

Making Investment Decisions in a Chilean Family-Oriented Business: Who is Right the Parents or the Children?

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ABSTRACT

The relevance of traditional methods of project evaluation in the decision-making process for family-oriented businesses is not completely clear, as compared with the importance of other variables such as the project's coherence with the family's values and interests, amongst others. This article presents a case study related to a Chilean family business, in its attempt to determine the importance that family members attribute to different variables that should be considered when making investment decisions. The investigation considered three types of data: a) evaluation of the investment from a financial and strategic point of view, b) presentation of results to the member of family, and c) follow-up with respect to the decision made and interviews with all the family members. The results show that the parents feel that stability in the family investment policies and the impact of the investment on the roles that each family member plays in the business are the most relevant variables, whereas the children assign more value to aspects associated with business returns.

Keywords: Investment Decision, Family Business, Small Business

INTRODUCTION

The study of investment decisions has gained importance recently, due to the recognition of their irreversible nature, which implies a high degree of commitment (Ghemawat & Del Sol, 1998). Thus, distinct techniques and methods have been developed to support and facilitate this type of decision (Del Sol & Ghemawat, 1999).

Financial theory indicates that a company should carry out all investment projects that offer a Net Present Value (NPV) greater than zero or an internal rate of return (IRR) greater than the capital cost, as this will benefit the shareholders or company owners (Ross, Westerfield & Jaffe, 1997). These rules are widespread in finance texts and in our classrooms, along with others that are framed within the methodology of discounted cash flows (Brealey & Myers, 1991). Nonetheless, Del Sol & Ghemawat (1999) state that these methods do not explicitly consider competition and that they show other important limitations such as: (1) poor practices in their application, for example, a poor treatment of inflation, excessive adjustments of risk, inadequate criteria of returns, or the separation of complementary projects, amongst others (Hodder & Riggs, 1985); (2) the inability to quantify intangible assets or organizational capacities; and (3) the lack of evaluation of flexibility under uncertainty or not considering the value of the options. Moreover, the evaluation of the investment decision is normally seen as the creation of new businesses, although most studies are done for businesses that are already operating (Sapag, 2001).

According to Kaplan & Ruback (1995), some studies confirm the benefits of discounted cash flow techniques, which provide reliable estimates of the market value of an investment. In this sense, the study by McConnell & Muscarella (1985) found increased market values for most industrial companies when these announced planned investments. Likewise, Woolridge (1988) reported that stock values have a strong positive reaction to announcements such as increased investment in research and development, new product strategies, and investments in expansion and modernization.

Del Sol (1999) also indicated that projects with a long-term NPV > 0 are the exception, as already pointed out by Leftwich & Eckert (1987), who found that extraordinary utilities do not exist in the long term. Given this, the criteria of discounted cash flow techniques should be considered to be important tools that allow the evaluation of investment decisions, but that simple calculations in a discounted cash flow analysis can, at times, lead to the erroneous calculation of a positive NPV (Ross, Westerfield & Jaffe, 1997) and, therefore, the origin of such numbers should be investigated (Brealey & Myers, 1996).

It is agreed that managers have two general criteria available for evaluating strategic investment decisions in highly uncertain and competitive markets – cash flow techniques and competitive strategy schemes – and that, in practice, these methods are not integrated (Del Sol, 1999), but could and should be (Hax & Majluf, 1996; Porter, 1980, 1985). Given the generally irreversible nature of strategic investments, it is necessary to predict the uncertain future in many aspects such as the behavior of