Operational Effectiveness and Strategic Positioning in Family Businesses[1]

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ABSTRACT

There is an emerging body of theoretical and empirical evidence that suggests that a growing number of family owned businesses (FOBs), especially those in the second generation, are displaying financial and strategic performance superiority over their non-FOB counterparts. Our goal in this paper is to investigate and identify the underlying causal system that triggers such a performance advantage. Based on certain empirical observations, we conjecture that the FOBs, by virtue of their value structure, management style, and the control strategies employed, mature into a business system that espouses greater operational effectiveness than their non-FOB counterparts.

INTRODUCTION

Several scholars have identified family businesses as a force for conservatism and backwardness, and associated family business dominance with the economic under-development and decline of nations (Landes, 1965; Rose, 1995; Lazonick, 1991). The separation of ownership and control is deemed beneficial since executives are hired on the basis of their managerial credentials rather than on their ability to finance the firm or family connections with shareholders. Furthermore, dispersed ownership allows the firms to meet the capital needs for expanding, and dominating key industries by virtue of their economies of scale; a handful of wealthy individuals in family owned businesses would not find it possible to provide the requisite financial support (Wolfson, 1984).

However, recent research suggests that a corporation with bifurcated ownership-control may also have certain disadvantages, frequently underestimated and overlooked in the relevant literature. Two disadvantages are particularly notable: resource-based and agency based.

In the managerially oriented businesses, there often tends to be an emphasis on free-wheeling growth and diversification, often driven by acquisitions, with an orientation towards creating greater opportunities for managerial work (Jensen & Meckling, 1976). The links of different business units with the core competencies of the firm in such businesses tend to weaken. The resource allocation and mobilization can become quite complex and inefficient in these businesses (Cassis, 1997). Consequently, non-family businesses may not be able to develop and

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sustain a strong resource-based operational excellence advantage.

Moreover, managers tend to seek control over strategic resources, such as patents, brands, supplier contracts, delivery channels, market infrastructure, and attractive market positions. However, the costs of constructing and protecting the strategic resources escalate in the globalizing market situations. The globalizing market situation tends to be 'hyper-competitive' (D'Aveni, 1994), i.e. the behaviors and strategies of one firm are closely monitored by the other firms, who are willing to bear heavy costs of replication or substitution of the strategic resources for realizing their strategic intent of a market leadership position. Consequently, the ability of the non-family businesses to deepen their operational excellence is jeopardized, as they are required to continually renew their strategic resources.

As compared to the managerially oriented firms, the family businesses are more strongly rooted in their communities, and in intimate, personalized relationships with various participants in the industry. These intimate relational resources are difficult to imitate and substitute, since they must be constructed through a sincere and genuine concern about the various participants, and a sense of belongingness to the community.

In addition, the family businesses are distinguished by a stronger overlap in the interests of those who have a financial stake in the firm, and those who are involved in the management and operations of the firm (Anderson, Mansi & Reeb, 2003). Consequently, the costs of monitoring and offering incentives to the agents are less salient in the family businesses (Cheffins, 2001).

Thus, both non-family and family businesses may be expected to compete on a different basis. In this paper, we first briefly review the documented performance of the family businesses in the literature, and develop a typology of strategic advantage in terms of strategic positioning and operational effectiveness. We identify the sources of operational effectiveness in family firms, and explore inter-firm differentials.

Family Business Performance – A Brief Review

A significant amount of research over the recent years has deepened our understanding of the family business firms. On the positive side, research suggests that family firms tend to be more future-oriented rather than driven by quarterly results; and they tend to prefer organic growth based on internal resources as opposed to acquisitions driven growth based on debt (Gallo, 1994). Empirical studies suggest that family firms outperform non-family firms on a number of dimensions, including financial effectiveness (Anderson & Reeb, 2003); operational effectiveness (productivity - Kirchoff & Kirchoff, 1987 & customer service - Lyman, 1991); and social capital (concern for employees and communities - Astrachan & Kolenko, 1994). Using the Business Week "CEO 1000", McConaughy (1994) reported family firms to be operationally more efficient, more valuable, having higher stock returns, using less debt and paying out fewer dividends than their non-family counterparts.

