionals) involves a varying amount of emotions, so that emotions can be considered as integral and inseparable part of everyday work in any organization, among family members there is a wider background of shared experiences and past events such that it remarkably influences the business activities, events, and relationships. The said family-related emotions may have both positive and negative implications on the family itself, and so on the business when lead by the family; they are dynamic, in the sense that they emerge and evolve, and they're influenced by (more or less) critical events happening within the family business environment (as succession events, divorces, illnesses, family or business loss, economic downturn. (Gersick et al.,1997)). Emotions are integral part of the family business and tend to massively influence its decision-making process, due to the blurred boundaries between family

and corporation. The benefits deriving from such strong emotional links among family members, make family firms the ideal place where sense of belonging, affection, and legacy may be fulfilled. The positive effect potentially generated by the emotional sphere in family firm has inspired several scholars, who talked, for instance, about emotional capital (Sharma 2004) and emotional value (Zellweger & Astrachan, 2008).

(e) *Renewal of family bonds to the firm through dynastic succession*: this SEW dimension refers to the desire, on behalf of the organism "family", to hand the business down to future generations in a sort of "trans-generational sustainability" perspective. The maintenance of the business within the family, generation by generation, end up being a key goal for family firms, such that it has been proved that family firms generally exhibit a longer-term planning horizon than nonfamily firms. In fact, from the point of view of a family shareholder, the business is not merely a saleable asset, since it symbolizes the family's legacy and history. As a consequence of this dynasty culture, family members consider the family business as a long-term investment to be handed down to the seed, where the creation of patient capital together with the learning from the past, are the priceless benefits obtained.

To have a family leadership oriented at SEW-optimization is a strategic choice with clear advantages. At first, SEW conservation is a means through which family firms gain loyalty and trust by the audience, and so improve their economic return. Not only customer loyalty, but also employees' loyalty: socioemotional intentions of a family management stimulate cohesion among the working team and the external stakeholders. Further, socioemotional principles can potentially lead the family business to establish a competitive advantage.

Although the line of research on the topic identifies SEW as an intrinsic character of family firms, family owners must have enough discretionary power within the organization to enforce their objectives of SEW maintenance. In the light of that, the investigation of the bound

between family governance style and socioemotional aspects may suggest an increase in SEW in parallel with the enhancement of the family control over the organization.

This means that, at the time when an external manager is introduced within the family system, part of the familiar synergy is compromised and a SEW loss occurs. The logic is quite immediate: a governance structure opened to nonfamily members tend to inhibit family control and discretionary power within the business and so, as a direct consequence, the family's ability to maintain and pursue its SEW.

CHAPTER 4. “VALUE BASED MANAGEMENT” AS WAY TO OVERCOME THE MISALIGNMENTS BETWEEN FAMILY AND NONFAMILY MANAGERS

The last chapter of this study is dedicated to investigating the use of Value Based Management (VBM) practices in family firms, as way to overcome the agency conflicts deriving from nonfamily executives’ inclusion and to encourage the alignment of their interests with the family’s one. In general terms, Value Based Management is a management approach aiming at guaranteeing a value-oriented management style within the organization, where value normally refers to the maximization of shareholders value. VBM is built according to the corporate purpose and values, so that it can incorporate either economic (like shareholder profits) and non-economic future perspectives. The starting point is quite immediate: the value of a firm is determined by its discounted future cash flows. Value is built up only if a firm invests capital at the return exceeds the cost of that capital. VBM expands this logic by focusing on how firms use the capital to implement major strategies and operating decisions. When correctly executed, this approach allows the management team to align company's overall aspirations, analytical techniques, and management processes so to channel management decision making on the key drivers of value.

The innovative side of our approach leads back to the application field: indeed, VBM was born in the Nineties as a new tool to support investors in assessing companies and executives in evaluating business performance and shareholder value. The application to the family firms’ field is quite uncharted. However, it could surprisingly prove to be the right path to follow in attempting to overcome VBM major weaknesses.

4.1 VBM: literature overview and history

Broadly, VBM has become a quite popular management practice in the last decades, gaining attention in the management accounting field of research and large-scale application especially among listed firms. Its peculiarity consists in the application of integrated management and monitoring systems such that executives are encouraged to undertake actions oriented to owners' wealth. The abstract intent of value optimization is achieved through the application of the so-called Value-based performance metrics, which basically turn the goal into numbers. By confronting the company's performance, especially under the management actions profile, to the owners' required profit return, VBM undertakes an action of alignment between the diverging interests of TMT and owners. Moreover, the metrics suggested by this management practice have the precise intention of providing unequivocal decision-making criteria by emphasizing value increasing practices and carrying out target-consistent monitoring actions.

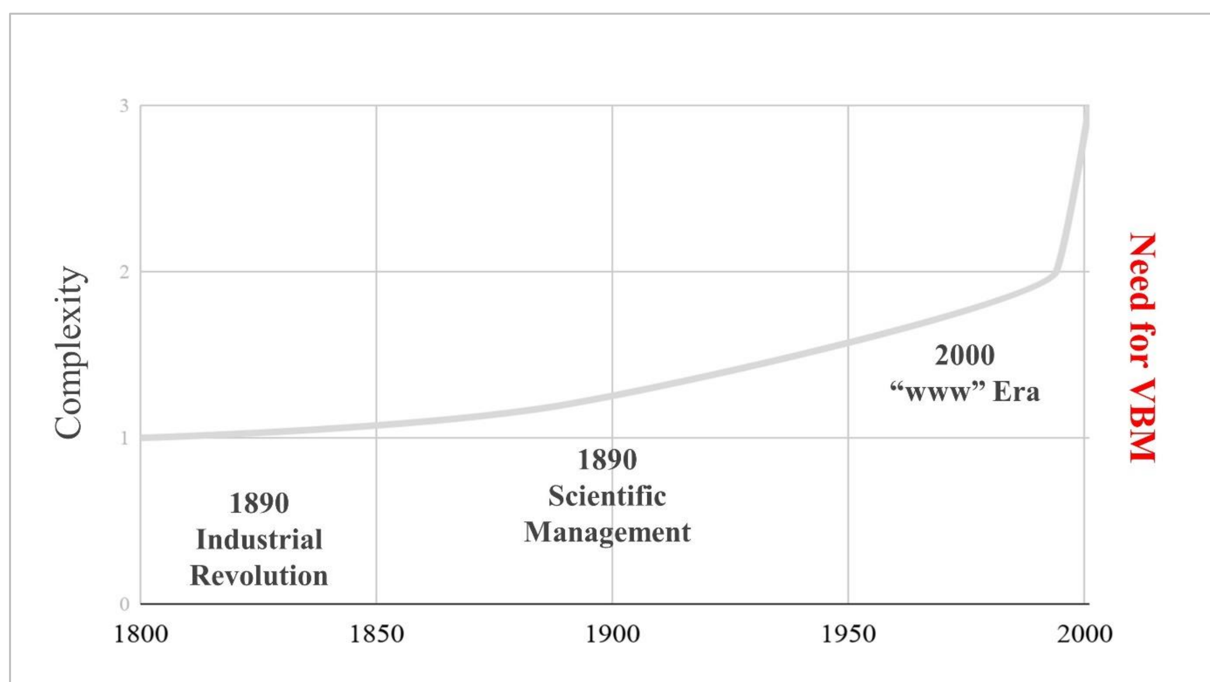

Table 13. Evolution history of Value Based Management: complexity and need.

According to scholars, the evolution of VBM is closely related to the increment of corporate complexity and the rising sophistication of the markets (Table 13). Before the advent of Industrial Revolution, enterprises were extremely modest in terms of dimensions and their complexity was limited, as well as the market which was relatively steady and simplistic. In this kind of scenario, the value purpose of companies was such spontaneous and inherent in the organization system, that it was not necessary to make it explicit through VBM simile practices. The birth date of VBM might be dated back in the early 19th century when the industrial revolution opened the door to large-scale economies of goods, services, people, capitals thanks to machines. The displacement of production and the increasing size of corporations lead to the elaboration of more effective methods to improve production, transportation, communication, supervision, but not jet on measuring and managing the idea of corporate value creation. We might adventure to define such as a period in which VBM was implicit in the organizational structures. With the advent of Twentieth century and the development of Scientific Management by Taylor (1911) and Emerson, a wave of radical change covered up the corporate management field by demonstrating new practices to conduct business in the best way. Taylor's basic assumption was that the optimization and simplification of jobs lead to increase the productivity, and that workers and managers must cooperate with one another. The boosting effects of the theories on corporate productivity and complexity were massive. As a direct consequence, academics and experts in the field started to draw up Management Accounting practices as way to evaluate the best assets allocation and decide about investment options. The assignment of time-value to money, the introduction of new metrics as Return on Investment (ROI), of new techniques as Discounted Cash Flow, of new models as the Capital Asset Pricing Model (CAPM) by Sharpe (1964) and the one by Black and Scholes (1973) for evaluating financial options, marked a new era of professional management and investing. On the wave

of the increasing attention over output value and significance (see “Managing for Results” by Peter Drucker (1964) and “Creating Shareholder Value” by Alfred Rappaport (1986)), the term “Value Based Management” finally came into use in early 1990s thanks to Jim McTaggart (1994) and his groundbreaking research. From that moment, the weight of decision-making strategies on the base of the resulting financial/shareholders’ value started to become common practice within the Corporate Strategy field, and the relative discipline concerning VBM is constantly updated and enriched to allow a proper evaluation of corporate investment.

4.2 The Value Creation Theory and its application to the family firm context

We might venture to say that the Value Based approach to management is born as way to align the interests of managers and owners, to overcome the conflicts of interest between the two parties and so to sponsor the creation of owners’ wealth. From this perspective, VBM report directly to agency theory. In fact, almost all the metrics developed within the VBM field are based on the maximization of shareholders value, with the aim of enabling managers to detect value-creating investments for their principals.

But is it fair to limit the idea of corporate value to shareholders’ profit? Is maximizing value for shareholders somehow equivalent to maximizing value for the organization as a whole?

The issue of defining what the real purpose of companies is, has been one of the toughest and most debated among academics. We might adventure to say that the interest on this matter put down roots back to late 18th century, when the economist Adam Smith released his greatest work titled “Wealth of Nations” (Smith, 1776/1999).

“Every individual endeavor to employ his capital so that its produce may be of greatest value. He generally neither intends to promote the public interest, nor knows how much he is

promoting it. He intends only his own security, only his own gain. And he is in this led by an invisible hand to promote an end, which has no part of his intention. By pursuing his own interest, he frequently promotes that of society more effectually than when he really intends to promote it." (Smith, 1776/1999).

The author adopted the "invisible hand" analogy to explain how human being pursuit the satisfaction of their own needs, and by doing so, they automatically generate wealth in the environment surrounding them (economy and society) as a side effect. Indeed, the cornerstone of the theory was the self-interest satisfaction to which every individual seeks to, capable of triggering a profit maximization process such that to ensure the best outcome for society. Smith basically believed that at a time when people are left free to seek their own interest, they will perform better than they will within a system choosing in their place what is "valuable". If the logic is adjusted to an inter-corporate perspective, the resulting reasoning would be that the actors of an organization, when encouraged to pursuit the maximization of their own wealth, will generate a beneficial effect on the corporate system and establish a steady state of equilibrium level of wealth. From this perspective many other scholars have contributed in support of a "classical liberal" vision of the market and corporations, first and foremost Milton Friedman in "Capitalism and Freedom" (1962), the extreme form of which claimed that "the only valid purpose of a corporation is to maximize shareholder value and that anything else is irresponsible". Recent studies have widely disproved this absolutistic perspective, criticizing especially the overlooked risk deriving from the achievement of profits, not always the ultimate purpose of an organization.

The obsolescent Neoclassical Theory has been replaced by a stakeholder perspective, claiming that organizations have multiple stakeholders, each group of which must be taken into account when defining the value-purpose of the company, not only the interest of shareholders. In the eighties, the previous theories successfully converged into the Value Creation Theory,

foundation of the VBM model, according to which an organization in free-market conditions survives and progresses only by creating value: therefore, value self-generation and maintenance is the prerequisite ensuring the business survival in the long term, the preservation of the equilibrium and the proper support to growth. From this point of view, shareholders' wealth, earnings growth and returns on assets are no longer the corporate targets to maximize, since the firms now is intended as vehicle for value creation and profits are no longer the ultimate goal themselves.

Indeed, value creation has different meanings for different people. For customers, value identifies with the utility provided by products or services. For employees, value means good working relationship and reward. For investors (shareholders / credit lenders), value coincides with receiving high returns on capital invested, which generally claims sustained revenue growth and attractive profit margins. The complexity as well as the variety of meanings that value may assume keep posing the issue of defining its semantic.

We would venture to say that the notion of Value Creation is founded on three axioms:

- firms' performances should be evaluated and compared each other assuming the achievement of the same set objectives;
- the set objectives should be shared, and imply the creation of value;
- the said set objectives should be stable in time.

In the light of that, with the advent of the Value Creation purpose and the need to maximize corporate value in a long-term perspective, management practitioners realized the urgency to ensure proper cash in-flows, the optimal level of which is evaluated by comparison with those of the major competitors. Moreover, a secondary lever for the creation of value should be identified with the effective communication of such value-creation objectives and their achievement, to the stakeholders.

Basically, the creation of corporate value implies the generation of current and future cash inflows and the communication of the said to the market, by the management team. The decisions undertaken by the TMT to achieve the value-creationist goal entail the awareness of several aspects: the outcome generated by the corporate and financial strategies in terms of value drivers, and the capacity of the single organizational units to generate a yield greater than the costs of such activities; the financial structure must be coherent with the organizational strategy; communication must properly address all the actors involved in the corporate community; business development in determined by the exploitation of right opportunities and the speed of growth.

A crucial lever in triggering value creation concerns the changes made to the management *in primis*, such that to improve the operating management. The first step towards an integrated process of corporate value creation involves the setting of strategic choices, concerning the corporation and its single units; indeed, this is a crucial part focused on the definition of competitive advantage. The next step is about the portfolio strategy and aims at identifying the business units engaged on value creations and those instead engaged on value disruption. Then, it should be considered whether the advantage of each unit is sustainable over time, since the sustainability of the said is what will ensure the generation of future cash flows. Finally, it is fundamental to create proper selection systems (to make strategic choices), measurement systems (to assess the relative outcomes) and incentive systems (to motivate the management team). We'll address this topic better in the next paragraphs, when describing Value Based Management practices in detail.

For now, the matter is to estimate whether and how family ownership influences the process of corporate value creation.

