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Research Article

The Impact of Founder Characteristics on CEO Succession in UK IPOs

Ying Liu*; Martyn Polkinghorne

Bournemouth University Business School, Poole, Dorset, UK, BH12 5BB, UK.

Abstract

This paper seeks to understand the impact of the company founder's characteristics on CEO succession for UK firms undertaking an Initial Public Offering (IPO). Previous work considering this issue has been related to large company examples, but there has been significantly less attention placed upon smaller and/or younger companies. This is particularly the case when considering companies that are undertaking the transition from being controlled by their founder during the start-up phase, to becoming public companies that require professional management. This paper focuses upon the factors that determine the choice of a successor, and investigates the importance, and role, of certain founder characteristics that may prove to be influential. To achieve this, the paper considers the implications of a firm passing through the IPO stage, and the pros and cons of having either a founder CEO, or a professional CEO, during this process. The findings indicate that a firm's leadership structure is not exogenous, and in fact the selection of the founder as CEO following the IPO stage, directly relates to their previous experience, education, and the level of ownership that they retain.

Keywords: Entrepreneurship; Research and Development; Mergers and Acquisitions; Strategy; Decision-Making; Corporate Governance.

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***Correspondance to:* Ying Liu**

Bournemouth University Business School, Poole, Dorset, UK, BH12 5BB, UK.

Email: yliu@bournemouth.ac.uk

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Introduction

When a company becomes successful, it may decide that it wishes to sell shares to investors, and the first occasion that its shares become available for purchase in this way is called an Initial Public Offering (IPO). This is the process that a private company must pass through to become a public one.

The IPO stage is pivotal in the development of an entrepreneurial firm's life cycle. However, by transferring from private to public ownership, the IPO firm's management team must invest the substantial effort to align the company within the marketplace to ensure that the offering is attractive to investors. To achieve this, both internal and external resources will be required to optimise the offering.

Typically, the focus at this stage is placed upon matching the key personal and professional characteristics of the company's Chief Executive Officer (CEO) with the projected needs of the organisation itself once it becomes public. The CEO is responsible, and accountable, for developing and delivering the organisation's strategy, and for the resulting business and financial performance [1]. In fact, the CEO's role is the most powerful in the company, and over a company's life cycle, this role may change and evolve many times [2,3]. Consequently, CEO succession becomes crucial because it will influence the passage of a company's formal authority, and its continued strategy [4,5]. In summary, the selection of the CEO will significantly influence the firm's future direction, strategy, culture and performance, and it will therefore impact upon all stakeholder groups linked with the organisation.

To those stakeholders who are internal to the organisation, the succession to a new CEO will be viewed as being a very important managerial change. To external stakeholders, the change in CEO is likely to be viewed as a signal about the future direction and values of the company [6-8]. Moreover, the successes and failures of the CEO are known to directly impact upon the successes and failures of the whole organisation [7,9]. This makes CEO succession a defining event in all organisations.

When undertaking preparations for the IPO, an important decision for the organisation to grapple with is whether or not the founder should be the CEO of the company once it has become public, or if a professional and more experienced person should be appointed instead. Experience in this context relates to being the leader of a public company with all of the associated responsibilities and decisions [10]. Several studies have suggested that the corporate governance, strategic orientations, and even the performance of firms that retain the founder as the CEO, can be quite different to that of companies that decide to select a new professional CEO [11-15]. Although upper echelon theory explores major decisions leading to CEO succession, there is limited research on corporate governance focused on the antecedent factors of CEO succession. By focusing on the impact that CEO succession can have on a company's stakeholders, and upon the organisation's financial performance [7,16-17], many studies overlook other factors that may also influence this critical change process. This paper will consider these underexplored issues, and will seek to determine the potential impact of founder characteristics on CEO succession in UK IPOs, so that a clearer perspective regarding these factors can be determined.

Research approach and method

This paper reports on a review of the literature relating to CEO succession in UK IPOs. Particular emphasis is given to the impact of founder characteristics. From this study, a model is proposed that enables those involved in the IPO stage to evaluate the impact of retaining the company's founder as the new CEO, in comparison to bringing in a professional CEO instead.

No primary data has been collected during this study. Secondary research has been undertaken using a range of public domain sources, with a particular emphasis on more recent publications. However, older publications that retain currency have also been considered. This research is aligned with Bournemouth University ethical guidance.

