# Generational Differences of Family Businesses in MENA Countries: Impact on Indebtedness

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**Abstract:** The purpose of this paper is to examine the differences and/or similarities in the determinants of capital structure between first-generation family businesses and their counterparts of second- generation and beyond. A quantitative analysis was conducted using panel data (2011- 2019) from two sub-samples (103 first-generation family businesses and 82 family businesses of second-generation and beyond). Regression tests were conducted on the debt ratio for both categories of firms, using some independent variables (previous debt ratio, ROA, ROE, business risk, growth, liquidity, cash flows, tangibility, firm size, and firm age). Broadly, findings support the theory of pecking order and reveal significant differences in the level of indebtedness and its determinants between the two categories of firms.

**Keywords:** Debt, Family firm, Generation, Panel data, Succession.

## INTRODUCTION

Research on family businesses is now an established field of management research (Samara, 2020). The legitimacy of this field of research has been reinforced by the prevalence of the family business in the world. In the Middle East and North Africa (MENA), family firms play a main role in the economy and account for nearly 80% of the productive structure (Moussa & Elgiziry, 2019; Abouzaid, 2014). Most of the region's businesses are family-owned. The results of a systematic review conducted by Cardella et al (2020) on the role of the family in economic and entrepreneurial development showed that family businesses contribute to economic and social development. In the MENA region, they promote growth by creating nearly 70 percent of jobs and generating about 80 percent of the region's gross domestic product (GDP) outside the oil sector (Abouzaid, 2014).

Since the 1970s, one of the most frequently analyzed topics is succession (San Martín Reyna & Durán Encalada, 2016). It is considered an inevitable and complex phase for family businesses (Duh, 2014) because it occurs over time, engages the family and the business in a long-term perspective (Yu et al., 2012), conditions its durability (Le Breton-Miller et al, 2004), affects the security and stability of future generations (Trevinyo-Rodríguez, 2010) and generates changes in terms of strategic management and financial decision-making (San Martín Reyna & Durán Encalada, 2016).

The aim of the paper is to identify how succession can impact the financing decisions of family firms in the MENA region. It is about the determinants of the capital structure in family firms, through a comparative analysis between family firms of first-generation and family firms of second-generation and beyond. Accordingly, this paper provides two main contributions. On the theoretical level, this study contributes to the growing literature on family firms by shedding light on a key financial policy, which is widely considered to be one of the main decisions in management and corporate finance (Poutziouris, 2001; Romano et al., 2001; King & Santor, 2008). While most studies compare the capital structure of family firms with that of non-family firms, the present study highlights the heterogeneity of family firms and raises their generational differences.

On the empirical level, this paper contributes to the literature on developing and, above all, little-explored fields of investigation. Given that the cultural and geographical context is crucial in determining the sustainability of a family firm and its transmission from one generation to another (Stamm & Lubinski, 2011), it is of paramount interest to focus the study on the capital structure of family firms of different generations operating in the MENA region, a geographical area where less than a third of family firms go beyond the first generation and about 12% of family firms survive to the third generation (PwC, 2019).

In order to meet our research objective, the remainder of the paper is structured as follows: the second section reviews the literature on succession and its impact on the capital structure of family firms and formulates hypotheses. The third section justifies methodology. The fourth section presents the results, while the fifth section discusses them, and finally, the last section concludes the paper, lists its limitations, and suggests new horizons for future research.

## LITERATURE REVIEW

The heterogeneity of family businesses raised many questions about the criteria for a clear and consensual definition

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of this category of business. Scholars generally agree on two criteria. These are the family's involvement in the firm and the intention of family members to preserve ownership and control (Schulze et al., 2002). For their part, Chua et al. (1999, p.25) define family firms as "organizations that are governed and/or managed to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families". Thus, the intergenerational succession of the family business is a criterion for its definition and an inevitable process for its sustainability. While this process is inevitable, it is delicate because of the changes it leads to, particularly in terms of capital structure across the generations. These changes make the determinants of capital structure in first-generation family businesses different from those in the second- generation and beyond.