Many have been the literature streams attempting to detect the peculiarity of the case: several demonstrate that family ownership enriches the organizational competitive advantage with distinctive features as patient capital and social capital; others focus on family-induced disadvantages as conflicts among relatives and resource scarcity. In the light of past research and enriched by personal reflections, we classify the effect of family ownership on value creation process in a tripartite perspective (Table 14).

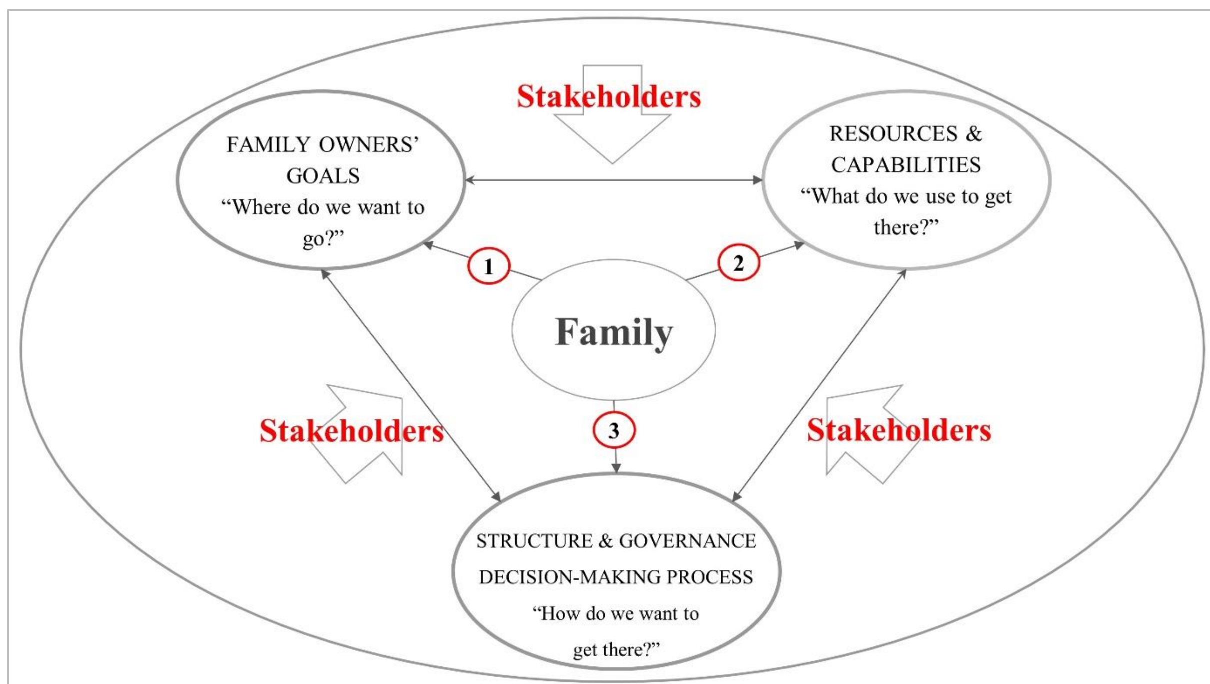

Table 14. Model of value creation in family firms.

Arrow 1: the effects on corporate goals

The majority position of the family within the ownership structure, allows it to exert a pivotal influence on the idiosyncratic goals of family firms, and so to affect organizational behavior and value creation process. In particular, the social endowment typical of family clusters imposes the configuration of non-economic goals such as the preservation of organizational

control or the long-term investing perspective (see the socio-emotional wealth theory, previous chapter), which clearly affect the corporate strategy and, at the base, the corporate value setting.

Arrow 2: the effects on resources and capabilities

Families have been proved to bring to the value creation process a unique set of resources and capabilities capable of enriching the corporate advantage, known under the title of ‘‘familiness’’. Features such as family-related social capital, human capital or reputational capital constructively support value creation process, while family company-specific lack of resources such as the scarcity of financial capital for investment may rather trigger a destructive effect on value.

Arrow 3: the effect on organization structure, governance and decision making

Finally, the governance structure implemented by the family influences the corporate value creation process. Indeed, as inherent in their supremacy role within the organization, owning families determine many aspects of the corporate structure such as executives’ appointment and compensation, or the monitoring systems and incentive schemes to control their consistency in pursuing owners’ interest. These structure not only affect the value creation process by setting the decision-making criteria and by supervising their implementation, but also by affecting the efficiency of information processes within the organization and its speed of adaptation.

4.3 Value measurement: metrics, principles and models

The value measurement represents a crucial issue for companies, especially in recent times, due to its implications for the detection of a fair corporate strategy and management. The rational is quite obvious: you cannot aim at improving something if you are not capable of

detecting and measuring what is getting better and what is not. Despite its apparent immediacy, the concept hides some tricky details: what should be exactly measured, with regard to the value assessment process, and what metric is more effective in doing so?

The need for a single metric

The first point to clarify is a true cornerstone of Value Based Management: for what reasons do we have to focus on shareholder value when estimating corporate value, rather than on the multiple metrics required under stakeholder theory? The explanation lies in the problematic nature of stakeholder theory, according to which every group of actors involved in the business claims for its own interests to be satisfied in order to stimulate value creation. This obviously goes against the simplest math principle of all: we can't maximize more than one component at a time (for instance profits, revenues, quality, market share, efficiency) unless they are all simple transformations of one other.

As a consequence of such interests' multiplicity, the value measurement process strictly requires managers to be aware of which measure has been applied in a certain process and to specify any eventual tradeoff between the various dimensions applied, in order to ensure an informed judgment. In the light of this consideration we can state the illegitimacy of the stakeholder theory as a candidate-criteria for value estimation, due to its lack of a single metric. Managers can't expect to balance the interests of all the organization stakeholders, because such interests are clearly diverging and conflicting.

A solution has been introduced through the "corporate value maximization principle". Such principle emphasizes the need to ensure a positive gap between the benefits received (namely, the long-term value generated) and the expenses incurred, and by doing so it offers a way out of the stakeholders dilemma by providing the TMT with a decision criteria: managers should

satisfy as many stakeholders' interests as they can as long as the resulting benefits for the corporation (i.e., the long-term value created) exceed the additional costs. Basically, managers have to promote the groups of stakeholders whose interests, once meet, generate the best economic return to the business. Accepting the fact that single metric is required to assess corporate value, we now turn our attention to find such metric.

The impropriety of accounting measures

Many metrics have been proposed and applied; however, most of them have revealed serious shortcomings. The most popular measures adopted by practitioners and academics can be clustered in two categories: market-based and accounting-based metrics. For a long time and still at present, conventional wisdom has been that market-based metrics as total shareholder return or total market value better estimate a company wealth creation/destruction. However, such metrics have proved to be hardly capable of providing a formal rationale for decisions based on intangible values, such as the organization prestige, the working team welfare, the effects on society, on the market or on the environment. Let's try now to detect the major weaknesses for each best-known metric.

1) Market-based metrics

Total Shareholder Return

$$Total\ Stock\ Return = \frac{(P_1 - P_0) + D}{P_0}$$

$$P_0 = Initial\ Stock\ Price$$
$$P_1 = Ending\ Stock\ Price(Period\ 1)$$
$$D = Dividends$$

The first of the market-based metrics considered is TSR, which is actually the leading candidate to excellently represent corporate value creation: besides, aren't equity returns the major

justification for any business activity? Nevertheless, total shareholder return has proved to have significant gaps in terms of reliability. (a) according to the controllability principle, the evaluation of a manager should be based only on elements that are under the manager's control. Being TMT in charge of the administration of the firm resources and the setup of strategic decisions, the extent of value potentially created within an organization is influenced by management's decisions and limited to their range of action. With this in mind, it's clear that TSR is not a good metric for value assessment since stock returns are affected by several factors outside TMT's control: for instance, broad-economic interest rates, overall economic conditions, governmental maneuvers, the environment. As a consequence of this ambiguity, it's difficult to estimate to what degree a certain return is attributable to management; (b) disregard for industry-related risk[11] and leverage-related risk[12]; (c) total shareholder return computation presume that all equity returns are reinvested in the business to maintain the value creation process, which is clearly unpredictable and unrealistic.

Total Market Value / Market capitalization

*Market Capitalization = Current Market Price per share **
Total number of Outstanding Shares

The greatest limitation of market value metric is that, per se, it provides no explanation to corporate wealth creation or destruction. Assuming that value creation occurs when the

[11] "a firm such as Alfa (in the high-risk biotech industry) would need to provide a much higher return than a firm such as Beta (in the low-risk, regulated-utility industry) to compensate for the additional precariousness of holding the stock."

[12] "All else being equal, a firm with a high financial leverage is riskier and requires a higher total shareholder return than a similar firm with low financial leverage."

difference between how much capital has been invested in the business and the value of the resulting business is positive, this metric lacks to consider how much capital went into the company. Basically, Total Market Value confines itself to explain how large has become the business, not how it became that large.

2) Accounting-based metrics

Return on Investment

$$ROI = \frac{Net\ Operating\ Profit\ after\ taxes}{Total\ Invested\ Capital}$$

Traditional accounting-based metrics as earnings per share or accounting return on invested capital have been and keep being widely adopted as indicators of corporate value, founded on the principle that share value derives from corporate earnings and earnings growth. But does the level of earnings fairly represent firm's value, and does a management geared to earnings maximization ensure firm's value maximization as well? Supporters of VBM and corporate finance experts claim that the extent of a company's earnings is an inadequate measure of value creation for several reasons, and that actually, a management merely oriented to generate economic profits may even lead to wrong, value-destroyer choices. Observations that can be made are that (a) accounting information are reliable and fair but tend to lack appropriateness and relevance if not inserted into the right context; (b) accounting-based metric are, indeed, accounting-based, and managers should never lose sight of their inherent mathematical limitations in describing "value", a non-mathematical notion.

A quite popular story in the finance field may clear ideas:

"A man takes a hot-air balloon ride at a local country fair. A fierce wind suddenly kicks up, causing the balloon to leave the fairgrounds and carry its occupant out into the countryside.

Landing in a farmer's field next to a road, the man has no clue how far he has flown or where he is. Seeing a man walking down the road, he cries out: "Excuse me, sir, can you tell me where I am?" Eyeing the man in the balloon, the passerby says, "You are in a downed balloon in a farmer's field." "You must be an accountant, sir," replies the balloon's unhappy traveler. "How could you possibly know that?" asks the passerby. "Because what you have told me is absolutely correct but of absolutely no use to me now," answers the balloonist. The accountant then replies, "You must be a manager." The balloonist says, "How would you know that?" The accountant replies, "Because you don't know where you are, you don't know how you got here, you don't know where you're going, and you are exactly where you were ten minutes ago, but somehow it's now my fault!" (Martin et al. 2009)

(c) accounting measures fail to consider opportunity cost, namely the earnings you gave up by preferring to invest in one strategic choice instead of another, and so does not allow to make totally-informed investment choices; (d) accounting measures do not equal cash flows, even if properly adjusted. In fact, while value creation is considered as a function of the amount, the timing and the risk of the cash flows produced by the company, accounting income is estimated in a firm's income statement when the earning process is completed. Hence, there's potentially no match between company's accounting income and cash flows; (e) accounting measures do not express the riskiness of companies' operations. Considering that risk is a driving factor in determining firm's equity value, such deficiency is critical. (f) accounting measures depend on the accounting policy adopted by a firm: for instance, the different methods applicable to account for inventories (like LIFO or FIFO), or the financial accounting and reporting standards followed by the governing accounting body. (g) accounting measures disregard the effects of the time value of money.

A step toward the solution: consider economic-profits rather than accounting-profits

The term *economic profit* refers to a new metric which measures an investment's profitability after considering its opportunity cost. A positive value for economic profit means that the return on invested capital are in excess of the opportunity cost of the invested capital. It is important to stress that neither net income nor ROIC or other traditional measures can provide information in order to make proper investment decisions in the way that economic profit does. In this perspective, the decision rule becomes simple: invest on projects with expected positive economic profit and reject the others.

4.3.1 A measure that captures the economic return of an investment: Discounted Cash Flows Method

The discounted cash flow (DCF) can capture the economic profit generated by a specific strategic decision, by determining the present value of the expected future cash flows. In general terms, such flow can be represented by either cash flows or cash flow and dividends. As claimed in the previous paragraph, financial assessment based on DCF is function of the amount of such cash flow, the distribution over time and the applicable discount rate. The adoption of this performance-measurement system is extremely useful for managers, since it allows to manage strategic choices in a shareholders' maximization perspective catching all three of these primary determinants of value, simultaneously. It works by comparing the firm's value with its capacity to generate cash flows capable of meeting investors' return expectations. The notion of Free Cash Flow is the cornerstone of value-based management. Beyond what VBM method we decide to adopt in decision making, free cash flow is at the base of any attempt to figure out the way management can support the value creation process: not by chance, any VBM method is built upon the basic assumption that the value of a firm (or of every single strategy and investment action that feature its strategy plan) is equal to the present value of the

future free cash flows the business is predicting to generate. It has been introduced as measurement standard for the first time in the eighties, and it keeps being considered a primary standard for evaluating a firm and strategic decisions, as acquisitions, joint ventures, divestitures, and new-product development. With respect to the field of value and its drivers, DCF has recently replaced earnings, return on invested capitals and traditional accounting measures, deemed inadequate benchmarks of value creation.