Firm performance and the CEO

Despite the extensive array of literature that examines the linkages between company performance and the origin of the CEO, the role of experience-based factors in the CEO succession process remains relatively unexplored. Past studies on CEO succession mainly consider the context of large and mature organisations. It is well established that upper echelon members (company senior management) can influence business outcomes, but the focus of such related research concentrates on Fortune 500 companies. Finkelstein and Hambrick [18] suggest that the effects for small and high-growth firms might be quite different.

Past studies have failed to consider the IPO stage, and the resulting consequences of retaining the founder as the subsequent CEO. Whilst it is true that large and mature companies are far more visible [10], there are remarkable differences between large / mature organisations, and small entrepreneurial companies, in terms of how they operate, and the leadership that they require. One important difference is that the ownership structure in an entrepreneurial firm is different from that for large / mature companies. With smaller firms, the founder, or co-founders, often own a large shareholding in the company [10], such that there is a much higher degree of 'inside ownership'. This provides the founder of the small firm with significantly more power and influence over the actual IPO stage. Furthermore, given the importance of the founder, or founders, in the creation and development of an entrepreneurial firm, there is evidence to suggest that a founder's personal traits will impact upon CEO succession decision. Therefore, it is inappropriate to extrapolate findings related to large / mature company succession and apply the findings to the case of small companies [15], as such small companies are unique and must be considered separately.

The exact start and end points of any succession event related to an IPO will often be unclear [6]. Instead, it is necessary to take a holistic overview of the event, and set appropriate time boundaries around it. Such time boundaries will relate to contextual factors that have occurred. The reality is that succession is unlikely to be a linear process which progresses smoothly from one stage to the next. This process has implications that will need to be considered individually.

Previous research that considered early-stage succession were often case-level explorations of the arising issues [19], or examinations of family-owned companies [20]. The published work related to family-owned firms has largely focused upon the CEO succession that occurs at the point of the founder's death, which is the signal event that forces a transition to occur in the family between generations, i.e. the previous CEO who is deceased is replaced by a new CEO who is also a family member. However, it is problematic to extrapolate this starting point of the succession event to entrepreneurial firms. Instead, the starting point of the IPO is considered to be a much more appropriate place from which to study CEO succession.

Given that the IPO is the first opportunity for a private company to be able to sell its shares publicly to raise capital, those businesses going through an IPO are often young companies needing additional investment to fund their expansion and growth. In an IPO, the issuer, with assistance from an underwriter, determines several key factors including the type of security to issue, the offer price, and the time when the event will occur. When a founder is making the decision to raise capital by issuing stock, the company undergoes a major corporate restructuring arranged by the underwriter with support from both lawyers and auditors.

Examination and evaluation of the firm by new potential stakeholders, investors, and regulators often put pressure on the organisation, and a common response to this pressure is to recruit a professional CEO with relevant experience. Such a move will make the organisation appear more legitimate and attractive to potential investors. Such a move to a professional CEO can also reduce uncertainty (risk) in a highly competitive environment, and this can result in an increased level of interest from investors and may therefore result in a higher offer price being justifiable.

The case for founder CEO succession

The strategic management literature has established the important role of the founder during the succession event. This was largely stimulated by the upper echelon's perspective [21], and the organisational demography framework [22]. Scholars continue to analyse how the founder may influence and shape an organisation, and how their experience can lead to a variety of different forms of impact [23,24]. Previous research considering the relationship between founders, and founding families, on market valuation, has generated mixed findings. For instance, Johnson et al. [25] analysed changes in stock prices following the unexpected death of senior corporate executives and identified a strong relationship. In contrast, other studies [26-28] identified the positive effect that founder CEOs can have on company performance. Alongside this, Anderson and Reeb [29] provide evidence that family firms often have a higher market value compared to non-family firms.

More recently, research has focussed on revisiting the evidence of previous studies including considering the role of inherited control. For example, Morck *et al*. [30] determined that a negative relationship exists for heir controlled Canadian firms in terms of their performance. Bennedsen *et al*. [31] provide findings that support this view. In contrast, Sraer and Thesmar [32] identified that in a group of French companies, family control firms (including those which were heir-controlled) reported better levels of performance.

