2. Executive Summary:

This paper examines the significance of the role of the founder CEO, particularly in relation to the value and market performance of these firms who have recently transitioned from private companies to being listed on a public exchange. It examines if and how founder-CEOs create (or destroy) value in terms of both intrinsic and extrinsic characteristics the founder displays, the decision making behaviour because of these characteristics, and ultimately the affect these characteristics have on firm performance.

This paper finds that that founder-CEOs not only reduce the agency conflict between managers and shareholders, but also make better long term managerial decisions in relation to investment in research and development, capital expenditure and merger and acquisitions. The reasons for this are discussed within. This superior decision making behaviour is particularly pertinent in high growth, technology based businesses as it allows continued innovation and response to an ever changing environment.

Because of the alignment of long term incentive of founders and shareholders - not only through stock ownership but also reputation factors - founder CEOs firms in high technology environments outperform non-founder firms in relation to stock performance at IPO and over the long term. While this holds for small and young non-technology companies, there is no suggestion of outperformance when the sample is expanded to include all founder led businesses across all industries.

3. Introduction:

According to research, 11 percent of the largest public US firms are headed by a founder-CEO[1] - that is, the firm still have have their original owner and manager. As Shulman notes, "this founder has been endowed with vision and managerial acumen in so far as they have raised the firm from a start-up, taken it public, listed the stock on an exchange and grown it to be a large capitalisation, publicly traded corporation[2].

There is much academic understanding that founder leadership represents a unique regime of both ownership and corporate governance. At a high level, As noted by Gao and Jain, "the extent of agency conflicts, managerial incentives, risk taking behaviour and nature of relationship with the organisation are fundamentally different for founder CEOs relative to non-founder CEOs"[3]

It is clear founder CEOs often feel pressured to adjust their leadership characteristics to become more suitable for leading large public companies. As their business grows, leadership style and capabilities evolve from the simple goal of future viability to the management of significant and complex organisational systems. The transition from start-up, to fast scaling, successful business, to eventually a large public company exposes CEOs to a whole range of previously foreign tasks. These previously unknown tasks, largely derived from the transition of ownership and governance from private to public, may include market monitoring, and pressure to meet analysts expectations (as well as their own company guidances). Boeker and Wiltbank aptly point out these requirements of large public company CEOs (management skill, meeting investor needs, rational decision making) are significantly different from the skills new start-ups require from their CEOs

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[1] Fahlenbrach, R., 2009. Founder-CEOs, Investment Decisions, and Stock Market Performance. *Journal of Financial and Quantitative Analysis*, 44(2), pp.439–466.

[2] Shulman, J., 2010. Are Entrepreneur- Led Companies Better? Evidence from Publicly Traded U.S Companies: 1998 -2010, *Journal of Risk and Financial Management,* pp 118-138

[3] Gao & Jain, 2011. Founder CEO management and the long-run investment performance of IPO firms. *Journal of Banking and Finance*, 35(7), pp.1669–1682.

such as entrepreneurial passion and visionary risk taking.[4] There is no doubt if a founder CEO fails to adapt to the new ownership and governance environment by adopting the required skills, that they are replaced. As such, there is a real risk (or mitigation depending on your views), that founder CEOs start to think and behave like professional (non-founder) CEOs who make more rational, realistic and logical decisions.

And for those that don't conform to the pressures of becoming a public company CEO, and still posses the entrepreneurial flare and foundations that have taken them to where they are, how do they in fact perform ? Does this organisational difference translate into differences in behaviour, valuation and ultimately performance of founders against professional CEOs? Do founders have a greater appetite for risk than their professional counterparts? Research suggests there is both short term and long term variation in all these factors between founders and professional CEOs.

In the IPO setting, perhaps the most turbulent and significant moment of transition a company faces, how important is a founder in creating value? It is a time of enhanced scrutiny, financing and investment decisions from potential investors, regulators, analysts and the business press.[5] So transitional is this phase is not unusual that a founder CEO is replaced prior to the IPO. Generally corporate milestones, such as product development completion or capital raising, are key moments of CEO succession.[6] The choice of founder versus non-founder CEO at IPO can also be be viewed as a potentially informative signal of the likely strategic direction, growth strategy, investment and financial policy choices of the firm during the post-IPO period. Because of this, choice of backing or replacing a founder CEO at IPO is of vital importance to market participants such as investment bankers, venture capitalists, institutional/retail investors, and analysts[7], as well as other executives, suppliers and customers.

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[4] Boeker, W. and Wiltbank, R., 2005. New venture evolution and managerial capabilities. *Organization Science*, *16*(2), pp.123-133.