1. Succession: An Inevitable Process that Determines the Longevity of the Family Business

Priorities for family businesses include the desire for family control and influence, preservation of social ties, emotional attachment, and succession (Berrone et al., 2012). Thus, the transmissionof the business from one generation to another is among the distinctive features that differentiate a family business from a non-family business (Zellweger et al., 2012; Chua et al., 1999).

Succession in family firms differs from succession in non-family firms in several respects. In particular, the interdependence between the family and the business lifecycle means that the pressure increases when the transition in the family coincides with the transition in the business (Kepner, 1983). Succession in family businesses is then a challenge to overcome since it involves family, management, and ownership (Long and Chriman, 2014).

The succession process leads to several changes in the family firm, including the realignment of family relationships, the redesign of traditional models, and new management and ownership structures (Lansberg, 1988). In the same vein, family relationships move along the dynastic chain from a concentration of management and ownership in the hands of the founder to the fraternal consortium and later to the cousin consortium. This change in family relationships can influence strategic management in family businesses (Sharma et al., 1997). In addition, intergenerational succession and the transfer of the family business from one generation to another can affect the business not only in terms of ownership and management but also in terms of financial decision- making.

2. The Capital Structure of Family Businesses: Generational Differences

The capital structure relates to the combination of sources of funding for the business. It is one ofthe key decisions affecting the value of the company (Nurlela et al., 2019). Understanding financing choices is of great concern for family businesses because of the "peculiar financial logic" that characterizes them (Michiels & Molly, 2017).

Focusing on capital structure, the literature emphasizes that it is linked to the life cycle of the firm (Darmawan, 2020). Empirically, some studies conclude a positive effect of succession on the level of debt. Others corroborate a negative association between succession and debt (San Martín Reyna & Durán Encalada, 2016).

According to the pecking order theory (Myers & Majluf, 1984), first-generation family firms enjoy stability and depend largely on internal funds to finance their projects. However, as the family business grows and passes from one generation to the next, the new generation introduces new strategies. As new strategies require increased financial resources, the need for funding also increases (Ward, 1997). This leads to the use of external sources of funding, mainly debt (Frelinghaus et al., 2005).

From the free cash flow theory's perspective (Shleifer & Vishny, 1986), members of the family businesses of second-generation and beyond, who become less involved in the firm, may opt for higher levels of debt since debt can serve as a governance mechanism to mitigate agency costs and management entrenchment (Gallo & Vilaseca, 1996).

**H1:** First-generation family firms are less indebted than family firms of second-generation and beyond.

3. Determinants of Capital Structure in Family Businesses of Different Generations

Over the last decades, scholars have been interested in the capital structure as one of the core strategic decisions. Paradoxically, the literature on the determinants of the capital structure of family firms is inconclusive and the question of how family firms finance their activity remains, to date, unexplained (Quiddi & Habba, 2021).

The heterogeneity of family firms appeals to the study of capital structure determinants by taking into consideration distinctive characteristics, such as the generation and life cycle of the firm. In fact, the literature argued the existence of differences between first-generation family firms and those of subsequent generations, and this may be due to differences in management behavior (Gersick et al., 1997, Gorriz & Fumas, 2011). The differences may be manifested in the financial decision-making process, particularly in terms of defining profit reinvestment rates or the dividend payout ratio. This can eventually impact the structure of capital (San Martín Reyna & Durán Encalada, 2016).

**H2:** The determinants of the indebtedness of first-generation family businesses are different from the determinants of the indebtedness of family businesses of the second generation and beyond.

## MATERIALS AND METHODOLOGY

This section justifies the methodological choices of the empirical study, whether for sampling and data collection, variable definition and model specification, or data analysis.

1. Sampling and Data Collection

Our study plans to investigate the differences in capital structure between family firms of first- generation and those of second-generation and beyond in the MENA region. Panel financial data extracted from financial statements and annual reports for the period (2011- 2019) is used. However, due to missing data, the panel is unbalanced and the number of observations for each firm differs.