In contrast to later stage chief executives, founders often control all, or at least most, of the firm's assets, and therefore ownership, and control, are far more integrated in companies managed by founders when compared to businesses managed by professional CEOs [10]. In addition, a founder is tightly linked to every level of the organisation, which may create a stronger psychological link between the individual and the company. Such a link can provide an improved understanding of the organisation's activities, and may also generate a stronger emotional response from employees in terms of loyalty and identity.

Given that the upper echelon model applies to a range of contexts, including stages in the corporate governance life cycle, recent research has improved our understanding of the processes by which such managers influence company outcomes. Upper echelon research capitalises on a theoretical framework linking the Top Management Team's (TMT) identifiable characteristics to the organisation's strategic profiles [18,33-35]. This can generate managerial cognition [36-38]. Prior research on management characteristics suggests that managerial cognition has a pivotal role to play when generating competitive advantage through the accumulation of strategic assets. Pegels and Yang [39] document that management experiences influence managerial cognition, and so this will often result in an impact upon the organisation's strategy and performance.

It is well known that the founder of an organisation will have had a significant impact on business success through the decisions they have been empowered to make for the company. The top-down organisational structure of many entrepreneurial companies allows founders to retain both tight control and high levels of personal influence. Taking a resource-based view of a company, which is a perspective associating strategic change and success with the availability of limited resources [40], the founder's professional experience can be categorised as being a resource that meets these conditions.

This experience will include an integration of both explicit knowledge which can be articulated, codified, disseminated, and stored, and tacit knowledge in the form of practical experience. Tacit knowledge is retained by individuals and so leaves the company when they leave, whereas explicit knowledge is documented and often remains as their legacy. Tacit knowledge is the key to good decision-making, and losing this knowledge makes understanding how previous decisions have been justified, and making future decisions that are optimal, quite problematic [41]. This is especially the case for entrepreneurs whose experience is highly valuable. For instance, Steiner and Solem [42] have demonstrated that the managerial knowledge and experience of the founder of a business is one of the main contributing causes for the subsequent success or failure of the company. Based upon the understanding described above, this research will discuss how founder's characteristics (i.e. functional background, education level, external directorship, age and share ownership) may significantly impact upon the succession event.

Characteristic 1: Founder's experience

Individuals are known to make decisions that align with their cognitive base [21], and this directly relates to their personal values and experiences. Mitchell *et al*. [43] document that cognition can be described as the processes through which sensory inputs can be applied. They define entrepreneurial cognitions as "the knowledge structures that people use to make assessments, judgments, or decisions involving opportunity evaluation, venture creation, and growth". That is to say, research into entrepreneurial cognition relates to understanding how they assemble information to develop new solutions (products and services), and how they then apply this understanding to stimulate and support the generation of business growth [43]. The resource-based view integrates the 'lived' experiences of those in an organisation, with their knowledge, skills and competencies. In the case of an entrepreneur, this directly impacts upon the growth and survival of the business. This link exists because entrepreneurs are known to provide significant tangible, and intangible, resources to their companies.

A founder's experience may be the source of valuable information, contacts, resources, and socialisation that together enable the company to move forward and implement important new strategies after the IPO. Resource-based view theorists argue that the founder has unique abilities, often developed over time, to accumulate the resources required to achieve new levels of business performance [40,44]. The changes in competitive conditions facing firms after the IPO are a therefore critical test for the entrepreneurial founder. The founder's work experience can include both expertise and contacts, which reduces the uncertainty associated with the flotation on the stock market. For a newly listed firm following the IPO, a senior manager's ability to develop contingencies, and ensure organisational success, are significant influencing factors in the subsequent success of the company [45]. In contrast, founders with less relevant experience, yet who are continuing their involvement in general management, may decrease the value of the organisation's value, and be detrimental to the firm's success after the IPO [46,47]. Consequently, a founder with prior managerial experience is likely to have a higher level of relevant knowledge, experience and skills regarding how to manage a threshold firm.