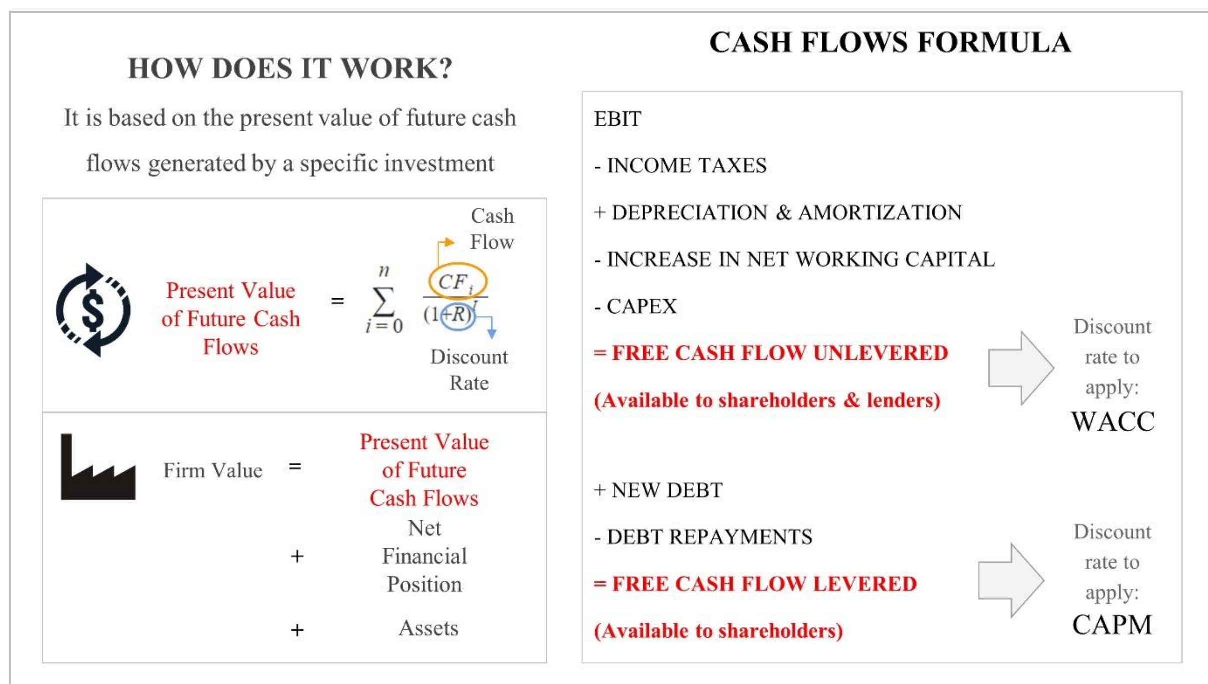

Table 15. Definition of Discounted Cash Flow.

CF computation:

The basic assumption of valuing through discounting cash flows is to determine such flows and their coherence with the discounting rates.

Two options are available:

- cash flows available to shareholders (levered flows) by adopting CAPM

- cash flows available to shareholders and creditors (unlevered flows) by adopting WACC

Unlevered cash flows are also defined as Free Cash Flow to the Firm (FCFF) and are computed as follow:

Revenues

- Operating Costs

Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA)

- Amortization and Depreciation (D&A)

Earnings Before Interest and Taxes (EBIT)

- Taxes on EBIT

Net Operating Profit After Taxes (NOPAT)

+/- Amortizations and Provisions

+/- Other (non-financial) assets and liabilities

Cash Flow (or Primary Steam) (CF)

+/- Working Capital

Free Cash Flow from Operations (FCFO)

+/- CAPEX (Capital Expenditure)

FREE CASH FLOW TO THE FIRM

Levered cash flows are also defined as Free Cash Flow to the Equity (FCFE) and are computed as follow:

FCFF

+/- Net Borrowing

- Interests

+ Tax Shield

FREE CASH FLOW TO EQUITY

"FCFF is the cash flow available for discretionary distribution to all investors of a company, both equity and debt, after paying for cash operating expenses and capital expenditure. Since interest payments or leverage effects are not taken into consideration in the computation of FCFF, this measure is also referred to as an unlevered cash flow. FCFE is the discretionary cash flow available only to equity holders of a company. This is the residual cash flow left over after meeting all financial obligations and capital requirements. Thus, interest payments or debt repayments are taken into consideration while computing FCFE."

FCFE and FCFF: which one to use in firm's evaluation?

FCFF is adopted in DCF valuation when the aim is to compute corporate value, namely the fair value of the firm. FCFE is adopted in DCF valuation when the aim is to measure equity value, namely the firm's value available to the shareholders.

Although the two methods lead to quite similar results, they tend to find different field of application depending on the kind of information required by a specific context. For instance, the management of highly leveraged businesses is biased to promote FCFF when estimating their investments. This because the need to check on the financial stability of the company

(specially to make sure it is not suffering from heavy obligations resulting in negative levered free cash flow) is crucial to ensure the long-term sustainability of the company.

How do we forecast Free Cash Flow? Value Drivers

After the establishment of the planning period, the next step is to estimate the firm's future cash flow. It should be noticed that the flow in question is located in future time, not in the past. This means that the yearly sales volume of the planning period and its growth rate (which is assumed perpetually-steady after the planning period) must be estimated. The evaluation of a firm's future FCF starts with the analysis of data concerning its historical performance and with an evaluation of the industry's evolution trends, which are subsequently adjusted following a scheduled procedure of changes. The variables that contribute to generate such free cash flow are called "value drivers" since they enhance the profitability, they mitigate the risk and boost the growth of a business in compliance with its strategic targets, and so they contribute to strengthen the company value. To identify and manage such drivers is fundamental in helping the TMT to focus mainly on those activities with a great impact on corporate value. In this way, the much general "value goal" is traduced in targeted actions, increasing the chances of effective value creation. Value drivers can be ranked in three main categories: growth factors, drivers of effectiveness and financial drivers.

The analysis of such drivers is an important and integral part of the strategic planning, since it helps the management to determine the critical levers for the business growth on which to focus. Value drivers can be easily identified through two tests: they must generate a significant impact on corporate value and they must be controllable. Moreover, the identification of value drivers is a process divided into three stages:

a) The first phase concerns the drawing of a map representing all the value drivers of a business. In order to understand where those value drivers are located within the organization, the business operational parameters should be broken into smaller and smaller components until the specific level where the operational decisions are located is reached. Then, it should be documented which factors affect specific business measures, such as sales growth, operating margin etc.

b) The second phase concerns the implementation of a test on the sensitivity of value drivers: after having grouped them into operational levels, the way each factor's change impact on the whole business value should be examined. This often leads to attracting opportunities that can change the priorities of the management.

c) Finally, the third phase requires a controllability test: each variable should be examined to detect those which can be controlled by the management.

Once the management team has been capable of building consensus around value drivers, it can focus on the process of performance enhancement through such drivers. Executives should agree which value drivers' measures to adopt, in order to monitor and develop a reporting structure including such measures.

Generally, the identification of a firm's future cash flows is carried out through the assessment of the following metrics for value drivers:

- the annual rate of sales growth;
- the operating margin (ante non-operational burdens as interest expense and taxes);
- the tax rate on cash-in flows;
- the interest rate on fixed capital investment;

- the interest rate on working capital investment;
- the planning horizon;
- the cost of capital.

The first five value drivers may be adopted to estimate the free cash flow of every year included in the planning horizon. Those are then actualized according to the cost of capital of the business.

Summing up, the analysis of the value drivers might be a powerful tool to focus the management efforts on those activities exerting a stronger influence on corporate value. Once the analysis is concluded, it might help to ensure the alignment of strategy, decision making process and value drivers.

Discounting rates reflecting the risk: CAPM and WACC

As mentioned above, the choice of which rate to adopt in discounting the cash flow depends on the typology of cash flow considered (levered or unlevered).

During the DCF valuation, FCFF is associated to the weighted average cost of capital (WACC) to preserve coherence in integrating all the capital suppliers while assessing corporate value. On contrary, FCFE is associated to the cost of equity (CAPM) to preserve coherence in integrating solely the common equity shareholders.

CAPM: The "Capital Asset Pricing Model" evaluates an asset's sensitivity to non-diversifiable risk (defined as systematic risk or market risk, corresponding to the quantity beta (β) in the financial industry), along with the awaited return of the market and the awaited return of a hypothetical risk-free asset.

The capital asset pricing model (CAPM) formulates that.

$$E(Ri) = Rf + \beta i\,(E(Rm) - Rf)$$

where:

- $E(Ri)$ represents the awaited return on the capital asset;
- Rf represents the risk-free rate of interest, often represented as the interest associated with government bonds;
- βi represents the sensitivity of the awaited excess asset returns to the awaited excess market returns. Namely, $\beta i = \frac{cov\ (Ri,Rm)}{var\ (Rm)} = \rho i, m\ \frac{\sigma i}{\sigma m}$
- $E(Rm)$ represents the awaited return of the market;
- $E(Rm) - Rf$ represents the *market premium* (the discrepancy between the awaited market rate of return and the risk-free rate of return);
- $E(Ri)$- Rf represents the *risk premium*
- $\rho i, m$ represents the correlation coefficient between the investment i and the market m;
- σi represents the standard deviation for the investment;
- σm represents the standard deviation for the market.

WACC: The **weighted average cost of capital** (**WACC**) represents the rate that a firm is required to pay on average to all its providers of capital. More precisely, it is the minimum return that the business must earn on its current asset base in order to meet their needs, otherwise they will invest somewhere else. It is important to notice that such WACC rate is determined by the external market, not by management.

In general, WACC can be assessed through the following formula:

$$WACC = \frac{\sum_{i=1}^{N} ri * MVi}{\sum_{i=1}^{N} MVi}$$

where

- N represents the sources of capital;
- ri represents the necessary rate of return for security i;
- MVi represents the market value of all the securities i.

In the scenario in which the firm is financed solely through equity and debt, the WACC formulation becomes.

$$WACC = \frac{D}{D + E} Kd + \frac{E}{D + E} Ke$$

where

- D represents the total debt;
- E represents the total shareholders' equity;
- Kd represents the cost of debt;

- Ke represents the cost of equity

4.4 The Management geared to Value creation: VBM

The rise of the notion "corporate value creation" has led to the creation of Value Based Management, intended as a managerial style which aims at maximizing the shareholders' value. The objective of any business is inarguably to increase the value for shareholders, but what might be uncertain is which type of evaluation measure is adopted with the aim of providing the maximum yield for shareholders. In organizational terms, VBM implies the arrangement of the whole corporate structure (objectives, techniques and procedures) in such a way to optimize the firm's worth. Both the definitions of VBM (corporate perspective and shareholders perspective) have common features: indeed, (a) the main goal is the value maximization; (b) management is carried out with the only purpose to create value (consequently, all the corporate objectives, strategies, processes, techniques and performances are set up with this purpose); (c) VBM is a tool useful to assess the effectiveness of past, on-going or future management activities.

VBM can also be considered as a synthesis of many disciplines: (a) from finance, it has taken the objective of corporate value creation and the assessment methods (DCF); (b) from strategy, it has taken the concept of value creation as the result of the exploitation of the firm's competitive advantage over its competitors, in a specific market segment; (c) from accounting, it has taken the principles on which corporate financial statements are grounded, properly modified to suit the new objectives; (d) from organizational behavior, it has taken the system of incentives and motivation tools adopted to encourage managers to pursuit shareholders' interest and value.

VBM might be also interpreted as a strategic tool, which managers can adopt to balance long-term and short-term decisions. In fact, traditional accounting tools such as budgeting tend to focus on short-term profit objectives, which do not provide the necessary elements to take decisions aligned with investor's interests. Under this perspective, value creation implies profitability to be high, durable and sure. Profitability is high when concerns the business operational activity; it is durable when the capacity to estimate and to manage future prospects is efficient; it is sure when the risk is minimized and accepted.

The main principle on which VBM is based is that any investment must generate a return higher than its cost, so that every corporate decision (of financial, operational or strategic nature) ends up based on parameters closely related to the future cash flow creation potential. Management geared to value creation starts by choosing which strategy to implement and it ends by achieving certain financial results; the mid-phase is built upon few key elements capable of generating value (a) explicit commitment to value creation; (b) education and training (for managers and workers, to raise their awareness of how their action contribute to corporate value; (c) ownership realization; (d) autonomy of each Business Unit; (e) reforms concerning the maximization process.

The main guidelines we can derive from such programs are: to avoid accounting complexity, to integrate budgeting and strategic planning, to invest in effective, ground-breaking information systems to build a comprehensive corporate strategy. Moreover, other key elements to ensure VBM effectiveness in value creation have been detected in (f) constant effort by the top management team; (g) the adoption of a proper communication and training system; the direct involvement of the operational heads; (h) the implementation of coherent assessment tools and systems; (i) compensations proportionate to created value; (l) continuous enhancement (Hennel & Warner, 1998). A proper application of the above-mentioned elements is essential to benefit from VBM application.

Long story short, to implement a Value Based kind of Management, two key steps must be faced.

At first, the creation of an organizational context such that corporate objective, culture and structure are consistent with VBM practices. This means that the firm's objective should aim at maximizing shareholders' value, the firm's culture should be imbued with this idea as well, and the firm' structure should be arranged in such a way that each Business Unit acts autonomously and consistently with such value-creation objective.

Secondly, integrated systems based on value must be absorbed by the organization: this basically implies coherence between planning systems and control systems.

We might conclude by stating that the Value Based Management is based on three ingredients: the first is the creation of value for the owners; the second is the adoption of an informed, effective management style, based on valid measurement tools; the third is the extension of such management style to the whole organization.

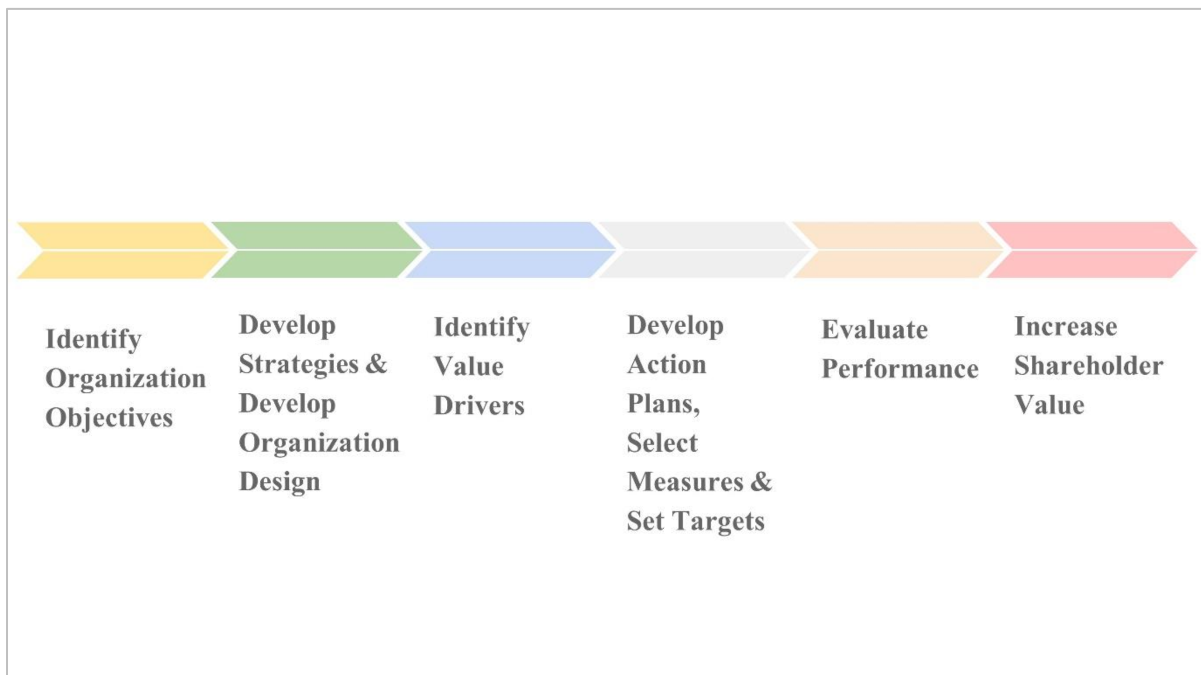

Table 16. The Value Based Management process.