**Table 1. Variables Definition.**

| Variable | Code | Formula | Empiricalrationale |
|---|---|---|---|
| Debt ratio | DR | Total debt / total assets | Rajan & Zingales(1995) |
| Leverage | LEV | Total debt / Equity | Cortez & Susanto(2012) ; Gottardo & Moisello (2015) |
| Previous debtratio | $DR_{t-1}$ | Debt ratio of the previous year | López-Gracia, &Sánchez-andújar (2007) |
| Return onassets | ROA | Operating income beforedepreciation/total assets | Rajan & Zingales(1995); Allouche et al. (2007) |
| Return on equity | ROE | Net income to shareholders' equity | Stickney etal., (2007) |
| Business Risk | RISK | σ EBIT / Sales | Oktavina et al. (2018) |
| Growth Opportunities | GROW | Tobin's Q | Amah, Ken-Nwachukwu, 2016 |
| Liquidity Ratio | LIQ | Current assets / current liabilities | Deesomsak et al.(2004) ; Manos et al. (2007) |
| Cash flows | CASH | Cash flows from operations | Charitou, & Vafeas (1998) |
| Solvency Ratio | SOL | (Net income + depreciations) / Total Assets | Berrada et al. (2021) |
| TangibilityRatio | TAN | Tangible fixed assets / Total assets | Jong et al (2008); Antoniou et al. (2008) |
| Firm Size | SIZE | Natural logarithm of total assets | Ramalho, et al. (2018) |
| Firm Age | AGE | Natural logarithm of the number of years | Schmid (2013). |

By definition, our sample includes firms operating in the MENA region, active during the study period, and excludes financial firms because of their specific regulations. In addition, the sample includes both firms that incur debt and those that do not. The exclusion of the latter can lead to selection bias.

In order to distinguish family firms, we consider a firm to be family owned if the members of one or more families hold more than 50% of shares and are actively involved in management. These criteria have been defined by (Poulain-Rehm, 2006) and have been widely adopted in empirical studies. In addition, a first-generation family business is one that has not exceeded 25 years since its creation (Gottardo & Moisello, 2015). Governance data were mobilized to cross-check information and verify the generation of the family business by referring to the name of the founder, the chief executive officer (CEO), and family ties between the CEO and the founder.

Applying the inclusion and exclusion criteria, the sample set is about 185 firms (103 family businesses of first-generation and 82 family businesses of second-generation and beyond).

2. Variables Definition and Model Specification

The selection of variables (dependent and independent) is mainly guided by the results of previous empirical studies on the determinants of capital structure in family firms, but also by the availability and relevance of data. Table **1** provides an overview of the variables selected for this study.

All things considered, the model can be designed as follows:

$$DR_{it} = \beta_0 + \beta_1 DR_{it-1} + \beta_2 ROA_{it} + \beta_3 ROE_{it} + \beta_4 RISK_{it} + \beta_5 LIQ_{it} + \beta_6 CASH_{it} + \beta_9 SOL_{it} + \beta_{10} TAN_{it} + \beta_{11} SIZE_{it} + \beta_{12} AGE_{it} + \varepsilon_{it}$$

Where :

$\beta 0$ = intercept of the regression line which is constant ;$\beta 1$ to $\beta 12$ = coefficient of independent variables ;

$\varepsilon it$= error term for company i at time t.

3. Data Analysis

Data analysis consists of three basic steps. A first descriptive step aims to compare the means of two measures of indebtedness (debt ratio and leverage) for the two categories of businesses (family businesses of first-generation and family businesses of second-generation and beyond). In a second phase, inter-group comparison tests are conducted to test the statistical significance of differences or similarities between the two sub-samples. Finally, regression tests on panel data are applied to identify the determinants of debt ratio in family businesses of differentgenerations.

## RESULTS

Findings generated by STATA are summarized and discussed using commonly used econometric and statistical techniques.