On the negative side, evidence suggests family firms put a low priority on growth goals (Tagiuri & Davis, 1992), avoid aggressive growth strategies (Daily & Dollinger, 1992), and have lower growth rates than start-ups or buyouts (Dunkelburg, & Cooper, 1982). The diminished emphasis on growth in family businesses seem to accentuate with the succession, as neglect of succession planning adds up to limit strategic regeneration by successors. In a study of 837 profitable family firms, Blotnick (1984) found that less than 20 percent of the heirs could maintain a positive inflation-adjusted growth rate. While, on average, founder firms tend to grow more rapidly, the firms controlled by second and later generations are operationally more efficient (McConaughy, 1994). Impediments to growth in family firms include limited financial resources (on account of a reluctance to share ownership and a desire to grow via internally generated funds), limited marketing resources (reflected in their lower market share and less participation in global markets), limited governance resources (limited professional managers and goal conflict between active and non-active family members), and focus on structurally unattractive industries (with low capital intensity and high barriers to entry) [Gallo, 1995].

A Typology of Strategic Advantage

Consistent with the pros and cons of the family businesses, we may identify two types of strategic advantage: operational effectiveness and strategic positioning. Porter (1996) lays out the distinction between these two types as follows :

"Managers must clearly distinguish operational effectiveness from [strategic positioning]. Both are essential, but the two agenda are different. The operational agenda involves continual improvement where there are no trade-offs. Failure to do this creates vulnerability even for companies with a good strategy. The operational agenda is the proper place for constant change, flexibility, and relentless efforts to achieve best practice. In contrast, the strategic agenda is the right place for defining a unique position, making clear trade-offs, and tightening fit."

Below, we elaborate on these two types of strategic advantage by drawing upon the operations management and strategic management literatures.

Operational Effectiveness :

Operational effectiveness is built on efficient supply management and responsive demand management competencies.

Efficient supply management competencies contribute to low logistic costs, distribution coverage and availability, dependability, standardization of operations, time definite deliveries, and delivery speed. The efficient supply management competencies may be enhanced through the adoption of appropriate operations techniques that promote time-based capabilities, such as :

a) Just-in-time (JIT) logistics, which emphasize time-definite deliveries, i.e. the deliveries with known lead times and low variability.

b) Lean sigma, which emphasizes reduction of all types of waste, error, unnecessary assets, and cycle times by continuously seeking perfection and operational efficiencies throughout the supply chain network.

Responsive demand management competencies contribute to customer closeness, value added customer services, customization and innovative solutions, and proactive quality and communications. These may also be enhanced through the adoption of appropriate operations techniques, in particular the principles of mass customization and agility :

a) Mass customization tailors supply chain capabilities and value added services to specific customer needs, through postponement until the point of demand.

b) Agility is the ability to market successfully low-cost, high quality products with short lead times in varying volumes that provide enhanced value to customers through customization (Vokurka & Fleidner, 1998). The essence of agility is a heightened capability on four major operational criteria – efficiency, quality, dependability, and flexibility. Ferdows & Meyer (1990) suggest that among the high performing firms, the improvements move from quality, to dependability, followed by flexibility and cost efficiency.

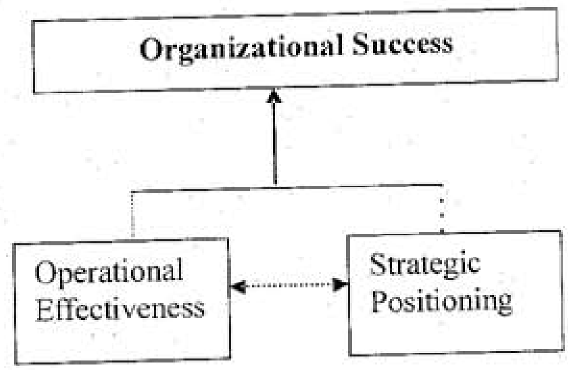
A combination of efficient supply management and responsive demand management enables the firms to attain an attractive cost position, along with differentiation. On the one hand, the efficient supply management competencies support an attractive cost position through total cost reduction, efficient and reliable supply, and high levels of basic service. On the other hand, the responsive demand management competencies support credible differentiation through high levels of value added customer service, proactive quality and collaborative communications and interactions with the customers (Morash and Lynch, 2002).

Strategic Positioning

The word "Strategy" has its origins in the Greek term strategos. Strategos means to "plan the destruction of one's enemies through the effective use of resources". Strategic positioning is externally focused, and is oriented towards gaining a strategic advantage given the level of a firm's operational effectiveness. Strategic advantage is achieved through the resource and capability mobility barriers that create walls among different strategic groups of firms, and to strengthen these walls to sustain their above-average returns and investments into growth (Porter, 1985). The firms seek to develop absorptive capacity for capturing new opportunities, by making pre-emptive investments and inducing others not to make additional investments. The concept of strategic position rests on the assumption that the firms have superior resources and capabilities that they may use to create and defend favorable positions.