4.4.1 The performance measurement

The assessment of a firm's performance is a crucial phase in the management control process, because it verifies the effectiveness of a certain strategic maneuver by confirming or denying the achievement of the premeditated goals. The choice of which performance measurement tool to adopt should be taken very seriously since it would affect the future managerial moves. Indeed, such measure considers not only the economic performance of the business, but also the competitive and social performances, and verify if they meet the expectations. There are many definitions of "performance": in the context of VBM, it is intended as the process through which the value creation purpose is realized. Hence, VBM purpose is to establish a link between strategies adopted and management performance, with the aim of creating shareholders' value.

Most of the models and techniques adopted to evaluate strategies' effectiveness originate from the accounting field, due to the ability of the accounting "language" to investigate and evaluate firm's outcomes. However, models based solely on financial statements have been proved to lack effectiveness in representing value creation. The most vocal critics condemn economic measures as featured by value incongruencies, incapable of considering risk properly, to adopt a short-term kind of perspective, to omit any specification concerning the exact moment in which results occur, to neglect time value of money, to overlook the immaterial features of corporate activities. All these characteristics have led to a review of the accounting models used for strategy assessment and management decisions, and to an increasing interest for the value creation process. Limitations have been overcome by focusing the attention on the notion of economic value based on expected cash flows. Otherwise, the creation of value would have been difficult to measure through the traditional accounting metrics.

The most popular method within the VBM context is the Economic Value Added (EVA), but there are many other such as the Free Cash Flow, the Cash Flow Added and the Cash Flow Return on Investments. It is important to stress the fact that the best way to create effective tools for performance measurement is through the integration of financial and non-financial indicators. According to the VBM ideology in fact, value is affected by both the nature and the time distribution of the outcomes, and the average cost of capital. For this reason, the use of exclusively one or few metrics can be misleading, since the variables to consider are too many to be synthesized in one index. Hence, it is necessary to adopt mainly non-monetary measures which focus on value drivers, sources of the corporate monetary outcomes.

4.4.2 The most popular VBM method for performance evaluation: Economic Value Added (EVA)

"The primary purpose of EVA is to provide an answer to the question, is management creating value for its shareholders? However, to think that EVA is simply about calculating a number—as informative as that might be—would miss an important point. In short, the intent is to use EVA as a behavioral tool to alter capital utilization and other incentives rather than as a tool of financial analysis." (Martin et al. 2009)

Of the different methods for measuring shareholder value creation, none has received more attention than EVA. While the Economic Value Added can be adopted for several purposes, its main use is as a period-by-period performance measurement, which allows to assess the return of an investment. It is widely considered as the performance measure that is closest to express the fair corporate profit. Its main purpose is to fill the gaps of accounting indicators as

the operating result, the ROI and the ROE. These in fact, as mentioned above, are obtained by means of an historical data analysis, omitting a proper consideration of the future perspectives. Basically, the Economic Value Added is considered a modified (for VBM advocates, new, improved and enhanced) metric to assess economic profits. As we can see in Table 17, EVA is somehow related to other basic accounting measures for profits.

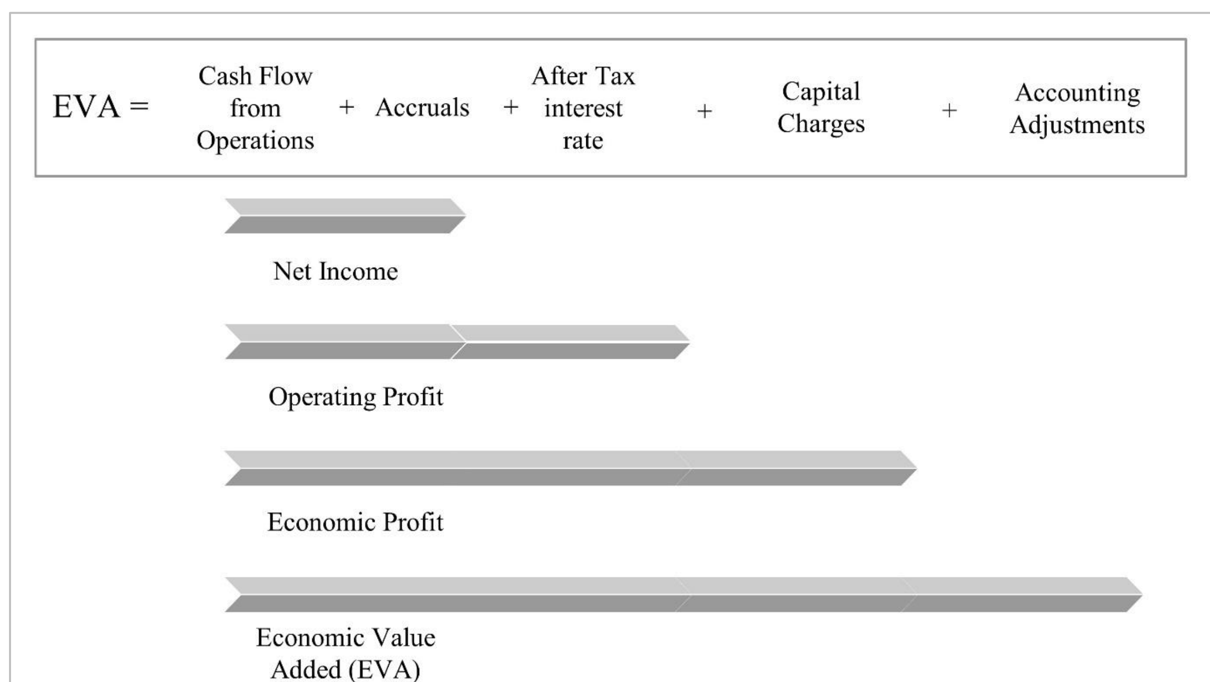

Table 17. The Economic Value-Added formulation.

Financial accountants started with the definition of Net Income, measure that appears in the income statement and outlines the profit attributable to shareholders as Total Revenues - Total Expenses. Subsequently, after-tax interest expenses are included in the computation in order to calculate the firm's operating profits: in this case, the earnings available to the firm's investors are the net profits the company generates from its core business functions. Next, the financial accountants decided to subtract the charges for using total capital invested (i.e. opportunity costs) and not solely for debt, detecting the Economic Profit (or Loss). Finally, EVA supporters

made further adjustments to the financial statement data, with the aim to express the economic sense of such data.

The logic behind EVA method is that a firm should not only cover the costs with its revenue, but should also be capable of repaying the corporate risk assumed by the owners/shareholders with an extra-profit. If this scenario does not take place, it might be affirmed that the company is not creating economic value but, on contrary, it is destroying it. When Stern Stewart & Co. (consulting firm) first proposed the model in the Eighties, they suggested to fill the said information gaps left by the accounting metrics by considering the return of both debt capital and risk capital, and through their comparison to verify if a company was capable or not to generate wealth. However, the identification of residual income as a clear improvement over conventional accounting profit measures was not the only observation the two authors made. Joel Stern and Bennett Stewart were convinced that accounting metrics are hardly ever reliable in providing evidence of a firm's capacity to create or destroy value, since investors' concern is about cash flow rather than profit as such. In the light of that, they considered accountant's measures as noise and distortion providers and strongly suggest practitioners to not take them into account when computing a firm's economic profit.

EVA method can be used in a double function: to assess the single performance, and to evaluate the whole company. With reference to this last aspect, EVA seeks to establish the value related to the corporate growth, with the solely purpose to modify management and workers' moves in order to encourage them to act for a value creation end.

In practice, EVA estimates the value periodically generated through the difference between the operating profit and the return on investment. The logic behind such computation is that the corporate management generates value exclusively when the operating profit is so much high

that it allows to obtain a residual income after having met shareholders and other investors' expectations.

$$EVA = NOPAT - WACC * IC$$

EVA is computed by the difference between the operating profit after deduction of taxes (NOPAT) and the Cost of Capital used to reach such income (WACC * Invested Capital). If the result is positive (greater than 0), the firm has repaid its "capital providers", is producing wealth and can attract new resources to produce further wealth. If the result is negative (lower than 0), wealth has been destroyed.

The first step towards EVA formulation is to calculate NOPAT.

$$NOPAT = EBIT * (1 - t)$$

where t represents the marginal tax rate.

Then, Invested Capital (IC) should be detected.

$$\begin{aligned} IC = {} & Total\ Debt \\ & + Total\ Equity\ \&\ equivalent\ equity\ investments \\ & + Non\text{-}operating\ Cash \end{aligned}$$

The third step requires to estimate the WACC, which is, as previously seen, the weighted average of cost of debt and cost of equity.

Finally, EVA can be computed following the formula.

The information required to compute EVA can be obtained by the consolidated Income Statement and Balance Sheet: the first is useful to gather data on the operating profit and NOPAT, while the latter is useful to gather data on the invested capital. Even if EVA

computation might seem as not fundamentally different from profits' accounting computation, its uniqueness lies in the adjustments made throughout the computation process itself. Such adjustments, defined as "equity equivalents", have the precise objective to convert both NOPAT and capital from their accounting book values to their economic book values. Although the consulting firm describes about 160 possible configurations of adjustments for a company, about a dozen of them are more typical. Two major themes feature the vast majority of such "equity equivalents":

(a) Fixing the accounting distortions (generally related to IAS/IFRS conservative nature) induced by generally accepted accounting standards, with the aim of approaching an economic, rather than accounting, notion of performance. For instance, "the capitalization of market building expenditures that have been expensed in the past (converting from a liquidating perspective to a going-concern perspective (e.g., capitalizing expensed R&D))" (Martin et al. 2009).

(b) Encouraging a fair managerial behavior, in particular the reduction of reporting discretion and the insurance of total accountability for the whole capital invested. For instance, "the elimination of many reserve accounts. (...) The removal of certain accounting reserves, such as one for bad debt expense, does get rid of reporting discretion and therefore does away with a temptation to "manage accounting earnings."" (Martin et al. 2009).

Counselling on which adjustments to adopt may be given by submitting a four-phases preventive test: 1) Is the adjustment going to generate a significant impact on EVA? 2) Is the adjustment conditioned by the TMT action? 3) Is the adjustment easily comprehensible? 4) Are the info required to determine and check the adjustment easily at disposal?

EVA proves to be a useful tool for a firm since it focuses corporate regard on two fundamental objectives. On one side, the recognition of the corporate main goal in the improvement of

shareholders' wealth. On the other side, the assessment of corporate value in the light of the excess/scarcity of profits compared to the cost of capital. Its greater merits lie in the ability to measure a company performance within a specific length of time, in particular the annual signals provided on value trends. Moreover, it can be implemented to define the actions of the management team, and to allow the management team in its turn to impact on certain measures (for instance, the ROR of the capital invested). The enthusiasm with which EVA model is implemented by managers is mainly related to the positive effects it has on the business' culture and procedures: indeed, it is likely to become more than a financial evaluation system, assuming the role of ideology-provider and value-creator itself. In the light of this consideration, EVA can be interpreted as a "corporate social tool" which encourages the firm's governance to embrace the whole work force in the value creation process, so that everyone would feel part of the value creation process., EVA is a metric for economic profit evaluation but also a metric for assessing the value added by management, reason why it has a significant control function on TMT action.

4.4.3 VBM: organizational model and operative implementation

When the VBM approach is implemented in organizations where the owners (family members or stockholders) do not directly manage the business at operational level, the creation of an *internal control mechanism* is compulsory to oversight the value creation process. The objectives of such system are on one hand, to provide a clear picture of how, and the extent by which, each corporate department / segment / unit contributes to shareholders' value enhancement, with the purpose of increasing business efficiency; on the other, to monitor the performance of the individual and to establish a fair remuneration system. Even though they might seem to have nothing in common and to pursue different objectives, these two purposes

start from the same assumption: the importance of each corporate unit (as well as each employee in an even more detailed perspective) for the firm's "welfare" should be evaluated, and consequently remunerated, according to their contribution to value creation. Basically, when the firm is managed with the objective of enhancing its value, the implementation of an internal control system aims at measuring the activities that support this objective, and to reward them properly, to make the actors "think and behave" like owners.

Without losing ourselves in a senseless debate on the theoretical difference in measuring the performance indicators of value-creation for remuneration purposes, for resources allocation, for organizational efficiency improvement, or even for M&A transactions, I rather take the *compensation set-up process* as reference for discussing the case. Indeed, the applications of the logic are multiple, but the rationale behind it is one only: a VBM model is correctly implemented when it penetrates deep into the organization and it is able to constantly check and assess the effective value creation activity of each subunit.

Rewards as incentives

The compensation and bonus scheme of an organization is vitally important for its operation and relies on a basic assumption: non-owning workers are not motivated to assume the risk deriving from corporate choices, without getting something in turn. This mechanism gains magnitude as the role the individual plays within the organization calls for greater responsibility and skills, as in the utmost case of Chief Executives and Top Managers. The matter of how to motivate workers to align their efforts in value-creative paths is crucial for any business, but especially for non-owners-managed ones. In fact, it is the duty of the owners, in quality of business' first beneficiaries, to ensure the effectiveness of corporate operations for value creation purposes by implementing two approaches: monitoring the activities of the

employees and formulating a remuneration policy to encourage their efficiency. Even though the supervision method may seem the best in terms of costs-and-efficiency, it becomes increasingly difficult to realize as long as the organization size increases and the de-centralization of the decision-making process limits the control activity of the owners. Hence, to come up with a compensation strategy is the best chance to engage worthy workforce and to motivate it all the way through the corporate value creation process.

Before proceeding with the investigation of how to evaluate the contribution of a single entity to shareholders' benefit, and therefore how to fairly reward it, it must be clarified that the nature of the said compensations can be not only monetary. Indeed, economic returns are not 100% capable of capturing the motivation of human beings since their perception of value often goes beyond measurable parameters, such as in the case of free time availability or respect for one's ethic. Nevertheless, money is generally preferred as a reward tool due to its distinguishing feature of being interchangeable, namely, that can be transformed into what is more valuable for the individual. Said that, remuneration strategies change from company to company according to their organizational complexity, the market they're playing in, the hierarchical distribution of competences and responsibilities among its members.