[5] Jain, B.A. and Kini, O., 2008. The Impact of Strategic Investment Choices on Post-Issue Operating Performance and Survival of US IPO Firms. *Journal of business finance & accounting*, *35*(3-4), pp.459-490.

[6] Jain & Tabak, 2008. Factors influencing the choice between founder versus non-founder CEOs for IPO firms. *Journal of Business Venturing*, 23(1), pp.21–45.

[7] Ibid

4. Summary of key impacts of the research:

4.1 What is a founder led business and what are their characteristics:

Before diving deeply in the key impacts of a founder on firm performance, it is imperative to understand the key attributes of founder led businesses. Amongst other things, Shulman observes founder led businesses have; a high ownership stake of the top 5 stockholders, high return on invested capital, high sustainable (organic) growth, little debt, low executive turnover and aligned executive compensation plans.[8]

Further to this, founder CEOs generally have a very concentrated skill set, often limited to the industry the company they have founded participates in and may indeed have no skill outside of their business itself - "Founder CEOs are also often characterised by a greater degree of firm specific skills relative to professional CEOs".[9]

4.2 How and why are these characteristics important in creating value in the public markets:

(1) **A reduction in agency costs:**

Agency costs primarily arise due to a misalignment of incentives between shareholders and management. As suggested by Jensen and Meckling in their seminal paper, agency costs are at their greatest in times of information asymmetry.[10] When managers have access to private information relevant to decision making, not only is there also a risk of adverse selection, but also the potential for a large moral hazard problem when managers go against shareholder's interest and act for their own benefit. Thus as Bertrand and Schoar suggest, agency theory implies that managers can exercise their discretion to influence decisions to

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[8] *Ibid.*

[9] Gounopoulos and Pham, 2018. Specialist CEOs and IPO Survival. *Journal of Corporate Finance,* pp217-243

[10] Jensen, M.C. and Meckling, W.H., 1976. Theory of the firm: Managerial behavior, agency costs and ownership structure. *Journal of financial economics*, *3*(4), pp.305-360.

achieve their own objectives.[11] As such, "manager's decisions will be detrimental to the firm if they are not aligned with shareholder's interests".[12]

(a) **High ownership concentration of stock between the founder CEO and key executives reduces agency costs:**

By having greater 'skin in the game', and aligning interests primarily through ownership, founders and key executives, will make decisions that are of long term benefit to shareholders. With more of their wealth tied to the performance of the business, there is a very strong incentive for the founder CEO to ensure the long term prospects of the business, and in doing so aligning their own interests with that of shareholders. The research supports this - the mean stock ownership of founder CEOs is 11.1%, while non founder CEOs have a mean ownership of just 2%. Of all founder CEOs, 13.6% hold more than 25% of the outstanding shares of the firm.[13]

(b) The research is deep and varied in relation to agency theory, but pertinent to this paper on founder led businesses and IPO;

- The risk of agency problems and their associated costs are at their highest in and around IPO markets primarily due to the very high information asymmetries between principal (the shareholders) and agent (management).[14] At the time of IPO, public information in relation to the company is very limited and generally financial information as outlined in a prospectus is the only source of information available to 'outsiders'.

- The superior firm and industry specific knowledge that a founder has, does in fact alleviate this information asymmetry, particularly when the firm is without venture capital

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[11] Bertrand, M. and Schoar, A., 2003. Managing with style: The effect of managers on firm policies. *The Quarterly Journal of Economics*, *118*(4), pp.1169-1208.

[12] Gounopoulos and Pham, *Ibid*

[13] Fahlenbrach, R., 2009. Founder-CEOs, Investment Decisions, and Stock Market Performance. *Journal of Financial and Quantitative Analysis*, 44(2), pp.439–466.

[14] Gounopoulos and Pham, *Ibid*

backing or high reputation underwriters. This reduction of asymmetrical information between firm and the financial markets is a key source of value creation for founder CEOs, and may reduce adverse selection and moral hazard discounts and in doing so "the founder CEO is particularly able to enhance an IPOs firm value".[15]

(c) Ownership is not the only reason for incentive alignment of principal and agent in founder-led businesses

Gounopoulos and Pham argue that because founder CEO are specialists, and their work is concentrated on particular industries and firms, that there is little job mobility or mobility potential amongst founder CEOs. Thus, their future prosperity is heavily tied to the firms performance and long term viability - poor firm performance reflects on their "employment histories and adversely affect their future employability".[16] Further to this, the long-lasting and on-going involvement in a specific industry equips the founder with considerable expertise, as well as deep understanding of the industry environment, and is therefore crucial to the viability of long term relationships with other stakeholders such as customers and suppliers.