1. Descriptive Statistics

Table **2** presents summary statistics of the two measures of indebtedness for each sub-sample. The statistics contain the mean, standard deviation, minimum, and maximum.

With reference to the table below, we can visualize the gaps between family businesses of first- generation and family businesses of second-generation and beyond about the two measures studied over the period (2011-2019). The means of debt ratio show that family businesses of first-generation are less indebted (0.39 versus 0.45). It is important to note that, overall, family businesses in the sample rely heavily on equity financing since both debt ratios are below 1.

**Table 2. Descriptive Statistics (Debt Ratio (DR) and Leverage (LEV)).**

| | Sub-Sample | N | Obs | Mean | St.dev | Min | Max |
|---|---|---|---|---|---|---|---|
| | FF 1st generation | 103 | 936 | 0.3966784 | 0.2745594 | 0.0030129 | 2.785381 |
| DR | FF 2nd generation and beyond | 82 | 765 | 0.4561493 | 0.2247364 | 0.0129096 | 1.361589 |
| | FF 1st generation | 103 | 936 | 0.8726036 | 3.884171 | -91.26178 | 48.35395 |
| LEV | FF 2nd generation and beyond | 82 | 765 | 1.429281 | 3.312724 | -25.24208 | 47.723 |

**Table 3. Medians Comparison Test.**

| Mann Whitney U- Test | | | | |
|---|---|---|---|---|
| H0: the medians between the two samples are equal | | | | |
| | Medians | | Sig | Decision |
| Variable | Family Businesses (First generation) | Family businesses (Second generation and beyond) | | |
| Debt Ratio | 0.389 | 0.4549 | 0.0000 | Reject H0 |
| Leverage | 0.6157 | 0.8178 | 0.0000 | Reject H0 |

Similarly, leverage shows divergent levels for the two sub-samples. The mean is 0.87 for family businesses of first-generation and 1.42 for family businesses of second-generation and beyond.

In sum, the descriptive statistics show differences between family businesses of first- generation and family businesses of second-generation and beyond. We still have to test the significance of these differences through non-parametric tests.

2. 2. Comparison of Medians

As widely used in studies of family businesses (Westhead et al., 2001), this study used non- parametric tests to statistically identify significant differences between the two sub-samples. Non-parametric tests are more appropriate for this study because of the sample size and the nature of the distribution of observations. The results of the Mann Whitney U Test are summarized in Table **3**.

Findings show that for both measures tested, the p-value is less than 5%. This allows to reject thenull hypothesis and to conclude differences in distributions among the two groups (family businesses of first-generation and family businesses of second-generation and beyond) over the period (2011-2019).

In the MENA region, the capital structure of first-generation family firms seems to be different from that of second-generation and beyond. significant differences exist between the two sub- samples concerning both the debt ratio and leverage.

3. Multivariate Analysis: Regression on Panel Data

The aim is to verify whether the capital structure and especially the indebtedness is explained in the same way, by the same factors in first-generation family firms and family firms of second- generation and beyond, by introducing the temporal and individual dynamics of the variables (panel data).

To ensure that the regression assumptions are not violated, the correlation matrix and the variance inflation factor (VIF) were checked before proceeding with the analysis. However, multicollinearity problems were found for the solvency ratio (SOL) for both sub-samples. Therefore, this variable was omitted and removed from the regression model. The regression results are summarized in Table **4**.

The F-statistics show that the model specification is highly significant for both sub-samples (p- value = 0.0000). However, further analysis is needed to test the individual effects of the observations. To this end, the Hausman test (Hausman 1978) was conducted to choose between the fixed effects model and the random-effects one. For both sub-samples, the fixed- effects model is more appropriate. Model estimation for first-generation family businesses shows an R squared of 41.2%, while in the case of family businesses of second-generation and beyond, it is about 42.83%.