With the aim now to analyze the structure of a reward, especially to determine which part of it is affected by the effective value creation capacity of the subject, let's take as reference the case of an Executive (main-focus of this study). His/her yearly compensation is generally composed of a fixed base wage, and a volatile component involving bonus, stock options, long term motivational prizes depending on business performance and target achievements. We might venture to say that the application of VBM do impact mostly this latter part of remuneration. In this perspective, VBM practices are conceived as measurement tools for determining the value creation potential of a unit and to modify the variable portion of its remuneration accordingly. It can easily be guessed that the metrics applied in the performance

evaluation play a crucial role in affecting the value-creation perception and so the variable component of a reward.

"What you measure is what you get - what you reward is what you get." (Martin et al. 2009)

Indeed, one of the major mistakes that can be done in determining an individual's contribution to corporate value creation is to choose the incorrect metric, generating a misalignment between measurement and compensation. Bonus computation generally relies on widespread metrics as sales growth, net profit, revenue per share, cash flows, ROA, market figures. Such metrics are undoubtedly useful for encouraging workers to pursue financial improvements and to achieve/overcome budgetary forecasts, however, they may fall short in educating for effective value creation and owners' wealth enhancement. The point is to select a metric capable of making employees (*in primis* executives) think as owners, in a way to be more focused on ensuring productive efficiency, team synergy, long-term vision, bottom-line results and taking advantage of good investment opportunities, rather than on striving for the achievement of a merely numerical target. The purpose of the metric in a VBM application perspective is, other than assessing the business performance at overall and sub-unit level, to support employees in wisely investing their efforts and company's resources for the purpose of generating value. Further, aware of the fact that value is built on the long-term performance perspective, the adoption of too numeric-centric (accounting) metrics may prove to be dangerous as it pushes for short term results. It is widely recognized by modern practice that the capacity to ensure ongoing revenues exceeding the cost of capital is much more productive than striving for short run accounting success.

So, it has been stressed the importance of spreading a sort of "ownership mentality" among the workforce, from the Top Manager to the employee at the forefront, in order to align

performance results and value creation goals. At the same time, proper metrics should be selected to verify the effective realization of value creation purposes and so to draw up a proportionate remuneration scheme. Accounting and market metrics have been excluded from the candidate list as too often focused on short-term results (in disagreement with VBM principles), so that the matter now is: what measures should the TMT of a value-oriented firm implement to promote a culture of ownership?

Born precisely to this end, a solution than many companies have implemented in recent years is to remunerate employees with *equity stocks and options*. Despite the iron logic, a first criticism concerns the fact that they are the expression of the overall evaluation of the business, and so are not effective in measuring and rewarding the partial value contribution of a unit or an individual. To give a clarifying example, providing employees with stock-based remunerations is like providing an entire class of students with a single mark, regardless the commitment and contribution of each. In the worst-case scenario, an anti-meritocratic compensation system as this one may even trigger an opposite effect to value creation, known in the economic field as *Free Ride Problem*. The Free Ride Problem is a sort of market failure situation occurring when some individuals who are benefitting from community resources, rewards or goods do not contribute to the obtainment and maintenance. In this way, free riders do not pay for the benefits, while they keep enjoy them. The phenomenon becomes a serious problem in economic terms when it results into below-productivity or above-consumption of a particular resource. By going back to the stock remuneration case, individuals realizing the little contribution they provide to the total company value, and so to the value of its stocks, might be less motivated to work hard, especially if they consider some others as not committed as they are. Moreover, it should be also noticed that stock rewards turn out to not be suited for privately held entities, for obvious limitations of structural nature, with a resultant poor enforceability in family-run companies.

De facto, to make remuneration incentives work effectively, it is compulsory to split the organization into small sub-divisions, and to relate each compensation level to the area of responsibility in which the single division can potentially create value. After that, a proper ownership mentality may be constituted.

In the light of that, the key for determining the volatile component of any reward is to implement a system of *bonus,* linked to individuals and corporate divisions' performance and value outcomes. Bonuses allow to remunerate the efforts of employees avoiding stock-related deficiencies, and to associate the reward to the performance results of the company as a whole or of the single unit *at will,* hence with the possibility to stimulate teamwork and optimization. Moreover, such incentive should be tied to the corporate welfare in the short term but also be oriented to the long-run value creation and performance, in accordance to the VBM principles.

By turning to the practical aspects, the establishment of a remuneration scheme should follow a tripartite path:

a) Identify a corporate reward standard
b) Identify the linkage between reward and performance results
c) Identify the method of administration of the reward

At first, compensation standards are generally drawn by looking at the market and considering the comparable organizations within the same industry as reference. As a matter of fact, there are specific market pressures out of the company's control, so that the establishment of a company's base level of compensation is partially (indeed, mostly) involuntary. Other than that, VBM supporters claim that the adoption of competitive remunerations alone is not enough to secure value creation for the owners: remunerations should be somehow tied to performance results. Since the goal of a firm in a VBM perspective is to enhance shareholders' value, the said firm should adopt a measurement tool coherent to this goal and use it for defining the

remuneration. The responsiveness of a reward to performance fluctuations is determined by two aspects of the remuneration scheme: the percentage of reward linked to performance results, and the mathematical equation adopted to link the outcome to the reward. As previously mentioned, the flexible component of remunerations is the pivotal element to determine their sensitivity to performance. By observing a popular reward formulation, we start approaching its structure:

*Incentive Reward = (Base Wage) **

*(Variable Wage) **

(Actual Performance/Target Performance)

Of course, the structure of the reward is the same for all workers, but the base wage and the share of variable wage would change according to the corporate responsibilities of each individual, so that the remuneration level would change as well.

Until this moment I discussed about the need for linking remunerations to performance results (in terms of value), avoiding any reference to the metrics to adopt. As said above and as it will be discussed in the next paragraph as well, a broad selection of *accounting-based, market-based* and *VBM-inspired metrics* are available for this purpose. Under my point of view there's only one essential prerequisite to look for when selecting the metric: it must reflect future performance.

A metric can verify the effective creation of shareholders value only if it exhibits a long run projection. But at the same time, a manager should be aligned to such long run projection as well, since his/her decisions would be driven by the financial incentives correlated. If an executive is too short-term focused and relies on metrics with the same limitation, the risk is

that he/she ends up selecting investments that ensure excellent short-sighted revenues but with poor potential for future value creation. On contrary, those investments with positive long-lasting forecasts but providing modest profit in the first years would be discarded.

Basically, is not only a matter of selecting the metric offering a long-term perspective, but also to address executives' mentality toward a long-term perspective as well, providing them with the necessary motivational rewards.

For this purpose, I collected few easy-to-apply expedients to help managers expanding their value creation intentions. For instance, within the framework of EVA method, it has been introduced a long-term incentive[13] that "splits" managers' bonuses over a certain number of years and bases each prize on the achievement of specific standards over that period. In this way the manager's decision perspective is encouraged to match at least the duration of the bonus-collection period. Another solution provides for the adoption of specific *value drivers* (namely, multiple metrics of economic and non-economic essence) in support of main value-based measures, with the aim of detecting the opportunities for future value creation.

For instance, if sustainability is considered as a fundamental enhancer for company's value, a measure related to its level should be incorporated in the bonus computation. Further, also *stock-based rewards* may contribute to broaden managers' value timeframe, not as main reward methodology but rather as a support tool, since they may include remunerations for long-term investments to the detriment of a short-term approach.

Summing up, the adoption of an effective remuneration system is compulsory to spread an ownership mentality among the workers and persuade them to behave and take decisions as they were the direct beneficiaries. The main feature of such system is that it must foster the

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[13] "Bonus Bank System"

harmonization of the workers and owners' interests; this is attained only when the remunerations of the workers are deeply tied to the effective enhancement of owners' wealth. Generally speaking, it may be said that owners' value creation is accomplished when the business earns more than its cost of capital. The selection of a proper metric that evaluates the effectiveness of this process is fundamental, but not enough: managers should also be capable of implementing it correctly, throughout the entire organization and in each sub-unit. With this regard, remunerations are more successful when are based on value improvement rather than on simply exceeding previous values.

"One should not be penalized by a low level of EVA - or some other performance measures - if one takes a poorly performing business unit to a higher level. Likewise, employees should not be rewarded just because they happened to inherit a high-performing unit where they simply coast along." (Martin et al., 2009)

4.4.4 Critics to VBM

In the early nineties, value-based management was widely celebrated as a revolutionary tool which allows investors to better assess companies and allows executives to better evaluate business performance. Undoubtedly, in a theoretical perspective, VBM is a great idea.

However, after two decades of experience and refining, have VBM promises been fully achieved?

Considering its gradual loss of relevance in the modern corporate finance field, can we venture to blame management teams for failing in the application of its principles, or do VBM principles themselves actually fall short in providing effective guidance?

And, with particular regard to family firm application and future perspectives, does VBM offer any kind of peculiar advantage for this type of business organization, and is it considered an effective management strategy for the next generations?

“Superficial” critics:

Despite the many advantages related to VBM, there are actually multiple criticisms to its effectiveness that, at first glance, can be traced back to a couple of remarks: it is considered a too financial-centric tool, and accused of ignoring the interests of stakeholders other than shareholders.

The answer to the latter is actually quite immediate. Indeed, the hypothesis of prioritizing the interests of all the company’s actors is as ambitious as unworkable. It would mean that any group of stakeholder asks for more and more benefits, with a resulting loss in terms of competitivity by the company. The scenario wouldn’t change much, if priority is given to suppliers’ costs would increase, if priority is given to customers margin would decrease, if priority is given to Government tax expense would be larger. Hence, value creation turns out to be the sole objective that, when achieved, it ensures utility to all stakeholders. Through value creation a firm proves to be a good investment, and so has the possibility to get further funds to invest in the interest of all the said shareholders.

Concerning the first critic, the dynamic is trickier. Value creation is founded on a fundamental postulate: corporate value coincides with the present value of future cash flows represented by dividends and by the difference between shares’ selling price and purchase price. Traditional accounting techniques are not appropriate for representing the company value since value *per se* is not a proper assessment tool due to its extreme brevity, and do not allows to identify the

most important factors leading to a result. In this perspective, it is advisable to pay more attention to value triggers determination rather than value calculation. Moreover, further doubts have arisen specifically on DCF as tool for managing value drivers to value creation. On the light of that, a change has already happened concerning future perspective, aimed at focusing VBM techniques on a much more real dimension. Practitioners have kept more attention to operational activities rather than administrative ones, and a shift from pure accounting models to executive models has enabled to a daily check of the organizational activities. If the TMT works with the aim of creating value, it must focus its interest on those elements which are the basis for it: it is compulsory to identify, know and measure them in an effective way. Hence, it comes the need to specify such elements to highlight the cause-and-effect relationships and relate them to the value creation policies. In other words, value is assessed and managed by identifying the determinants, making them explicit through measures and detectors, and observing the results.

More "in-dept" critics:

In general terms, original VBM practices are not capable of providing managers with exhaustive guiding principles for managing value creation. This is the main reason why VBM credibility has always been quite doubted.

The simplistic approach with which VBM tools address any type of management issue, from the easier daily corporate affair to the important ones, has not gone unnoticed. For instance, VBM reveals managers how to enhance Net Present Value, but overlooks any reference to improve the valuation quality as by means of Multiples (i.e. the Price-Earnings Ratio). Even its superficiality is source of critics: VBM defines what the corporation should work for and

how to make decisions on the way but provides little support on how to integrate the whole organizational culture to be dynamic and effective in the value creation process.

The said shortcomings may be traced back to three main practical gaps in traditional VBM principles:

1) *Lack of reference to capital market realities.* Concerning the market scenario, it must be stressed VBM lack of consideration for value intended as *relative* shareholder value. Indeed, the comparison to other market players is fundamental to provide investors with a better sense of the value of the company. P/E or other valuation multiple should be included in managers' lists of levers for value creation, since they show the expectations of the market and give an idea of how profitable a company is and how profitable it will be in the future in a fair financial perspective.

2) *A missing linkage to organizational culture.* Getting to the hottest topic for a management team, this shortcoming refers to how VBM drives sustained value creation over time. Indeed, from enhancing and motivating human capital to build an effective and integrated leadership, provided with master managerial capabilities, the path is long and the practice is plenty. The fact that VBM do not address all the corporate functional areas with a clear and unique process results into an unbalanced enhancement, mediation and evaluation of created value.

3) *A lack of coordination among value creation levers.* This group refers to the gap of solid basis for reflecting on and managing the network of levers resulting in value creation. VBM gives abundant counseling on how to manage accounting principles and

levers, but barely addresses how to integrate and coordinate strategic, cultural and cognitive levers. Indeed, there should be an alignment among the strategic choices and functional priorities of the management, the impact on multiples and the satisfaction of the shareholders' needs. Value creation is the result of the way the whole system of levers, priorities and behaviors interact.

4.5 Why should family firms use VBM?

The main objective for any firm is, according to VBM, to create value for its shareholders. The strong correlation among share price, trade value and surplus value for shareholders explains why the majority of the companies adopting a VBM perspective is publicly traded on stock markets. However, even if it may be that private, small organizations do not fully benefit of VBM procedures and notions, the basic idea behind VBM is actually valid and applicable to any business organization beyond its legal form.

In these terms, family firms may hypothetically encounter some difficulties in applying VBM guidelines, especially in the most common form of privately owned, small size companies. Nevertheless, it will be enough simply to carry out specific, tailored adjustments on traditional VBM practices to solve the inconsistencies. It is crucial for small firms, including family-run ones, to comprehend the notion of VBM and to apply its procedures to the business activities after a careful customization. The capacity to create and enhance shareholder value is crucial for ensuring longevity to a business, and it becomes even more important in family run businesses, were the owner family is the majority shareholder and to look out for its interests is a key priority for the TMT. There is need to focus on strategic financial management instead of normative financial accounting metrics, since this change of course makes family businesses

more vibrant and strategically offensive rather than market-passive and merely focused on economic survival.

The two core principles behind VBM concern a) the enhancement of shareholders value (equated to the whole business value), achievable when revenues are higher than cost of capital; b) the focusing on the preset strategic results. The fact that all management decisions are considered under a multi-period perspective, leads VBM to be interpreted as a long-term approach. The awareness of the two core principles and the value drivers' control should ensure the achievement of the value-enhancement goal to every organization, since the application of such principles ought to secure a better capital allocation in the long-term.