Operational Effectiveness and Strategic Positioning

Most firms tend to see operational effectiveness and strategic positioning as substitutes. Many neglect operational effectiveness for the pursuit of more fashionable strategic positioning. Others believe that operational effectiveness would allow them to compete without any concern for strategic positioning. However, organizational success is a function of both operational effectiveness and strategic positioning :



Operational Effectiveness Hypothesis

Harnessing and sustaining family values, resources, and heritage (as opposed to exploring new, untried ways of adding values) is critical to the success of the family firms. The principals of the family businesses are risk-averse and have a strategic intent bias towards controlled growth. Consequently, the behavior of the agents also differs. In non-family firms, the agent is contractually bound to pursue new growth options, and is compensated more for successful pursuit of such growth options. In contrast, the agent in the family firms is under obligation to preserve the family business, and derives more intrinsic compensation as well as employment stability for successful pursuit of operational effectiveness advantage for better servicing the existing core of customers, and the referrals of these customers based on the word of mouth.

We propose :

Hypothesis 1(a) : The strategic advantage of the family firms stems from their superior operational effectiveness, as opposed to discovering opportunities for new growth avenues.

However, recent studies suggest that the benefits of family business diminish when the founding family retains a large share of the business ownership. Using a sample of S&P 500 firms in the US, Anderson and Reeb (2003) found that Tobin's Q – an indicator of intangible resources of the firm – is higher for family than for non-family businesses. However, at high levels of founding family ownership, the performance measures deteriorate. In a related study, Anderson, Mansi & Reeb (2003) reported that firms with family ownership levels of less than 12% enjoy about a 43 basis point reduction in the cost of debt financing, while firms with greater than 12% ownership have about a 22 basis point reduction in the cost of debt, relative to non-family firms. Therefore, we predict:

Hypothesis 1(b) : The family firms with moderate levels of founding family ownership control enjoy a greater operational effectiveness advantage than those with higher levels of founding family ownership control.

Sources of Operational Effectiveness

The organizational theory suggests that mutually reinforcing culture and market structure would facilitate superior operational effectiveness.

<u>Agency Theory and Family Business Culture</u>

The family business enjoys a committed ownership that is very involved in the business (Cheffins, 2001). The agent-employees are selected and delegated authority on the basis of trust and loyalty to the family interests, and are seen as members of one big family. Consequently, the family business can take a long-term view; it enjoys a more patient family capital that promotes educated risks. When non-family businesses develop a culture of future orientation, such future orientation tends to be characterized by a strong focus on the individual careers, and performance-based rewards. Thus, loyalty to the group in the non-family business tends to have a contractual undertone. In contrast, such loyalty tends to have a visionary undertone in family businesses. Based on the distinguishing cultural attributes of the family businesses, *we predict* :

Hypothesis 2 : Greater future orientation and greater group orientation enable the family businesses to develop a strategic advantage based on operational effectiveness.

<u>Social Capital Theory and Family Business Market</u>

Hanifan (1920) defined social capital as "those intangible assets [that] count for most in the daily lives of people: namely goodwill, fellowship, sympathy, and social intercourse among the individuals and families who make up a social unit". For social capital, both vertical as well as horizontal associations are important. While intra-community horizontal ties give families and communities a sense of identity and purpose (Astone et al, 1999), the vertically coordinated inter-community ties cross various social divides based on religion, class, ethnicity, gender and socioeconomic status. The horizontal ties are referred to as 'bonding' social capital, and the vertical ties are referred to as 'bridging' social capital (Gittell and Vidal, 1998).

The family businesses tend to rely more on the intra-community horizontal ties, while the professionally managed firms are better able to tap the inter-community vertical linkages. Barr (1998) reported that local and typically family-run African firms in traditional industries tend to form solidarity networks to exchange personal information about members' conduct and intentions. The members of the local community clusters tend to be dependent on the bridging agents (Burt, 1997) for securing access to the information, knowledge, and resources lying outside the cluster boundaries. As such, the market for the family businesses tends to be structurally unattractive, with low bargaining power relative to the bridging agents.

On the other hand, the personalized relationships with various market participants – vendors, customers, and competitors – allow the family businesses to gain deep knowledge about their local market. Consequently, in these structurally unattractive local market structures, family businesses can productively build an operational effectiveness advantage. The non-family businesses, on the other hand, are more likely to pursue structurally attractive markets, where the firm-specific capabilities may become a basis for distinctive competencies and where firm-specific positions may be leveraged for extracting a disproportionate share of value-added in the market exchange process. Therefore we predict that :

Hypothesis 3 : The family businesses that rely on community linkages and unattractive industry positions are more likely to have a strategic advantage based on operational effectiveness, than those who rely on market linkages and attractive industry positions.