Three similarities can be identified between the two groups. First, the past debt ratio ($DR_{it-1}$) has a significant and positive impact on debt ratio of first-generation family businesses and that of family businesses of second-generation and beyond (The coefficients are 0.188 and 0.215 respectively). Liquidity ratio (LIQ) has a significant and negative impact on the debt ratio of first-generation family firms (-0.00275) and also on the debt ratio of family firms of subsequent generations (-0.00897). Similarly, firm size (SIZE) has a significant and positive effect on the debt ratio of both categories (0.295 and 0.240 respectively).

As for the differences between the two groups, profitability (ROA), business risk (RISK) and tangibility ratio (TAN) are determining factors only in the case of first-generation family firms, while return on equity (ROE) remains a determining factor only in the case of family firms of second-generation and beyond.

**Table 4. Regression Tests Results (*** Significant at 1%, t-Statistics are between Parentheses).**

| Debt Ratio | | |
|---|---|---|
| | **FB (1st generation)** | **FB (2nd generation andbeyond)** |
| **$DR_{it-1}$** | 0.188*** | 0.215*** |
| | (9.54) | (10.32) |
| **ROA** | -0.00372*** | -0.00107 |
| | (-6.28) | (-2.37) |
| **ROE** | -0.000282 | -0.000809*** |
| | (-2.29) | (-11.99) |
| **RISK** | -0.00949*** | -0.00460 |
| | (-6.68) | (-1.65) |
| **GROW** | 0.000990 | -0.00260 |
| | (0.75) | (-0.47) |
| **LIQ** | -0.00275*** | -0.00897*** |
| | (-3.84) | (-5.33) |
| **CASH** | -5.78e-08 | -1.55e-08 |
| | (-1.78) | (-0.33) |
| **TAN** | 0.00170*** | -0.00109 |
| | (5.47) | (-3.08) |
| **SIZE** | 0.295*** | 0.240*** |
| | (11.06) | (8.42) |
| **AGE** | 0.0250 | 0.0117 |
| | (0.84) | (0.12) |
| **_cons** | -1.312*** | -0.911*** |
| | (-9.21) | (-4.36) |
| **Observations** | 829 | 727 |
| **R squared (Within)** | 0.4120 | 0.4283 |
| **Fisher test** | 0.0000 | 0.0000 |
| **Hausman Test** | 0.0000 | 0.0000 |

## DISCUSSION

Succession is undoubtedly one of the most crucial processes for the survival of a family business.The results of our study corroborate hypothesis H1 stating that, in the MENA region, first- generation family businesses incur less debt than do family businesses of second- generation and beyond. This finding is consistent with the pecking order theory (Myers & Majluf, 1984). First- generation family firms prefer to finance their investments first with retained earnings, then with external funding. In addition, the founder aims to transfer a healthy business to future generations and to preserve the family name and its reputation. Therefore, first-generation family firms may prefer slow growth rather than financing investments by debt that may cause financial distress (Miller & Le Breton-Miller, 2005).

The hypothesis H2 is partially supported. It should be noted that the determinants of the debt ratio in first-generation family businesses and those of next generations are largely different. Firstly, results related to the previous debt ratio state a positive association for both types of businesses. This means that the debt ratio of the previous year is taken into account in the debt decision for the following year. This result refers to the trade-off theory (Kraus & Lintzenberger

1973) and shows that family firms, regardless of their generation, adjust their debt level to a target ratio. Tax benefits allowed by debt would not compensate for the increased probability of financial distress and bankruptcy.

In terms of profitability, the results show that the higher the profitability of the family business (regardless of its generation), the lower the need for debt financing. This result is again consistent with the theory of pecking order and with several works on the indebtedness of family firms (Berrada et al., 2020; Agustini & Budiyanto, 2015; Booth et al., 2001; Rajan & Zingales, 1995). If profitability increases, the firm is considered capable of generating profits. Family firms often prefer to retain earnings so they can meet financing needs without using debt (Oktavina et al., 2018).