Additionally, founders often consider the business as their life achievement, and with it the intrinsic motivation and long term thinking encourages them to "pursue optimal shareholder value maximising strategy instead of concentrating on short term actions".[17]

2/ Founders fundamentally make different investment behaviours and managerial decisions.

This is partly due to an alignment of incentives, but importantly, thanks to their equity stake, entrepreneurial spirit and often the fact the founder's name becomes synonymous with the

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[15] Johnson and Yi, 2013. How do Founder CEOs create value?, *Asia Pacific Journal of Financial Studies,* pp 777-812

[16] Gounopoulos and Pham, *Ibid*

[17] Fahlenbrach, R., 2009. Founder-CEOs, Investment Decisions, and Stock Market Performance. *Journal of Financial and Quantitative Analysis*, 44(2), pp.439–466.

business, the repetitional risk of failure does drives managerial decisions. Compounding these factors, “founder CEOs are likely to have more influence and decision making power”[18], allowing them to have a significant impact on value accretive long term strategies.

However these decision are not limited to the incentive alignment. Fahlenbrach finds[19] that after controlling for managerial ownership (and as such confirming a significance of founders aside from the alignment of incentives) amongst other things, founder CEOs;

- spend up to 22% more on research and development
- spend up to 38% more on capital expenditure than non founder firms
- make more focused merger and acquisitions.

<u>In relation to this last point:</u>

It has been discussed in significant literature that founders have higher risk bearing capacities than non founders.[20] Specifically in relation to M&A and given this different risk profile, founder CEO firms may therefore be less prone to making acquisitions that could be seen as diversifying away from core business and therefore potentially value destroying. The literature suggests founder CEO firms are “active in the acquisition market, but they buy targets that are operating in their industry of knowledge and that are smaller in size”,[21] suggesting they make considerably more non diversifying acquisitions than non founder CEOs. This too flows on from the research of May who shows that because of the specific nature of the entrepreneurs skill set, they tend to acquire firms well within their narrow skill set and understanding.[22]

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[18] ibid

[19] Ibid

[20] May, D. 1995. Do Managerial Motives Influence Firm Risk Reduction Strategies? *Journal of Finance* pp1291-1308

[21]Fahlenbrach, R., ibid

[22] May, D., Ibid

This finding counters a suggestion by Jenson some 15 years earlier that executives can in fact use strategic acquisitions not to create long term value, but rather to simply build an empire.[23] While this is anecdotally rejected based on the alignment of management and shareholder incentives under the founder-CEO model, Jensen notes that if they did choose to in fact choose this, they may succeed more often due to the powerful position they hold within the firm. Fahlenbrach's research rejects this hypothesis laid out by Jensen.

3/ Founder are more optimistic that professional CEOs

While the discussion so far has centred on mainly on attributes of founder CEOs that are value additive, there is one that may in fact be counter productive - overconfidence. Entrepreneur scholarship has delved deeply into this and long considered that entrepreneurs have higher dispositional optimism than non - entrepreneurs. This is clear and has numerous academic data points in small start-ups - Busenitz and Barney find that entrepreneurs show significantly greater confidence than professional managers.[24]

The reasons for gestation of over confidence bias are evident from the very nature of the job; from the moment their new venture launches, the odds of success are clearly against them - so few start ups succeed, and yet entrepreneurs, such is the nature of being one, expect their's to be the outlier. This is a culmination of the underestimation of the risk starting a new venture as well as an overestimation of their own abilities[25].

Lee, Hwang and Chen argue that the over confidence of founder CEOs even increases as their firm develop into large public companies.[26] By this stage they have beaten extreme odds, surviving immense external competition, and as Hayward and Hambrick point out,

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[23] Jensen, M.C., 1993. The modern industrial revolution, exit, and the failure of internal control systems. *the Journal of Finance*, *48*(3), pp.831-880.

[24]Busenitz, L.W. and Barney, J.B., 1997. Differences between entrepreneurs and managers in large organizations: Biases and heuristics in strategic decision-making. *Journal of business venturing*, *12*(1), pp.9-30.

[25] De Meza, D. and Southey, C., 1996. The borrower's curse: optimism, finance and entrepreneurship. *The Economic Journal*, pp. 375-386.