Basically, with the application of VBM, organizational effectiveness is promoted within any corporation, regardless of its dimension or legal status. In fact, every business organization competes to secure a certain amount of capital available in the market, and to do so they must be competitive with one other. The capacity to collect external capital depends on the expected return meant for external investors. In this perspective, VBM is adopted as a risk-management tool, useful to avoid insolvency risk and necessary to ensure financial backing even to those investors, as entrepreneurs and owner families are, not accustomed to risky investments.

A value-based management style might be considered an effective solution to mitigate interest disagreements between management and owning family, according to several considerations.

At first, VBM measures allows the maintenance of a goal-congruent perspective and preserve corporate decision-making quality from the potential harmfulness of the emotional sphere, involved in family businesses as well as the financial one. Under this perspective, VBM is a powerful tool which allows the leading family *in primis* to detect the values on which the organizational culture should be built on, through a mix of economic and non-economic purposes. With this regard, the "managerial weakness" that may mislead the owning family in

the process of identification and maintenance of such corporate values is, at first, attributable to their lack of know-how concerning optimal decision making. In fact, as it has been proved in several studies, family leaders tend to not exploit formal financial and accounting principles, measures and tools as nonfamily professional managers do (due to a lack of proper experience, education, instinct). Secondly, the inherent gut of "socio-emotional wealth" preservation misguides the owning family from aligning its goals with the firm specific goals. This because, as previously described in the SEW theory (Cap. 3), family decisions tend to be propelled by and devoted to the conservation of the gathered family heritage, in the form of family business. These interests mostly reveal an emotional nature rather than financial and aim at securing the interests of the household by means of the family company: in such a way, family decisions concerning business value and strategy might be misleading and self-centric. Nevertheless, considering than the perpetuation of the family business activity is one of the priorities induced by socioeconomic wealth, the importance of ensuring an effective decision-making process, capable of achieving the corporate goals on a regular basis and enhance firm value, grants to the owning family the rationality to adopt effective safeguard mechanisms. Among the many tools available to carry out this job, VBM performance measures allow to ensure the maintenance of value congruence, and to modulate/customize such corporate values in a way to blend economic and non-economic interests, according to the family reasons. Moreover, with specific regard to agency conflicts mitigation, VBM allows the family to not lose the sight of the corporate needs in favor of such selfish interests, and so to maintain a business perspective much more in line with that of professional managers.

Secondly, family firms dealing with external managers may choose VBM practices to reduce the arising agency conflicts of Type I (principal-agent relationship) on the other side, namely by bringing the nonfamily managers closer to the non-economic values of the business. In fact, if on one hand the decision to hire external executives provides the professional skills required

to lead the firm and so ensures the continuation of the business over generations (in support to the SEW of the family), on the other it exposes the family business to a huge loss of socioemotional wealth due to the excessive profit-orientation of the professional and their inability to perceive the non-economic value of the family. In this case, the adoption of VBM techniques would be incredibly precious in controlling the action of the managers and to orient them toward the peculiar values typical of family businesses.

In the light of these considerations, we expect family firms to go for a value-based management approach, with the aim of enhancing decision making quality and mitigating interest conflicts. *In primis*, because it may help them to compensate for the lack of professionalism and to maintain a value-orientation (especially the economic goals) despite their emotional involvement. Then, because the engagement of nonfamily managers may potentially trigger the rise of agency problems and so of opportunistic behavior, which can be averted thanks to the application of value-based measures to assess their coherence with family and corporate values.

Of course, considering the heterogeneity of family firms, it's not possible to determine a VBM methodology universally applicable to all. The peculiarities of each family business must be taken into account while deciding which value-assessment tools to apply. The external pulses and the internal reasons determine, in conclusion, the value orientation. However, EVA method stands out for the flexibility and adaptability to every corporate structure, in a way that it might be the favorite for the application of VBM to the specific case of family firms.

At this point, clarity must be done on the topic. VBM is a field in which family businesses can get their hands on. As a consequence of the overlapping of three spheres, namely the family, the management and the ownership, corporate values are particularly relevant in this type of business organizations since the strong values typical of founding families tend to be

transmitted to the corporation too. Hence, family's portfolio of values generally matches the values portfolio of the business activity. The identification of the peculiar values of the family implies the identification of the acceptable/unacceptable behaviors within the organization system. Indeed, the owning family' set of values guide the key decisions concerning corporate strategy, business structure, organizational culture, governance, management style.

For this reason, business values in family firms' culture tend to be partially different than those in nonfamily firms. In general, corporate values within family-owned corporations are more likely to be people-oriented rather than financial profit-oriented, in the sense that they favor the creation of healthy relationships with all stakeholders and strongly emphasize the raise of positive behaviors within the organization.

The application of VBM practices in family-run organizations is actually not hindered by any extra-ordinary issue as long as the organization at hand is publicly traded. However, what really makes the application of VBM to family firms trickier is the fact that they may be privately held, and so that the computation of the shareholders' value may not rely on market computations and comparisons.

4.6 VBM in (privately held) family firms

Said that, we now propose an updated approach to value creation, family-customized, with the aim of determining a) which is the most effective procedure to apply VBM in practical terms, b) how can we rearrange/enhance VBM practices in order to overcome as many methodological deficiencies as possible, and c) in which part of the value measurement process, diverging practices should be introduced when the subject is privately held.

"The easy part of managing value creation is conceptually convincing managers and employees that it is their most important, overriding, and shared focus. The hard part is figuring out where to start and how all of the pieces fit together. Delegation, training, and incentives only take you so far and then they break down into unproductive or misdirected efforts." (Eric Olsen)

VBM clearly transmits the idea of value creation as the highest corporate ambition for a firm. However, when it comes to practices, things get blurred and practitioners realize that VBM do not provide a specific value creation agenda to follow. Once VBM is applied within an organization, it can be concluded that multiple metrics may be applied for different purposes and, during their implementation, simplicity is preferable to precision. With the aim of managing value drivers rather than calculations, the latter should be carried out in the easier manner possible to divert attention from metric. Synthesis, simplicity, comprehensibility and responsibility have proved to be the prevailing guidelines for metric selection. A proper VBM usage entails a directed implementation of the procedure by the company's headquarter and greater regard towards value drivers than numbers. Attention is drawn to how value is created, rather than to its quantity; hence, the focus is on value creation-drivers and no longer on values resulting from mere math calculations. The pilot project for VBM implementation is drawn only a single time, however, it is considered an ongoing process where adjustments and regulations may be carried out on a regular basis to improve the system. VBM execution would be successful if managers and workers are educated on the different scope of competencies of the model, according to their area and position within the company. TMT must be educated on social responsibility; Top and Seniors have to be educated on calculations, principles and strategy; lower levels are educated according to their tasks and responsibilities. Finally, professional consultants are crucial to support VBM implementation, contributing to train the staff and providing the backing to the whole corporate structure.

With the application of VBM principles, firms that previously were based on budgetary outcomes and the control of those results by means of traditional accounting measures, tend now to implement more action-controls through a value driver management. Moreover, personnel supervision is more frequent with the aim of developing the skills and changing mentality to have a wider perspective on decision-making and to implement a much more "entrepreneurial" approach to the business. Managers would be more likely to dialogue with employees on strategy development and reporting management, instead of following an austere top-down instructions process. Anyone, in carrying out its activities, is motivated to consider the invested capital, to act in a proactive way and to think of their unit's strategy on a value creation perspective.

Aware of that, the first step should be to set a s*equence for thinking* in order to define the starting point and the steps to face gradually along the value creation process. Here is a hypothesis of VBM framework to follow (Table 18).

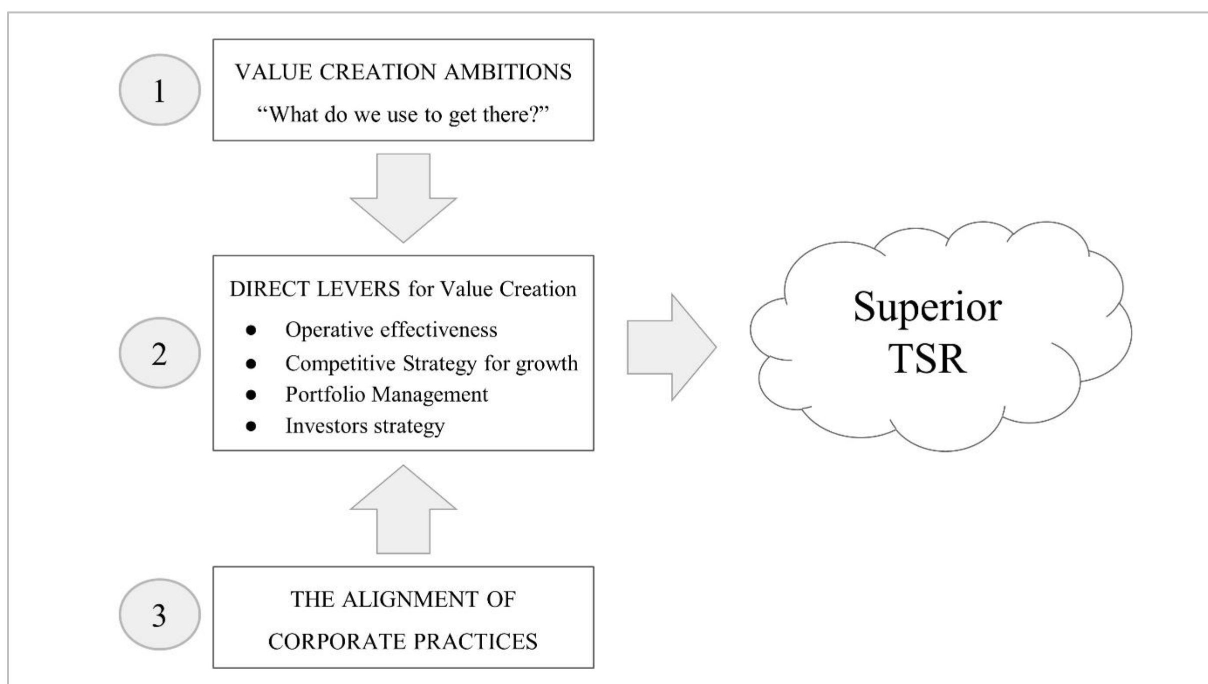

Table 18. The process for the creation of superior Total Shareholder Return

The setting process begins by making explicit the value ambitions of the business. This strategy column paves the way to the “value drivers” (levers), whose job is to meet such expectations in practice. Then, once the TMT has identified the value goals and managed the levers to reach such goals, the third step is to ensure that all the organizational practices and activities are aligned with the plan. As the value creation framework turns into practice, managers should check on the presence of a shared consensus on the ambitions of the company, on which levers take priority, on which levers are hot topics and which are negligible in the ongoing agenda, and on the effective alignment of the business practices to enable value creation within the organization.

STEP 1. The establishment of Value Creation ambitions

An organization has the opportunity to achieve its value creation goals as long as is able to spread, focus on and align all the members around a *common mission*. If the final goal, the value ambition, the corporate purposes are confirmed and encouraged every day by the leadership team, the whole corporation would be coordinated and the members would have matching behaviors. The whole business performance benefits if corporate ambitions are in harmony, since value needs are more likely to be satisfied. On contrary, when such purposes are too general, highly volatile and unstable, or become weaker due to an excess of priorities, they immediately lose their effectiveness as corporate success enablers.

To allow value creation targets to be set out, VBM practitioners generally opt for a series of metrics proposed for value creation measurement, mostly from a shareholders’ perspective and so ideally suited for listed companies. A list of the major models follows:

1. EVA (Economic Value Added, see Paragraph 4.4.2), intended as earnings before interest minus the book value of the company multiplied by the average COC;
2. EP (Economic Profit), intended as the book profit minus the book value of the equity multiplied by the demanded return to equity;
3. MVA (Market Value Added), intended as the gap between the market value of the company's equity and the book value of the initial investment;
4. CVA (Cash Value Added), intended as earnings before interest added to amortizations, minus the economic depreciation minus the COC employed;
5. CFROI (Cash Flow Return on Investment), intended as the inner return on investment uncorrected for inflation;
6. TSR (Total Shareholder Return), intended as the shareholder return obtained from dividends paid and equity appreciations.

In this perspective, VBM guidelines claims that the establishment of a single, long-term-based corporate ambition is compulsory to align the entire company over a shared mission. All such metrics are characterized by some advantages and disadvantages, in a way that the final choice should be estimated according to the specificity of the case.

If we must put forward a personal remark and go to the extreme of VBM meaning, according to which the objective of a corporation is the maximization of the value creation process intended as the maximization of shareholder value, the Relative Total Shareholder Return (RTSR) is probably the more effective aspiration-setting tool. Indeed, to promote more vague goals such as the satisfaction of all stakeholders' interest, sounds good on paper and public speeches, however, it doesn't really work in enhancing corporate cohesion. RTSR is a powerful single perspective to delineate and transmit the ambitions of the firm, and for supporting the action in practice (if correctly implemented). Once it is anchored on shareholders' value implementation, this technique can be expressly quantified and then drop down to each single

corporate unit as a long-term purpose that stimulate linear management and enable regional entrepreneurial thinking concerning the levers to realize value creation. RTSR process is effective, it generates targets that are impartial, adequately elastic, and it links straight away the corporate management to the financial market discipline. It constitutes an easy-to-understand figure of the total profit generated for stockholders, by assessing the way the market judges the overall performance of an organization over a given period of time.

$$TSR = \{(current\ price - purchase\ price) + dividends\} \div purchase\ price$$

In the family firm context, we might venture to say that the association between shareholder value and company value is taken to extreme since a) there's a majority shareholder owning a significant part of the shares (at least 50%+1), and b) such majority shareholder is a family, generally the founder of the business. This means that employees tend to recognize more easily the ownership structure and to accustom to the family leading presence with fewer difficulties, compared to nonfamily organizations. Hence, the family context facilitates the identification of the company's needs in the needs of the shareholders, being such entity mostly traceable (at least the majority) to the owner family.

Further consideration: the adjective *relative* when referring to Total Shareholders Return is not accidental. The achievement of RTSR goal by an organization can be verified and fairly assessed only by comparing it to the TSR of a group of compeers. The choice of which peer group to use as a comparison for a company is one of the most critical aspects of designing a relative TSR plan. Inadequately selected peers may introduce significant market volatility into the plan. Quite popular indices as the S&P 500, Dow Jones, Nasdaq are easy yardsticks to use, however, custom peer groups turn out to be more reliable in such process. It must be notices

that as plans become more sophisticated, the focus turns to increasingly smaller custom groups, to ensure a fair representation of company's effective competitors. Otherwise, as an alternative way, management has also the possibility to set a future target for TSR to evaluating the effective attainment of the objectives and controlling the results of the business plan and strategic initiatives over time. It means that a certain TSR future goal has to be translate, someway, into a specific number.