The key factors of company survival, and the linkages to the founder's prior work experience, are well established. For instance, Cooper *et al*. [48] determined that industry-based knowledge plays an important role in both company survival and growth. Shane [49] found that knowledge about a specific industry or market experience can prove to be the fundamental driver of entrepreneurial activity. Dimova and Shepherd [41] suggest that a founder's previous experience from starting one company, and the consideration of how many founders there were in total to support them, will together provide a useful indication of the knowledge available to a founder when trying to support a new organisation navigating the process of funding and growth. Brüderl *et al*. [50] have proposed that company failure rates are lower when the founders have prior business experience in the same sector as the new company. Segel *et al*. [51] also argue that such prior experience in the same industry is key, and is often the only discriminating factor between organisations with high or low growth. Furthermore, Marvel and Lumpkin [52] have demonstrated that relevant industry and market knowledge are major factors for the stimulation of radical innovation.

In this study, we are using the definition of work experience provided by Hambirk and Mason [21] and differentiate 'output' background from 'throughput' background. Output in this sense includes marketing/sales and product development (R&D) and emphasises the need to ensure that company growth is underpinned by the continuous search for new business opportunities. This also includes the responsibility for managing both products and markets. In contrast, throughput functions include operations and financial control, so there is focus upon increasing efficiency. These two functional areas are quite distinct in their own emphasis and requirements, and over time, staff working in either area will develop very different perspectives and priorities that may become incompatible [18,21,53].

Throughput based managerial behaviour refers to the separation of strategic and operational management. The output concept refers to "a greater integration of operational functions, either through technical specialisation or through strong personal involvement and leadership" [54]. Founders with an output functional background may emphasise business growth and innovation, whilst founders with a throughput functional background may emphasise the efficiency of the transformational processes [21]. Jain and Tabak [15] argue that founders with career experiences with an output orientation tend to capitalise on internal resources and capabilities, and focus on organisational innovation and growth, whilst founders with a throughput background will be positioned well to employ external resources [18]. It may therefore be true that in cases in which a founder has an output functional background, there will be increased pressure to select a management professional as the CEO.

Characteristic 2: Founder's education

The founder's education is another factor that is heterogeneously distributed across firms. New business approaches have led to a move away from traditional ones, and to a new era in which senior executives are required to have and demonstrate knowledge and learning abilities. It is a recognised characteristic of successful entrepreneurs that using their knowledge, they can identify potential business opportunities that others cannot see [51]. Such knowledge can be gained through formal education, or from experience gained working in a variety of roles and sectors [55].

In terms of formal education, variance can occur based upon the level and quality of the education received. Postgraduate degrees are perceived to provide students with greater access to specialist explicit knowledge. For founders, such knowledge is vital because it provides a valuable resource and an alternative perspective. The importance of education has been heightened by changes in global marketplaces and advances in technology. As a result, the current trend of mergers and acquisitions, efficiency saving through cost cutting, and the formation of strategic alliances, is changing the face of business.

Taking a knowledge-based view of a company enables us to realise that the success of the IPO firm not only arises from the quality of its tangible resources, but also from differences in the way that companies, and their employees, learn. Individuals with PhD are assumed to have more knowledge and higher intellectual potential [56,57]. Therefore, individuals with advanced educational backgrounds can use their intellectual capability and knowledge to help them to make better strategic choices, which in turn can lead to improved business performance [51,55]. For instance, Chow [58] found that when senior management have qualifications from higher education, it can have a significant impact upon a company's overall performance.

Storey [59] documents the positive role of an entrepreneur's own education when determining the growth of small firms. Segal *et al*. [51] investigated the effect of a founder's education level, and industry experience, on company performance. They argue that higher levels of founder education improve business performance in the founder-managed companies which they studied. Cooper *et al*. [48] have also shown that high growth firms are more frequently created by more educated individuals.

The growing literature on entrepreneurship processes also explores, and identifies, a link between an entrepreneur's education, their contribution to firm growth, and their personal attitude towards risk [49,60]. For example, Datta and Guthrie [2] indicate that educational attainment is positively associated with characteristics such as open-mindedness and risk-taking. Given the IPO firm usually grows fast, and faces greater risk, it is therefore possible that in an IPO firm, the more advanced the level of the founder's education, the less likely there will be for pressure to select a professional CEO as their replacement.

Characteristic 3: Founder's external board membership

As a response to changing organisational, market and resource demands, growing new firms often generate a variety of social networks to exert influence that will support the organisation's development. With uncertainty and information asymmetry, social networks can generate a business advantage for a company that seeks to obtain resources from others [61,62]. Such advantages depend largely on the ability to access valuable external information.