[26] Lee, J.M., Hwang, B.H. and Chen, H., 2017. Are founder CEOs more overconfident than professional CEOs? Evidence from S&P 1500 companies. *Strategic Management Journal*, *38*(3), pp.751-769.

founder CEOs are "likely to attribute much of that success to themselves"[27] In addition founder CEOs tend to receive more attention from the media, and favourable coverage of "an underdog who rose to the top", which also no doubts affects this overconfidence.[28]

The practical application of how the over-confidence of founders affects decisions is particularly pertinent in relation to this discussion. Lee, Hwang and Chen conclude compared to professional managers, founder CEOs;

- make faster (but less comprehensive) and more risky (but potentially more rewarding) decisions
- create unrealistic (but perhaps more motivating) goals for employees and stakeholders.
- frequently issue earnings warnings that are too high to actual earnings

Relatedly, Galasso and Simcoe find a positive association between proxies of overconfidence and innovative behaviour.[29] This ties in nicely to the previously mentioned result in relation to founder R and D and capex expenditure

Regardless of where you fall in the argument as to the benefits or pitfalls of overconfidence, it is imperative to understand that there is an overconfidence bias in founders, particularly if you are looking to replace a founder with a professional CEO.

4.3 The value of Founder CEOs in the IPO process: A look at the short term performance of found led businesses in public markets:

The IPO process, such is its magnitude as a transformational event, provides a unique setting to evaluate the performance of founders versus non-founder CEOs. As previously discussed, the consequences of going public are significant. It is a period of enhanced agency conflicts, arising from a different ownership and governance structure, as well as

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[27] Hayward, M.L. and Hambrick, D.C., 1997. Explaining the premiums paid for large acquisitions: Evidence of CEO hubris. *Administrative science quarterly*, pp.103-127.

[28] Lee, Hwang and Chen, Ibid

[29] Galasso, A. and Simcoe, T.S., 2011. CEO overconfidence and innovation. *Management Science*, *57*(8), pp.1469-1484.

"adapting to the enhanced scrutiny of its business, financing, investment decisions from potential investors, regulators, analysts and the business press".[30]

Jain and Tabak[31] reveal several factors in relation to the probability of a founding CEO being retained in that role during IPO process. They are all fairly self explanatory, but important for context. Namely;

- If the founder has a 'output based' background in functional roles such as product R and D, there is an increased likelihood of retaining their role for an IPO
- The greater the size of the founding team, the more likely the founder will retain their role
- The greater the number of 'insiders' on the board, the more likely they will retain their role
- The higher the outside block ownership, the less likely the founder will retain their role

It is worth noting, 37% of IPO firms from 1997 to 2005, go public with the firm founder as CEO[32].

Generally speaking research provides argument a positive as well as negative founder effect on IPO performance, both immediately and in the short term after listing.

The benefit of reduced agency costs during this period has already been discussed. Further to this though, since a newly public firm does not typically have an established reputation (although this is disputable most recently with the exponential growth of private 'unicorns'), it relies heavily on the reputation of the founder to attract investors.[33] This coupled with the intrinsic and extrinsic attributes of a founder - their power within the business, their stronger attachment and identification with the company, greater firm specific skills, higher ownership incentive and longer investment horizons - it is hypothesised that this will lead to superior post IPO performance.

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[30] Jain and Kini, Ibid

[31] Jain and Tabek, Ibid

[32] Johnson and Yi, Ibid

[33] Gao and Jain, Ibid

On the other hand, founder CEO leadership has the potential to influence post IPO performance negatively. This is due to the potential consequences of entrenchment - behaviour that aligns with self interested corporate control, tendency to distort investment due to a lack of diversification and the lack skill in running a publicly traded company[34]

<u>Some key finding that are relevant to this paper in relation to IPO performance generally;</u>

1. Firms with founder CEOs have higher valuations *at the time* of the IPO[35]

2. There is no strong or consistent evidence of superior investment performance in the first 36 months following IPO on the part of founder CEO led IPO firms.[36]

3. IPO firms with a specialist CEO (one whose experience is firm or industry specific to that of the IPO) have a lower probability of failure and a longer time to survive in subsequent periods following the offering[37]

4.3.1 Founder leadership of <u>high technology business and their IPO performance:</u>

Most pertinent to this discussion is the performance of founder CEOs of high technology based businesses. These businesses are often fast scaling and belong to high velocity growth industries that are at the forefront of innovation in both product and service. These firms typically face short technology life cycles, and therefore require management to "respond nimbly to risky investment opportunities with uncertain payoffs in order to remain at the

[34] Gao and Jain, Ibid.

[35] Johnson and Yi, Ibid.