Expected t-years corporate *COC*	**≃ 10%**
Expected *spread* to achieve RTSR	**x%**
Forward Looking t-y *RTSR Target*	**10% + x%**

Table 19. Process to detect TSR's future target.

The process is straightforward (Table 19). The first step consists in calculating the risk-adjusted awaited TSR for the market, represented by a firm, a group of peers or a market index. Many models can be used for such purpose, as the Capital Asset Pricing Model or Dividend Discount Models (however, it must be noticed that the awaited COC is generally considered around 10%). After that, the surplus with which the company aims at exceeding such benchmark must be determined. Considering that it is quite challenging to achieve superior TSR every year,

since it would mean to be capable of sustaining repeated performance improvements, under a value creation point of view it is more rational to set cumulative goals for achieving superior TSR in four, eight, ten years rather than striving for constant performance enhancement each year.

Under this perspective, family firms may be considered as more advantaged due to their natural propensity toward long-term plans. While on one hand, *capital investors* are interested in short terms revenues that cover their investment in the faster way, being ready to disinvest as soon as a batter opportunity occurs, on the other *family investors* evaluate their business more than a simple investment chance and are interested in ensuring its maintenance over time. However, when dealing with family firms, we also cannot fail to notice that a) this type of business organization mostly appears in the non-listed legal form, and b) that next to monetary value, family members gather a big portion of value from non-monetary gains. Both such aspects make the traditional process of TSR calculation a bit trickier. In a family run-organization, the economic and financial performance goal may be questioned by the purpose of creating and preserving aspects concerning socio-emotional wealth such as the continuation of the family name, culture, leadership and values, or to ensure a convenient lifestyle at the expense of the business wealth. Thus, traditional measurement of value creation should seek to focus at unison on short and long term, financial and non-financial aspects, while connecting to the firm's goals. Especially TSR is inapplicable to both divisional level (Strategic Business Unit) and to privately held companies, due to its nature.

Aware of this, a methodology not exclusively designed for listed companies might come in handy for family firms. Total Business Return (TBR) is defined as the hypothetical shareholder return in privately held companies and in corporate divisions (anticipation of the next Step, focused on which method is more valuable in capturing a business unit's contribution to the achievement of the RTSR target). It is basically a forward-looking measure of CFROI,

designed to imitate how capital markets determine TSR. It is highly recommended for the application into privately held companies.

Here are two versions of the formula.

- TBR = Relative Capital Gain + Relative Dividend Yield

$$\text{TBR} = \%\,\Delta\,EBITDA\ +\ \frac{Free\ Cash\ Flow}{EBITDA\ x\ multiple}$$

Or

- TBR = Terminal Value (end of the period)

  - Gross Cash Investment (begin of the period)

  + Gross Cash Flow in the in-between period

We might venture to say that Total Business Return is quite similar to the “forward-looking IRR” procedure adopted in EVA model. In fact, also EVA is suggested for the application in non-listed companies and at divisional level.

Summing up, corporate ambitions are an effective tool that tune an entire organization on a common target. However, clarity, measurability, accessibility and comparability are *conditio sine qua non* to confirm their effectiveness. Corporate value ambitions have then to be bestowed to each business unit, to activate the lever of cohesion for a more productive process (see Step 3).

STEP 2. Levers for value creation

We can group the value levers that allow a business to reach its value goals in four groups:

A) Operating effectiveness: The level of efficiency at which a business is operating, basically represented by carrying out a task and obtaining the maximum outcome with minimum expenditure of resources.

B) Competitive strategy: how the firm is planning to gain competitive advantage over its competitors in the market, in a long-term perspective.

C) Portfolio management strategy: how to make decisions about investment mix and policy.

D) Investor strategy: how investors interpret the ultimate value targets.

Of course, such levers are interdependent and should be aligned with one another to stimulate value creation.

Among all, VBM practice has traditionally ignored the investor strategy lever in favour of the other levers. The focus was on providing new value metrics for helping TMT to achieve value creation, intended as the realization of returns in excess of the COC (by means of metrics as Existing Assets and Incremental Investments), and the improvement of the corporate intrinsic value (by means of CFROI, EVA, NPV, Cash assessment). Indeed, VBM claimed that such economic tools were the most rational for fairly evaluating the business plans, the operative tradeoffs, the allocation of resources, the performance results, the rewards of the managers, the management of the overall portfolio. However, they are not perfectly efficient and truthful in doing so, since they fell short of considering the investor's lever.

"To earn returns in excess of the cost of capital" has always been VBM mantra, but the majority of VBM approaches have interpreted such principle exclusively from an internal point of view, focusing on enhancing intrinsic (*theoretical*) value instead of *realized* value. Pushing the ROI on existing assets over the COC and making sure that incremental new investments realize returns in excess of the cost of capital are undoubtedly good corporate practices. Yet, they fell

short in considering investors' expectations and segmentation, a big issue if we consider that the interpretation these prescriptions make of the ultimate targets completely change if observed from an investor's perspective.

Investors' goal is to invest in a business that is going to exceed the performance forecasts already integrated in the firm's current stock price. Investors are less interested in whether a business' ROI on existing assets is exceeding the COC, focusing on whether the business will be capable of improving its current or expected performance. Firms with a modest ROI that boost their ROI turn out to be good investments while firm with impressive ROI that do not enhance can be interpreted as wrong investments. The inclusion of such investor-centered logic among the levers for value creation results in a change of performance evaluation by the TMT, since having a high ROI compared to the cost of capital doesn't necessarily mean to have a high TSR. To enhance value, ROI must increase over the predicted levels or be complemented by higher than foreseen reinvestment growth, and the target for assessing its improvement have to represent the expectations already in the current stock market.

High ROI business units can't coast, and low ROI business units are not value destroyers per se if they can improve ROI above expectations. (Olsen)

In this perspective, the choice of focusing on *intrinsic* value maximization translates into the adoption of VBM traditional evaluation measures such as EVA or NPV that, as sore point, ignore *realized* value. To improve the effectiveness of VBM methods, a management team should develop an efficient investor strategy that defines the most attractive long term-value improvement-plan for the targeted investor segments. It means that a firm has to carry out a careful analysis of the investor-type currently involved in the ownership structure, and to initiate the incorporation of the ownership mix peculiarities within the group of direct levers that constitute a firm's value proposition.

About the specific case of family-run organizations, it should be noted that next to monetary value, families derive a great portion of value from nonmonetary revenues. Hence, value creation results need to be interpreted not merely in financial terms but also according to the personal interpretation investors put on them, even more so in family firms. In a practical perspective, the main challenge in family businesses is to better comprehend the factors affecting subjective value in order to get a more accurate perception of the corporate finance activity.

Summing up, good choices under an *intrinsic value* point of view may not be as good under a *realized value* point of view, especially in the short/medium term. But the ability to properly manage the tradeoff between the improvement of both the value interpretation is a crucial matter for the management team, not brought to light in traditional VBM approaches. The adjustment of the traditional VBM methods to make them more investor-focused is a very important step for better driving the levers to value creation.

STEP 3. The alignment of corporate practices

After the development of a strategy for coordinating the value creation levers, consistent with investors' needs and rendering, TMT has to spread such strategy plan along the corporate units to ensure their alignment. The role of this phase is as crucial as full of pitfalls. The corporate practices adopted by each unit carry over the culture and values of the organization, set up its behavior norms, and establish priorities. This process introduces important choices to be made: on one hand, whether to break down the overall target and allocate different targets according to each business unit's perspectives and potential, or to keep the overall average target equal for each department; on the other, which measure the organization should adopt to capture a business unit's contribution to the achievement of the value target. In this case, the most

effective approaches to adopt are considered the Total Business Return (TBR) measure, already introduced as one of the best options for private companies, and EVA measure. Both indeed capture the capital gain and the contribution to value creation made by a single business unit, even if the first through an easier and straighter formula. More than a company has found TBR an helpful system since it imposes corporate unit management to find the right compromise between increasing EBITDA and allocating capital investments. On the purpose of TBR enhancement, each business unit that invests cash to increase the EBITDA should generate a capital profit higher than the free cash flow "dividend" outcome it would have obtained from paying the cash back to the organization. Firms spreading the TBR method inside the organization give an explicit, unbiased and motivating communication to their department teams: "I appoint you to the role of creating value-enhancer outputs in our business as though you were Chief Executive of your autonomous enterprise. You have to guide and coordinate the members of your team with the aim of delivering a value contribution that is compliant to capital markets forecasts in case of listed entities, or personal and competitors' targets in case of private entity. As a consequence of that, TMT is removed from its "bumper" function in connecting corporate units and capital market accountability, eliminating futile bargaining on targets, empowering and regulating corporate unit management to draw their path, theoretically aligned but physically independent, for boosting value creation.

In summary, value creation effectiveness is mostly a matter of how corporate practices are formulated and executed.

At first, when attempting to align corporate unit practices on value creation practices, the potential of the organization to enable value creation is fully achieved when a balance across goals is reached. To find a balance means to hierarchically distribute priority among goals. Do I (as the TMT) want to achieve long term value creation by means of units' empowerment, or do I want to retain a centralized power system? Do I want to apply an iron discipline to boost

value creation, or would I rather encourage the out-of-the-choir, enterprising kind of action? Is it better to promote interaction across departments, or to keep them separated as much as possible? Goals are generally linked each other, so that the configuration of one affects the configuration of another. For instance, the decision to encourage unit empowerment is more likely to reduce discipline and to increase enablement. Of course, the priority allocated to each goal changes according to the firm's features (i.e. centered vs diversified, high growth vs adult) and culture.

The second step consists in setting the corporate managerial style consistent with the chosen mix of goals. At one extreme, executives retain a more absolutist approach over decisions that concern day-to-day operating results; at the other, TMT has little or no direct decision-making power on day-to-day operating issues and concentrates on regulating financial outcomes and managing the portfolio mix. Both the described management styles can be effective (as well as all the shades between them) provided that the chosen style fits the business features. If units' practices do not align around a single managerial style, or range across styles over time, their contribution to corporate value creation could be seriously compromised.

After that goals and style have been set, the last matter concerns the practical alignment of the corporate unit practices by means of supporting practices. With this regard, the choice of which performance metrics to adopt in assessing the results is crucial. The measure implemented in case of empowerment-goal priority under a hands-off managerial style is going to be very different from that chosen if the goal is to retain an iron discipline under a hands-on managerial style. In the first case, a high-level metric (such as EVA or TBR) that enable local tradeoffs to be maximized would be the best option. In the second, a wider amount of specific metrics limiting local room for maneuvers would prove to be the best option (for instance, revenue growth, margin, FCF targets). Moreover, the fact that company features and business environment can change significantly over a period of 3, 5, 10 years implies that an

organization needs to systematically manage the evolution of its corporate center practices in order to capture unrealized opportunities for in creating value.

Final considerations

Now, doing a quick review of what has been claimed in this paragraph, we fix some crucial points on VBM applied to family firms. The definition of shareholders value creation is generally grounded on stock returns and so intentionally relies on market prices. This choice aims at reflecting the consensus of the whole stockowners group, even if the personal perception of value diverges person-to-person because of different qualities in the information amount, control perception, time horizon, risk tolerance. Despite the fact that shareholder value definitions tend to focus on stock quotations (not attainable in privately held companies), VBM practices are anyway enforceable in non-public organizations by means of few precautions.

Although the environment often differs for private companies (less disclosure required, greater concentration of ownership and leadership, greater informality of the dispute resolution methods), the issues of performance evaluation, profit opportunities detection and capital expansion are still central for management. *A fortiori* privately held companies are, in my opinion, blinded by the easiness of multiples and accounting reports in such a way to overlook the real determinants of value - the quality and the amount of expected cash flows. The temptation to recognize themselves within the prevailing range of earnings multiples for listed peers, without regard of whether they account for such earnings / cash-flows in the same way, or whether their business activities are actually comparable. The point for privately held family firms (for listed family firms, VBM applied in the traditional way) is to detect what creates value, how such value creation can be assess, and how traditional earnings-based criteria for performance evaluation can be adjusted for a non-public context.

What is important to stress is that privately held companies, of which a huge share consist of family firms, may take huge advantage from a shareholder value approach, even more than public firms do. Indeed, even if private firms do not have listed share prices, they likewise need to obtain the correct strategy and value outcomes as their public fellow. We may venture to say that they are actually more in need of well-grounded value creation procedures than public firm do precisely due to the absence of any share-price comparison. Of course, privately held companies have demonstrated in many case-histories to be capable of producing huge value creation with barely few management procedures and elementary metrics. However, even admitting that some entrepreneurs may have an extremely sharp intuition such that to compensate a lack of resources, the utility provided by a well-designed business management plan is priceless for any business progress especially once the business is consolidated.

At first, it must be said that the confusion about what “shareholder value” means is a lot. Firms adopting performance measure principles based on shareholder value start by agreeing with the idea that increasing the value of the business in the course of time is advantageous for the shareholders and so, in return, for all the other organization’ stakeholders. Which basically means, the best for shareholders in a long-term perspective coincide to balancing the interests of all the organization stakeholders.

What we can say is that the metrics adopted in the assessment of shareholder value are, in fact, better metrics compared to the tracking, even if accurate, of the share prices in the long run. Hence, shareholders value estimators have corporate metrics that tend to conform much better to long-term performance strategies. Moreover, the fact that such “superior” metrics are cascaded into each sub-unit in charge of developing strategies, plans, budgets, investment policies, and incentives is a further advantage.

Summing up, we might summarize the rationales of why shareholder value principles and VBM practices are useful for privately held organizations in three sentences.

At first, there's a matter of business expansion and size growth. Over the years, private companies of success tend to grow in terms of size and broaden the business embracing new industrial segments and national/international markets. Such enlargement generates further complexity to the corporate system, hence reducing the capability for the family and its few partners to efficiently supervise the whole business network. In a way to successfully proceed with the value creation process and to fulfill corporate needs in a wider perspective, part of the TMT decisions should be decentralized (through external managers' involvement, as previously discussed). However, in doing so, private firms start needing the appropriate tools and processes to successfully handle the business in a decentralized landscape and to align the efforts of an increasing multitude of actors towards a common target.

Secondly, there's a matter of succession planning and authority. As generations go by, the number of family members involved (actively or passively) in the business potentially increases. Especially under a passive-owner point of view, the risks to leave a portion of their personal wealth in the hands of others, especially if other family members not endowed with particular business intuition and acumen, starts being a great concern. Especially when they have very few direct influence or oversight, to obtain the best governance becomes a priority and VBM might become attractive thanks to their sharpness.