Variations in Operational Effectiveness

The levels of operational effectiveness may not be similar across different family businesses. To understand these inter-firm differentials, we draw from the family business system theory. According to the family systems theory, the family businesses comprise of two major systems: family system and business system (Poza, Hanlon & Kishida, 2004). In theory, there is a fundamental gap between the family dimension and the business dimension. Businesses, when they are customer-oriented, are always changing, always adapting to the customer-induced changes in competitive dynamics. Families, by their very nature, are about stability, reliability, consistency, enduring values, traditions, love and caring, that support individual development and family harmony. The family business leaders carry significant amount of experiential knowledge, relationships, passion and innovative spirit. The performance of next generation is critically influenced by the effectiveness with which these intangibles are transferred across generations. Not all family businesses, however, are focused equally on the operational effectiveness. Based on their strategic intent, three types of family businesses may be identified :

Family-driven : These family businesses prefer to employ mainly family members or family-like members, especially in managerial or senior management positions. Family members maintain a high level of secrecy about the business, and use the business as part of their lifestyle. There is an explicit commitment to the continuity of the family business, characterized by multiple forms of family involvement (Astrachan, Klein, & Smyrnios, 2002). The thrust is on using the idiosyncratic family knowledge for operational advantage; however, family concerns and weak boundary regulation may inhibit the effectiveness of such advantage.

Business-driven : These family businesses prefer to employ personnel, based on qualifications; they review the performance of the employees and compensate both family and non-family members using similar criteria. There is no specific commitment to inter-generational continuity of the family business; the continuity option is evaluated on the basis of the ability and willingness of the next generation to develop and grow business. As such, operational effectiveness from idiosyncratic family knowledge is likely to be least developed.

Family and business driven: These family businesses prefer to employ family members; however these family members are evaluated using criteria similar to those used for the non-family members. Further, the family members are often encouraged to work outside the family business to gain alternative experience and to test their commitment to the family business. Finally, the role of different family members in the business varies, with some involved actively as employees, and others playing a more passive role as responsible shareholders. The underlying vision is that the integration of family and business imperatives would cultivate (a) a healthy family, (b) a healthy business, and (c) cross-generational continuity. These firms are most likely to integrate the family-based operational advantage with the business case to achieve high levels of operational effectiveness.

Based on the above typology of family businesses, *we predict that*

Hypothesis 4 : The operational effectiveness is likely to be moderately developed in the family-driven firms, most developed in the family-and-business driven firms, and least developed in the business-driven firms.

Learning from the Variations in Operational Effectiveness

Inter-firm differentials in operational effectiveness offer an opportunity for learning. More professionally managed firms, in particular, tend to be quite concerned with the opportunities for improving their operational effectiveness, so that they may defend and sustain their structurally attractive market positions and their core competencies. Therefore, we predict :

Hypothesis 5 : A family business making a more sophisticated use of formal operations management methodologies would have a higher operational effectiveness than one making a less sophisticated use.

Conclusions

In this paper, we build upon the empirical research related to the performance of the family vs. non-family firms. We drew upon the literature of strategic advantage, which identifies two major sources of firm-specific advantage – operational effectiveness and strategic positioning. We proposed that the strategic advantage of the family firms is rooted in their operational effectiveness. This operational effectiveness derives from their more future and group-oriented culture, and from their reliance on community linkages and occupation of structurally unattractive market positions. We suggested that family system oriented firms enjoy moderate levels of operational effectiveness, the family and business system oriented firms enjoy highest levels of operational effectiveness, and business system oriented firms enjoy least levels of operational effectiveness.

Our analysis highlights a need to empirically validate and account for the greater operational effectiveness of the family-oriented firms compared to the business-oriented firms, and for the greater operational effectiveness of the successor-controlled family firms compared to the founder-controlled family firms. Such a research should investigate the following issues :

- Do family-oriented firms in general and successor-controlled family firms in particular, indeed enjoy a superior operational effectiveness?
- Do the family businesses indeed operate under distinctive sets of cultural factors (future orientation and group orientation) and structural context (unattractive industry and relationship-intensity)?
- Does the use of formal operations management methodologies balance the inter-firm differentials in operational effectiveness amongst family businesses?

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