[36] Gao and Jain, Ibid

[37] Gounopolous and Pham, Ibid

cutting edge of innovation and compete effectively in industries that are themselves evolving and ill defined."[38]

In relation to high technology firms, the lowering of agency costs is particularly valuable - they are in a much better position to convince public market investors to give more autonomy to management to retain rather than distribute excess cash, lowering credit risk when attractive investment opportunities arise that requires a nimble and rapid deployment of capital.[39]

Corporate governance literature argues that governance structures that are designed to increase CEO power relative to the board - for example 'insider' dominated boards or duality of CEO- Chairman - while weakening the reduction in agency conflict, do provide a more effective way of providing strategic guidance and direction, particularly to firms in fast growing and high technology industries.[40]

Gao and Jain point out that since high growth, high technology IPO firms are unlikely to be generating a large volume of free cash flows (if any), the need for monitoring and control of a powerful board is less critical than the function of strategic guidance expertise that will drive innovation and ultimately growth.[41]

Importantly, in the context of these high technology firms, Gao and Jain find *"substantially superior post IPO investment performance of founder CEO firms compared to non-founder CEOs".*[42]

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[38] Carpenter, M.A., Pollock, T.G. and Leary, M.M., 2003. Testing a model of reasoned risk-taking: governance, the experience of principals and agents, and global strategy in high-technology IPO firms. *Strategic Management Journal*, *24*(9), pp.803-820.

[39] Carpenter, R.E. and Petersen, B.C., 2002. Capital market imperfections, high-tech investment, and new equity financing. *The Economic Journal*, *112*(477), pp.F54-F72.

[40] Zahra, S.A., 1996. Goverance, ownership, and corporate entrepreneurship: The moderating impact of industry technological opportunities. *Academy of management journal*, *39*(6), pp.1713-1735.

[41] Gao and Jain, Ibid

[42] Gao and Jain, Ibid

4.4 The relationship of founder CEOs and long term investment performance:

Literature suggests that founder CEOs are in a unique position to influence firm valuation and long term stock performance - and many empirical studies suggest founder CEOs distinctly and significantly affect both these.[43]

As previously mentioned throughout this paper, there are two competing views as to how founder CEOs create or destroy long term value;

1/ The agency hypothesis - due to their entrenchment and inclination to seek private benefits of control, that founders destroy long term value. This managerial moral hazard problem exists simply due to the nature of the founder and their superior ability to pursue self interest opportunities - they have a higher proportion of ownership, detailed organisation knowledge and power over employees due their status.

2/ The value creation hypothesis - founders can uniquely exploit their high ownership, devotion to the firm (which they often see as they life long work and legacy), longer investment time horizon, and the information advantage of deep and specific firm and industry knowledge, over an above that of a non-founding CEO.

Key findings from the research pertinent to Founder CEO firms for general consideration;

1. Founder CEOs on average have significantly longer tenure than hired CEOs (16.4 years to 6.4 years)[44]
2. Mean ownership of a founder is 11.1%, while non founders CEOs have mean ownership of 2%
3. Of all founders, 13.6% hold more than 25% of their outstanding stock

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[43] Johnson and Yi, Ibid

[44] Farlenbrach R., Ibid

Specifically in relation to long term performance:

1. Family firms where the founder still has an active involvement (is CEO or Chairman of the Board), have a higher valuation, and higher return on assets compared to non family/ founder S&P 500 firms[45]

2. Sampling just 47 large public founder CEO firms from 1980-1991, Jayaraman et al., find NO positive stock market performance effect of founder CEOs[46]. This suggests that underscores there is a need to assess the founder's ability to enhance shareholder value through effective general management practices at different stages of the firm's life cycle, rather than assume any simple and direct correlation between founder led businesses and outperformance

3. Despite (5), Jayaraman do find that founders do add market value in both smaller and younger firms, and the presence of a founder may in fact erode value in older and larger firms. [47]

4. Using Tobin's Q as a measure for firm value (that is market value of assets to book value of assets), "founder-CEOs have a sizeable positive and statistically significant impact on firm value" - 28% higher in fact in founder CEO firms than non founder CEO firms[48]. It is noted in this study there may in fact be a section bias, as non performing founder CEO may have well been disposed prior to public listing

5. Founder led businesses outperform the market over the long term. An equal-weighted (value-weighted) investment in the founder-CEO portfolio in July 1993 with one

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[45] Villalonga, B. and Amit, R., 2006. How do family ownership, control and management affect firm value?. *Journal of financial Economics*, *80*(2), pp.385-417.

[46] Jayaraman, N., Khorana, A., Nelling, E. and Covin, J., 2000. CEO founder status and firm financial performance. *Strategic Management Journal*, *21*(12), pp.1215-1224.

[47] Ibid

[48] Farlenbrach R, Ibid

rebalancing period per year would have yielded an average annual raw return of 16.34% (13.87%) in December 2002, while the equal-weighted (value- weighted) market return over the same period was 9.99% (8.48%).[49]

[49] Ibid.

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