Unlike many transactions that are governed by market-oriented rules, information sharing largely has to do with prior social contacts. By embedding such a transaction within an ongoing social relationship, the founder's external links generate diverse information, including market demand, technical information and environmental uncertainties. Here, we want to distinguish between the founder's past and present directorships. Social capital theorists have determined that when levels of human and social capital are high, organisational outcomes are more likely to occur [63]. The ability of a founder to contribute to the firm as it grows will vary based upon their own particular skills and experiences. At the initial stage, the founder's skill sets may be immature with regard to the developmental needs of the firm. However, previous professional experiences as an external board member can indicate acquired human capital because these experiences shape the individual's cognition and perception [64], and enable founders to develop necessary skills that relate to operating a threshold firm. Therefore, a founder's past external directorships are valuable experiences that can enhance resource acquisition under conditions of information asymmetry.

In the absence of these attributes, the founder should hire a professional CEO from outside the organisation who has the relevant strategic experience, and who can play a pivotal role in navigating the company through the IPO. This may prevent managerial errors from occurring and offset the founder's comparable inexperience [37].

Several components of a company's operations can generate a degree of uncertainty for an organisation. Examples may include the upstream supply chain (for example suppliers), and downstream supply chain (for example customers), direct and indirect competitors, and relevant government strategy [65]. Therefore, the more contacts the founder has developed, the greater their ability to control these critical contingencies. In the absence of such networks, professional CEOs may be able to compensate for a founder's lack of relevant experience and contacts. Whilst this may create agency problems [37,38], from the perspective of the resource-based view for the case of an IPO firm, a high level of a founder's previous external board memberships will often reduce the need to select a professional CEO.

Characteristic 4: Founder's power and influence

It has been proposed that a founder's experience contributes to both their learning ability, and also to their organisational and social resources. A founder with relevant experience and knowledge will reduce the level of risk for an IPO firm. In the context of IPOs, the founder's power may also have an impact on CEO selection. Power in this sense is defined by the capacity of an individual to exert their will upon others [66]. Emerson [67] and Blau [68] suggested that power is a function of exchanges, and the availability of alternative sources of exchange. Founder CEO succession is often a question of the power dynamic between the founder and the other stakeholders, for example underwriters and shareholders during the IPO [10]. For instance, Filatotchev [38] suggests that the founder status of the CEO could reflect the dimension of their power within the organisation [12,69].

When starting the business, and subsequently as the company develops and grows, the founders will find themselves with extraordinary influence over staff, activities and strategy [14]. The research undertaken that considers the role of behaviour and power in organisations has found that an executive's level of ownership is directly related to their power. Fredrickson *et al*. [70] identify ownership as being a CEO characteristic that leads to a lower likelihood of CEO dismissal. Boeker and Karichalil [71] also test for ownership and found a significant negative relationship with a founder's departure.

The power associated with concentrated ownership comes from two sources. First, by concentrating on ownership, the power of monitoring can be strengthened. From an agency theory perspective, researchers have shown that direct managerial ownership of equity is more effective than other forms of incentive compensation in terms of producing effective managerial monitoring. In the US, and other market economies, there is strong evidence of a positive relationship between ownership, and organisational performance, and they assign this observation to the impact of better monitoring [72,73].

Secondly, concentrated ownership may strengthen the founder's administrative power [74]. Pettigrew and McNulty [75] report a positive relationship that can be determined between executive ownership, and their influence on decision-making processes. Ownership clearly represents a vital source of power that can be employed to support or oppose other stakeholders. In general, the more concentrated the ownership, the more influence can be wielded. Unlike other large block shareholders, such as institutional investors, who can use the indexed investment to diversify their risk, a founder usually invests all, or most, of their wealth in the company. A founder with a sizeable ownership stake is more likely to be continuously involved in general management activities and so ensure the resources of the firm are used prudently and efficiently. This means that companies in which the founder is entrenched in their point of view, and who is therefore less willing to listen and act upon the advice of others [21], will be more likely to need to be replaced by a CEO with a wider variety of extra-organisational links. Based on these arguments, it is possible that in an IPO firm, when a founder has a high level of ownership and influence, there will be less pressure to select a professional CEO.