Thirdly, the notions of shareholder value creation give the chance to strengthen the "ownership culture" among those TMT members who have few or no ownership. In many occasions privately held firms retain a sort of family-inspired-culture, where long term employees have a sense of belonging to the family. This practice is actually of great value and may led family firms to establish a competitive advantage over all the other businesses. Devotion, intended as

commitment of the workers to the organization, and conversely, is a significant occasion for ensuring success and continuity to the business. However, if the company culture is not deep-rooted in the system and assimilated by its members, it may lose its significance on long term results as the founder moves out or the family lets go. In anticipation of that, VBM may be a useful tool to reinforce the corporate culture and to allow the family to preserve its influence even as generations go by.

To adapt VBM to their peculiarities, there are few recommendations that privately held firms should avoid as opposed to listed ones. For instance, to avoid the establishment of extremely short-term targets such as quarterly earnings and earnings calls, common practice among public companies due to the confrontation with stock exchange estimations. Indeed, private firms should, of course, watch out quarterly results and compare them with their competitors, but considering their effects on long term results.

VBM turns out to be particularly suited for private firms that have grown in terms of size and sophistication, that have undergone generational successions, or that are worried about the evolution of their corporate culture. Such companies should take into consideration the adoption of a shareholder value perspective, since the higher quality measures and practices of VBM provide multiple benefits: beside the improvement of governance effectiveness, they help managers at all levels of an organization to draw up superior strategies, and to implement them in order to achieve better results. VBM may also, due to its professionality, attract and properly reward brilliant managers, and so allows private organization to compete with their public organization peers. Indeed, in the context of shareholder value creation, incentives are probably the most effective tool for allowing private firms to better align nonfamily executives with the corporate culture, and for helping to attract skilled managers and deal with public firms by reaching their value standards.

CHAPTER 5. CONCLUSIONS

The purpose of this study was twofold: on one hand, I wanted to give evidence of the pivotal role played by nonfamily Executives in family-run organizations, specifically after the founder departure; on the other, aware of the unavoidable threats coming with the benefits, I wanted to suggest Value Based Management as a corporate strategy solution to overcome the main issues.

In Chapter one, after a general overview of the structure of the project, I started by introducing the latest statistics on the family business population in Italy, with particular interest for leadership composition and nonfamily managers' involvement. Data has been provided by AIDAF, the most prominent association of family businesses in our Country. It was found that Italian family firms, despite their population density in line with the major European economies, tend to be relatively smaller in terms of size. I traced this trend back to a second evidence: Italian family firms fall short of nonfamily managers. Indeed, there's no denying that family leaders who are skeptical about the inclusion of externals in positions of prominence as management and ownership are, *de facto*, more likely to result in lack of meritocracy in terms of leadership nominees and inability to trigger economic growth in the long run. The fact that best performing, Centenary and Élite (fast growing private firms) family firms demonstrate a greater openness towards nonfamily executives, is further proof of the beneficial influence of this strategy. Moreover, statistics agree that the tendency to open to nonfamily managers should increase as time goes by, due to its contribution in overcoming generational succession troubles and recovering from bad performance periods.

The operational front of the project starts with the **Second Chapter**. I spent few words investigating the nature of *family businesses* and enhancing the main peculiarities that arise from the family sphere's involvement, first and foremost the involvement of the family in the business affairs, concerning (with potentially different extent) two spheres of actions:

ownership and leadership. However, while the owner status does not require the presence of neither specific skills nor abilities and merely impact the individual in economic terms (to benefit from profits or to cover losses), be manager is another story that calls for experience, training and talent to be successfully performed. That's why I decided to use the Top Management Team as body of reference for discussing the fairness of seeking to hire externals in family-run organizations. In addition to that, it has been interesting to notice how different configurations of the Team may affect performance in different ways. With respect to this I introduced Upper Echelons Theory to explain how TMT's perception and interpretation of the corporate environment affect the strategic decisions taken that, in turn, influence performance results. The two main considerations I made in a UET perspective follow here: a) hiring nonfamily members allows the family to select the demographic traits that positively impact on firm performance, especially the experiential background and the academic training; b) hiring nonfamily members increases the heterogeneity of the management team by mixing family and nonfamily individuals, that positively impact on firm performance by triggering "constructive conflicts" among the members. This takes the reader into the second part of the Chapter, dedicated to presenting *the benefits* associated with the involvement of nonfamily executives in leadership roles. I traced them back to two macro-processes: *professionalization* and *diversification*. Professionalization in the management field is intended as a fundamental prerequisite to ensure a certified level of leadership and skills, and it is built through academic education and working experience. I show that the launch of a professionalization process in a family business becomes compulsory under specific conditions: when it lacks managerial skills and talent among the family members; when it needs a change in the organizational culture; when it needs to overcome succession troubles (as mentioned in the introduction); when it needs to access alternative sources of financing; when it wants to increase the heterogeneity of the leadership structure. The above observations link to the topic of Diversification, which in

the management field refers to the heterogeneity degree a TMT can assume under a functional or educational backgrounds' perspective. Indeed, Bengtsson et al. (2018) suggest that TMT diversity arises from two distinct characteristics of the team's individuals: surface-level attributes (age, gender, nationality) and deep level attributes (knowledge and experience). I assumed that the introduction of the "external managers" group within the TMT of a family firm can be read as an act of diversification, in the sense that it provides to the management team a configuration of deep-level and surface features other than those provided by the group "family managers". Such differences in knowledge, expertise, and perspectives provide greater availability of job-related technical knowledge and expertise within the TMT, and so may be useful in establishing higher quality, creativity and innovation. Moreover, the positive effects deriving from diversification culminates in the rise of "constructive conflicts", where the integration of diverse information and perspectives can stimulate a much more creative and dynamic strategic thinking.

Chapter 3 is dedicated to outline the Opportunities and Threats related to the inclusion of nonfamily managers in the family business environment. Starting with the positive side, I concluded that success for family firms is likely attributable to the recruitment of external leaders, firstly due to the guarantee of *professionalization* they provide, customizable on the base of the organization's needs, and secondly due to *degree of heterogeneity* they generate, stimulus for the creativity and the effectiveness of the management team. From the review of the most influential literature on the topic, it has been possible to notice that such benefits are triggered especially when: the founder is no longer active in the leadership role; family and nonfamily managers co-exist on top (since family members contribute with their "familiness" to build competitive advantage and value culture, while nonfamily members provide their competence to well-administration practice); equity capital and management team are simultaneously open to outsiders (in this case, performance enhance particularly in terms of

internationalization); when the inclusion takes place after the necessary capital (to properly reward them) has been risen. Basically, under these conditions external managers are likely to enhance family businesses' performance in terms of productivity, profitability, Tobin's Q, sales growth and survival, due to the contribution to the establishment of better managerial practice. Regarding instead the issues triggered by openness, I have identified two major groups: those attributable to Agency Theory, and those attributable to Socioemotional Wealth. By restricting my attention to Type I Agency Problems I focused on those conflicts of interest due to the tendency of the agents (managers) to pursue their own interests (and, what they deem appropriate) instead of the owner's interests. In this perspective, I observed that in family firms 1) Type I Agency Problems tend to *increase* as the owning structure is diluted and the share of nonfamily executives increases, mostly due to the clash between economic and non-economic interests; 2) Type I Agency Problems tend to *decrease* when mechanisms of control are implemented, and the family seeks for the preservation of business welfare on a long-term perspective. On the other hand, Socio Emotional Wealth (SEW) Model is based on the idea that family run companies are traditionally inspired by, and dedicated to, the preservation of their nonfinancial features next to economic profits, intended as the whole range of feelings solely attributable to the family, as the will of exercising authority, the enjoyment of family influence, the preservation of clan membership, the assignment of important positions and role to loyal family members, maintaining an intense family identity, the perpetuation of the dynasty and so on. Gains or losses occurred in SEW correspond to the pivotal framework inspiring family-controlled firms when making all the major strategic choices and setting policy goals. The threat I pointed out is that governance structures opened to nonfamily members may inhibit family control and discretionary power within the business therefore, as a direct consequence, the family's ability to maintain and pursue its SEW.

In the light of all these considerations, **Chapter 4** is dedicated to proposing the application of Value Based Management (VBM) practices in family firms, as a way to overcome the agency conflicts deriving from nonfamily executives' inclusion by encouraging the alignment of their interests with the family and by incorporating either economic and non-economic future perspectives. The innovative side of my approach leads back to the application field: indeed, VBM was born in the Nineties as a new tool to support investors in assessing listed companies and executives in evaluating shareholders value. The application to the family firms' field is quite uncharted and may be considered challenging at first sight, due to distinctive features in the value creation process (concerning corporate goals, resources, capabilities, organization structure, governance and decision making) and to the nature of the family business, mostly privately held. However, it has surprisingly proven to be the right path to follow in attempting to overcome VBM major weaknesses.

A general overview on the value measurement practice has stressed few key points, as the necessity to use a single metric, the impropriety of accounting and market measures, the management of value drivers, and the approach to economic-profits rather than to accounting-profits (with specific focus on DCF Method and its implementation). I reach the conclusion that VBM is based on three ingredients: the first is the creation of value for the owners; the second is the adoption of an informed, effective management style, based on valid measurement tools; the third is the extension of such management style to the whole organization. The most popular method within the VBM context is the Economic Value Added (EVA), to which I dedicated a brief deepening to get more into practical terms, however, it must be clear that there are many other models such as the Free Cash Flow, the Cash Flow Added and the Cash Flow Return on Investments. What I pointed out is that the best way to create effective tools for performance measurement is through the integration of financial and non-financial indicators, since the use of exclusively one or few metrics can be misleading and

the variables to consider are too many to be synthesized in one index. In this perspective, it is necessary to adopt non-monetary measures which focus on *value drivers*, the sources of corporate monetary outcomes.

Furthermore, a crucial topic has been that of understanding how to estimate the way and the extent by which each corporate unit contributes to shareholders' value enhancement. On my opinion, the best way to address this topic was by discussing the remuneration system of a company, since individual performance and remunerations are extremely linked to each other. On this side I concluded that the adoption of an effective remuneration system is compulsory to spread an ownership mentality among the workers and persuade them to behave and take decisions as they were the direct beneficiaries.

Despite the many advantages deriving from a management approach geared to value creation, there are also few criticisms to its effectiveness. At first, it's accused of ignoring the interest of the stakeholders other than the shareholders, and to be too financial-centric and simplistic in terms of application, in a way to be far from perceiving the real non-economic component of corporate value. Further critics concern the lack of comparison with the market competitors, crucial in providing investors with a better sense of company value; the lack of connection to organizational culture, which makes hard to implement long-term strategies plan for value enhancement; the lack of coordination among the levers for value, with too few references to integration and coordination tools.

However, for this paper's purpose, the hottest topic comes next: why should family firms adopt VBM? As a matter of fact, family firms may encounter some difficulties in applying VBM guidelines especially in the most common form of privately owned, small size companies, due to the impossibility to compute shareholders' value relying on market computations and comparisons. Nevertheless, it is crucial for them to comprehend the notion of VBM and to

apply its procedures since the enhancement of owning families' value is the only way to ensure business longevity and retain competitive advantage. In addition to that, a value-based management style might be considered an effective solution to mitigate interest disagreements between management and owning family, by bringing the nonfamily managers closer to the non-economic values of the business. VBM measures allows the maintenance of a goal-congruent perspective and preserve corporate decision-making quality from the potential harmfulness of the emotional sphere, involved in family businesses as well as the financial one.

Said that, I finally proposed an updated approach to value creation, family-customized, with the aim of determining a) which is the most effective procedure to apply VBM in practical terms, b) how to rearrange/enhance VBM practices to overcome as many methodological deficiencies as possible, and c) in which part of the value measurement process, diverging practices should be introduced when the subject is privately held. I concluded that value creation effectiveness is mostly a matter of how corporate practices are formulated and executed. At first, when attempting to align corporate unit practices on value creation practices, the potential of the organization to enable value creation is fully achieved when a balance across goals is reached. To find a balance means to hierarchically distribute priority among goals. The second step is about setting the corporate managerial style consistent with the chosen mix of goals. Finally, after that goals and style have been set, the matter concerns the practical alignment of the corporate unit practices by means of supporting practices. With this regard, the choice of which performance metrics to adopt in assessing the results is crucial.

Drawing conclusions on the work done, I advocate the utility of VBM as way to implement a managerial strategy oriented to value creation, where the notion of "value" brings together economic and non-economic features. Despite its original feature intended for publicly traded organizations, I suggest the application of VBM principles and practices in privately held family firms *a fortiori* under specific circumstances: when the business grows in terms of size

and sophistication, when it’s undergoing generational successions, and when nonfamily members are introduced in leadership positions.

LIST OF TABLES:

Table 1. Family Firms in the TOP 500 ranking of Italy, Germany and France. Source: AIDAF. 10

Table 2. Percentages of family firms with a Pure Family Leadership in Italy, Germany and France.. 12

Table 3. Presence of Pure Family Leadership and Non-family Majority Leadership: a comparison between the average of the overall AIDAF sample, and the Benchmark Cluster. 13

Table 4.In the Benchmark cluster, the amount of Non-family managers increases more sharply as generations go by.. 14

Table 5. The percentage of nonfamily managers involved in leadership positions is higher in Centenary family firms Cluster and in family firms part of the "Elité Programme" 15

Table 6. Performance data reveals a positive effect triggered by the openness to nonfamily managers during the 3° generation 16

Table 7. Nonfamily managers are more likely to trigger sharper recoveries from worse performance scenarios, compared to family managers.. 17

Table 8. The Three-circle model of the family business system. 21

Table 9. The Upper Echelons Theory by Hambrick and Mason 26

Table 10. The seven observable characteristics described by Hambrick and Mason 29

Table 11. Summary of the major observations by academics in the last decade, concerning nonfamily management in family firms. 65

Table 12. Possible configurations of family/nonfamily ownership and management within family firms, and the resulting presence or absence of Type 1 Agency Problems 69

Table 13. Evolution history of Value Based Management: complexity and need............................ 80

Table 14. Model of value creation in family firms.. 86

Table 15. Definition of Discounted Cash Flow. 94

Table 16. The Value Based Management process. 104

Table 17. The Economic Value Added formulation.. 107

Table 18. The process for the creation of superior Relative Total Shareholder Return 129

Table 19. Process to detect TSR's future target. 133

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