However, the indebtedness of the first-generation family business is determined by return on assets (ROA) while the indebtedness of family businesses of next generations is explained by return on equity (ROE). In concrete terms, the first-generation family business relies more on operating profitability and total assets (equity and debt) to decide about the level of its indebtedness. Whereas in the case of family businesses of second-generation and beyond, it is financial profitability (linked only to equity) that determines the indebtedness.

The negative association of business risk as a determinant of the capital structure shows that first-generation family firms are risk-averse and are concerned about the risk of bankruptcy or financial distress that indebtedness may cause. Volatile flows imply a higher level of risk, a high probability of bankruptcy, and consequently a lower use of debt, which explains the negative effect on the debt ratio (Cuong, 2012).

Regarding growth opportunities, it does not affect the debt ratio in the two sub-samples. This result coincides with the works of Harjito (2011) and Sansoethan & Suryono (2016). However, this neutral effect is not consistent with the trade-off theory (Kraus & Lintzenberger, 1973) that suggests that a high-growth firm will rely on external sources of financing such as debt.

Concerning the liquidity ratio, it is negatively related to the debt ratio only in the case of the first-generation family firm, which is in line with the pecking order theory. This result is also in line with the work of Oztekin & Flannery (2012) arguing that liquid assets could be used as a source of internal financing (extraction of liquidity) instead of incurring debt; this leads to a reduction in the debt ratio. In the same vein, Saarani & Shahadan (2013) argued that liquidity has a negative relationship with the debt ratio. They concluded that liquidity reflects the ability of firms to meet current liabilities. The most liquid firms are able to generate more cash flows for their operations and thus incur less debt.

As for the tangibility of assets, it has an explanatory power on the debt ratio of first- generation family businesses. The coefficient linked to this variable is positive suggesting that tangible assets can serve as collateral and thus protect the interests of creditors by alleviating the costs of adverse selection. Increased tangibility helps mitigate agency costs between first- generation family businesses and lending institutions (Degryse et al., 2010). As a result, the use of debt becomes more accessible (Michaelas et al., 1999). Conversely, the tangibility ratio is not a determinant of the indebtedness of family businesses of second-generation and beyond. One possible explanation is that future generation of the family business benefit from the family's accumulated reputation on the banking or financial market, that no longer requires collateral through tangible assets.

Finally, firm size has a positive effect on the debt ratio. Concretely, the more the family business grows, the higher is the level of indebtedness, regardless of its generation. This is in accordance with the life cycle theory (Ando and Modigliani, 1960). From the signaling theory perspective (Ross, 1977) too, large family firms can easily access financial markets thanks to their reputation (Diamond, 1989) and because they are more likely to choose safe investment projects (Frank and Goyal, 2009), which attracts creditors.

## CONCLUSION

The purpose of this paper was to analyze the effect of intergenerational succession on the capital structure of family firms in the MENA region. A comparative analysis between first- generation family firms and family firms of second-generation and beyond was conducted to compare their capital structure over the period (2011-2019). In summary, we deduced significant differences in levels and determinants of the debt ratio between the two categories of firms. Despite generational differences, the theoretical framework that is largely consistent with the results is the pecking order theory.

Typically, capital markets in developing countries, as is the case for the majority of MENA countries, have a limited range of financial instruments and a large number of constraints on financing decisions (Singh & Hamid, 1992, Tong & Green, 2005). In this respect, we note that the geographical context also plays a role in the choice of financing modalities and makes firms prefer internal financing to external financing, which affects the debt ratio.

In addition to the theoretical and empirical implications of this paper, it also provides an interesting research perspective as it reinforced the thesis of heterogeneity among family firms by distinguishing between different generations and by shedding light on a special field of investigation such as the MENA region, known for its peculiar culture, values, managerial practices, and financial markets.

Nevertheless, some limitations are noteworthy. We tested a limited number of variables due to data access constraints. Other measures can be incorporated into future research. In addition, our study neglected the industry effect. It might be interesting to focus this study on each sector separately over a long period and analyze the capital structure of family firms under different economic conditions.

## CONFLICT OF INTEREST

The authors reported no potential conflict of interest.

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