Characteristic 5: Founder's age

A founder's age influences their strategic decision-making and subsequent choices. This is evidenced by the association between age and resulting organisational outcomes. Younger managers and executives appear to be more closely associated with company growth [76-79]. Hambrick and Mason [21] note that this may be because older managers and executives are more conservative in their approaches. Firstly, older executives may be less able to compete with youthful ones both physically and mentally. Secondly, older executives will have greater reason to maintain the status quo [80,81], i.e., they may have less drive to achieve change as they have more to lose from risky ventures, and less time to benefit should the new activities be successful. Thirdly, older executives at a later life stage, and one in which financial security becomes even more important, may wish to avoid work decisions that could involve significant changes in the strategic direction of the firm, and consequently increase their own personal risk and stability [82,83].

Recent demography-grounded studies demonstrate that age is an important variable affecting our perception of risk. When engaging in company decision-making, an executive's interpretation of options will reflect their own cognitive base. Drawing on their previous work, Hambrick and Mason [21] proposed a model of cognition influencing decision-making which can be applied in this situation. A founder's field of vision, or selective perception, is often limited by mental and physical factors. Previous studies have found a link between age and values, i.e., how CEOs integrate new information and/or their risk appetitive [77-79,84]. Researchers argue that older executives, in comparison to younger ones, are often risk averse. As a result, they are less likely to support strategies leading to potential business growth. They may also have difficulty grasping the potential of innovative new ideas [33,85].

An IPO firm has great growth opportunities, and requires large financial expenditure, in order to retain competitive advantages in an uncertain environment. The conservative, and risk averse attribute, of an older founder may harm the firm's future development. Both Jain and Tabak [15], and Joos *et al*. [86], therefore suggest that IPO companies with substantial growth options should hire younger CEOs. From these perspectives, in an IPO firm, the older the founder, the more pressure there is likely to be to select a professional CEO.

Summary

There is considerable evidence that the characteristics of the founder can make a difference to the succession of the CEO after the IPO stage (Figure 1). Some characteristics can support the acceptance of the founder as CEO, and in these circumstances, the founder is most likely to be the best choice. However, there are other characteristics that will severely limit the ability of the founder to support the investment and risk taking required to drive growth. In these circumstances, the selection of a professional CEO has the potential to be best for the firm, for its employees, and for the shareholders who have invested at the IPO stage and thereafter.

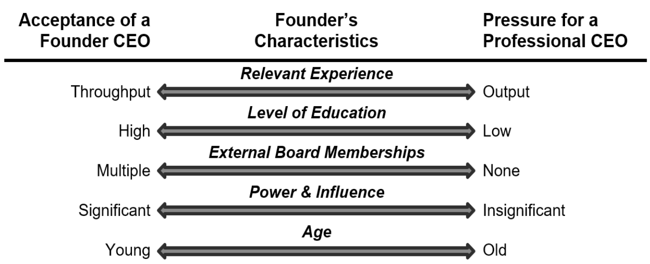

Figure 1: Model relating founder's characteristics to acceptance as CEO after IPO.
Source: Author's Own Work.

However, what is unclear at this time is if some of these founder characteristics outweigh others or are in fact counteract by the influence of others. For example, is a founder with the highest level of education able to compensate for a lack of relevant experience? In another example, is it possible that a founder with significant power and influence within the firm, can compensate for being older and less dynamic? These interrelationships need to be explored in more detail to fully understand how they operate in practice, and what the implications are for the CEO succession selection process.

Conclusion

The research undertaken has revealed that founders may wish to take a prominent leadership role in forming the boards of their companies after the IPO has occurred [14]. If we take a governance viewpoint, and move away from concentrating simply on the role of boards related to their structural characteristics such as monitoring and control (as highlighted in agency theory), we can also take into account how the founder may influence the CEO selection approach taken. Our suggested paradigm clarifies how a founder's characteristics should influence ex-ante the choice of selecting the founder as CEO, or a professional CEO instead whose talents and experience may be better placed to drive business growth. We are therefore proposing an integrated model that connects the founder's traits, governance development, and CEO choice, from the beginning of the succession event. Such an approach is underpinned by agency theory, upper echelon theory, and RBV. We now need to further understand how this theory relates to practice. This will be the basis for a future study and will require the collection and analysis of data related to actual IPOs that have occurred. To do this, we will need to source data relating to entrepreneur-led IPOs that have been floated in investment markets so that our proposed connection can be fully verified. In the meantime, the model presented provides a useful guide to help the consideration of selecting a new CEO at the IPO stage of a company's development.

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