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Founder exits and firm performance: An exploratory study

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ABSTRACT

In this exploratory work, we examine the relation between founder exits and firm performance in new and emerging ventures using data ($N = 3120$) from the Kaufmann Firm Survey (KFS) database which tracked firms over a seven-year period. We find that founder exits have an inverted-U shaped relationship to firm performance. Furthermore, the relationship between exits and performance is weakened when ownership is consolidated and governed by formal ownership agreements, and strengthened when owners are actively engaged in management of the firm. Overall, our results suggest that new and emerging firms' organizational development influences the relationship between exits and performance. We discuss the theory-based and practical implications of this work as well as multiple lines of future research that can build on our findings.

1. Introduction

Consensus in the literature supports the premise that founders in new and emerging firms play a critical role during the inception, and subsequent evolution, of the ventures they create (Aldrich and Yang, 2014; Boeker and Wiltbank, 2005; Sahaym et al., 2016). Despite the importance of founders within these ventures, estimates suggest that one or more founders depart within the first few years in at least half of multi-founder new firms (DeTienne, 2010). Exits of one or more founders—defined as relinquishing ownership of the firm they helped found—can induce changes in the direction of a firm particularly in terms of performance, growth, and survival (Bhide, 2000). Accordingly, the topic of founder exits is of particular interest to academics and practitioners alike.

Extant research has examined departures of founders from ventures controlled by a single owner-manager (e.g., Bamford et al., 2006) or from managerial teams in established firms (Boone et al., 2004; Maltarich et al., 2010; Quigley and Hambrick, 2012). However, few efforts have been made to shed light on the performance effects of founder exits in new and emerging ventures (Wennberg and DeTienne, 2014; Wennberg et al., 2010). Accordingly, the current exploratory work examines exits of founders early in the life of firms, focusing on how organizational attributes, or lack thereof, may affect the exit-performance relation. We draw attention to contextual factors that influence the exit-performance relationship and illuminate the conditions that affect how and when exits can improve (or inhibit) performance.

2. Theoretical development: exit and performance

Regarding the impact that founder exits might have on new and emerging ventures, the literature is ambiguous. On one hand, we have scholars who contend that founders contribute human, social, and financial capital to a venture and that founder exits deprive the firm of critical resources (Beckman et al., 2007; Ucbasaran et al., 2003). From this perspective, the exit of one or more founders

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disrupts the process of building unique and often socially complex resource combinations leading to an adverse impact on performance.

On the other hand, some scholars contend that founder exits might be beneficial for a firm. In particular, if the departure of one (or more) members of the founding team facilitates more efficient and effective decision-making, an exit is potentially beneficial (Maltarich et al., 2010). New firms do not have the luxury of waiting for a consensus to evolve between multiple founders because of the fleeting nature of opportunities (Pearce et al., 2008; Roberts and Eisenhardt, 2003), the dynamic nature of new venture environments (Wang and Song, 2015; Zahra, 1993), and the need for quick and fast heuristics (Shaver and Scott, 1991). New and emerging firms that wait to build consensus or act passively will be disadvantaged compared to those that act in a decisive manner. Accordingly, from this perspective, founder exits might be exactly what is needed for the venture to survive and thrive, and cohesiveness may be better with the remaining founders (once some founders leave) who then can reach decisions more quickly and decisively (Wagner et al., 1984).

In sum, while exits may deprive the firm of valuable resources, exits might also serve to improve coordination and communication, rapport, and understanding among the remaining founders—especially early in the life of firms when routines to manage the venture have not yet evolved. To explore this apparent quandary, we take a novel approach to answer our primary research question: "*What is the relation between founder exits and firm performance?*" And, given the potentially irreconcilable arguments on each side of the exit-performance relationship, we surmise that a non-linear relationship might emerge between exit and venture performance.

2.1. Conditions affecting exit and performance

To unpack the relationship between founder exits and performance, we explore conditions unique to new firms that sharpen the dialectic relationship between founder exit and performance. Scholars have noted that organizational development might influence how much impact founder exits have on the firm (Bowen and Ostroff, 2004; Miller et al., 2012). We explore three such aspects of organizational development in new and emerging firms—(1) ownership concentration, (2) owner involvement, and (3) presence/lack of a formal ownership agreement.

In terms of ownership concentration, new and emerging firms often involve multiple founders with differing control over the firm. A firm in which one or more founders own a large share of the firm differs from one in which multiple founders own smaller stakes (Demsetz and Lehn, 1985). The difference is often manifested in how decisions are made and influenced within the firm (Goodstein and Boeker, 1991). High ownership concentration enhances hierarchy and leads to tight control over the firm, and when ownership is dispersed, control tends to be diffused (Stevenson and Gumpert, 1985). Concentrated ownership aligns the interests of the firm with the interests of the largest owners (Shleifer and Vishny, 1997). It acts like a quasi-routine where founder control can enhance speed of decision-making and permit efficient hierarchical control over the firm resolving holdups. Therefore, we hypothesize:

Hypothesis 1. a *(H1a): The relationship between founder exit and performance is less salient (such that the curve becomes flatter) when there is high ownership concentration as compared to when there is low ownership concentration.*

In terms of owner involvement, active involvement on the part of the founders provides the benefit that the team can draw upon a greater set of capabilities and skills (Boeker and Wiltbank, 2005). Conversely, passive founders are less likely to influence day-to-day operations of the firm. Passive owners afford firms' access to founders' resources without the encumbrance of needing a consensus on all decisions. Passive ownership therefore permits informal separation of ownership and control akin to established firms with a board of directors. Consequently, we predict that the effects of founder exit on performance will be steeper in the presence of active founders relative to passive founders.

Hypothesis 1. b *(H1b): The relationship between founder exit and firm performance will be more salient (such that the curve becomes steeper) when founders are actively involved in the day-to-day operations of the firm compared to when they are not actively engaged.*

In terms of formalization of ownership, some firms have a contractual delineation of ownership rights. Formalization helps define *ex ante* the scale and scope of the power vested in each individual founder (Kelly and Amburgey, 1991) and enables division of responsibility and facilitates coordination. Formalization of ownership may reduce the amount of discretion an individual owner can have as privileges and responsibilities are clearly spelled out in the contract (Bowen and Ostroff, 2004). In the absence of formalization, or if formalization is weak, there will ambiguity and uncertainty regarding the rights and authority of individual owners who will then seek to define their own power. In contrast, when formalization of ownership is strong, there will be fewer deadlocks in decision-making and less prospects of impasse in strategic activities. Accordingly, we predict that when ownership is formalized, the relationship between founder exit and performance will be less salient.

Hypothesis 1. c *(H1c): The relationship between founder exit and performance is less salient (such that the curve becomes flatter) when there is strong ownership formalization as compared to when there is weak ownership formalization.*

3. Method

3.1. Data and sample

To build the dataset to test our predictions, we start with the Kaufman Firm Survey (KFS), which is the largest longitudinal dataset