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THE STONEWOOD PERSPECTIVE

A STONEWOOD GROUP INC. BULLETIN

Spring 2006

The Founder Syndrome

Why it's still a big messy issue and why attitudes have to change …….
Part 1

It has been debated for years yet remains a small-talk favorite around the water coolers of the venture capital industry. It is "The Founder Syndrome" and it goes something like this….. founders innovate, incubate and invigorate. They are the life-source of entrepreneurial endeavor. They make things happen. They think differently, they act differently, sometimes to extraordinary effect. But for whatever reason, many don't scale particularly well; they have difficulty adapting to change; they are often one dimensional; their egos can be a problem; and they are idiosyncratic to boot. Whether you are inclined to view this as a nature or nurture issue, it is often easier to simply replace the founder with a proven day-to-day manager who will guide the firm more skillfully to increase shareholder value and ensure a better exit.

A recently published article by venture capitalist Pascal Levinson suggests that two-thirds of venture capital-backed start-ups will apply similar logic to replace or demote their founding CEOs. For Levinson the question is not 'whether' an organization should replace its founder but rather 'when', and in his opinion, many boards of directors wait much too long to pull that trigger. Pursuing a similar theme, a study released last year by Concordia University's Jean-Philippe Arcand found that firms replacing their founder with a professional manager prior to an IPO were rewarded with an average $11mm higher valuation. Such a finding seems to support the view that investors reward firms which restructure their management teams in conformity with expectations around the increased value of professional managers. The Board of Directors of internet telephone pioneer Vonage are clearly counting on this phenomenon to hold true as they recently announced, in preparation for their forthcoming IPO, that they would be replacing the company's founder with an executive from Tyco International.

But not so fast! When Arcand examined longer-term performance (three years post IPO), he discovered that founder led firms were more likely to remain listed and had substantially better performance than firms in which the founder was replaced as CEO. This suggests that what is rewarded at the time of the IPO does not necessarily lead to longer-term performance. It also gives reason to pause and re-consider popular thinking on dealing with the founder syndrome.

In this two part article, we will discuss the dilemmas surrounding founders, current approaches by the investment community in addressing them, and offer thoughts on an alternative path forward.

Investor Perspective

A prominent business magazine recently profiled BitTorrent Software, a San Francisco-based start-up company whose software package was described as "the hottest way in the world to download anything bigger than a music file". With over 45 million users regularly downloading its 'free' software, the company has garnered worldwide acclaim for the ease, elegance and ingenuity of its technological breakthroughs. BitTorrent's success recently attracted the attention of investors who bet $9mm on the firm's ability to develop a commercially viable business model for monetizing its legions of users. This task falls on the shoulders of the firm's young founder, technical creator and CEO, Mr. Bram Cohen. Now consider that Mr. Cohen was born with Asperger's Syndrome, a form of autism sometimes referred to as 'geek' syndrome. Though blessed with unusual focus and intellect, he admits that "I don't understand people very well". In high school, Mr. Cohen would spend evenings developing algorithms to accelerate complex software calculations such as protein modeling. Yet at the same time, he would perform poorly in his academic coursework, even failing math on at least one occasion. In an important final examination, he answered the first question then went home explaining afterwards that "the other questions were all variations on the first". Mr. Cohen insisted that he remain as CEO of his company because "I do not trust many people". In the article, he tried to allay fears as to his leadership and business skills by arguing that "these are just other puzzles to solve". Investors have nine million reasons to hope that he is right.

Mr. Cohen illustrates the wondrous yet maddening world of founders. Blessed with an alchemist's brew of attributes such as uncanny vision, charisma, creativity, determination, drive, passion, optimism, single-mindedness, and resilience, the founder has emerged as one of the technology sector's most compelling icons. Firms such as Microsoft, Google, Dell, Apple, Oracle, RIM and scores of others are inseparable from the larger-than-life entrepreneurs who continue to infuse them with their uniqueness. However, in what often appears to be a perverse zero-sum game of attribute distribution, founders distinguished by exceptional abilities in some areas often bear equally noteworthy offsetting weaknesses and/or idiosyncrasies in others. Technical brilliance is frequently dulled by decidedly under-developed business or people skills. Market and customer intuitiveness is rarely matched by operational savvy. Traits such as rebelliousness and individualism, which often distinguish truly creative minds, clash with the increasing need for structure and process as firms grows. It is common for founders to suffer from glaring leadership blind-spots such as arrogance, autocratic or micromanaging leadership styles, volatility, hubris, and even eccentricities which threaten to limit their overall effectiveness. Finally, as any perusal of the literature on genius will support, bipolar personality disorders and even psychotic behavior have been the unwelcome bedfellows of some of history's most brilliant minds.

For investors, founders are the stuff that both dreams and migraines are made of. As both the sources of inspired innovation and one of the more significant risks in realizing their potential, founders consume an inordinate amount of the investment community's decision-making energy. Who among the myriad of aspiring entrepreneurs will be the coveted alphas? How does one most effectively deploy, support and manage a founder? Why do some founders successfully adapt and grow while others don't and how can one tell in advance? How does one deal with a gifted innovator such as BitTorrent's Bram Cohen if he proves ineffective as a business leader? What are the risks in removing founder DNA from a young emerging company? And on and on and on ….

Scores of 'scientific' techniques have been developed throughout history to answer such complex questions. In the 19th century, practitioners of 'Phrenology', also known as the 'Science of Mind', claimed the ability to map and predict human behavior simply by touching twenty-seven diagnostic bumps on a person's skull. Had 'bumpology', or the many other panaceas before and after it, not fallen by the validity wayside, the matter of picking, sorting and positioning founders would have long been resolved. That it has not is testament to the sheer messiness of the human condition. Though some investors still turn to modern day practitioners of 'Science of Mind' for assistance, for most, the blunt sorting instrument of choice is risk management.

In a recent address to a venture capital forum, a prominent Canadian investor punctuated his talk with the following statement: "If there is only one thing you should take away from today, it is that I am not, I repeat not, in the business of assuming risk. I am in the business of minimizing risk". The investor proceeded to explain that his industry is "serious business for serious people entrusted with the money of serious institutions". It is an industry which gravitates towards stability and predictability at the expense of higher risk alternatives. It seeks opportunities falling within specific analytical quadrants of consideration, and red-flags outlying variables such as unproven markets, unproven management and unproven technologies.

If the speaker is correct, to an industry guided by risk minimization, the uncertainty surrounding inexperienced founders must outweigh whatever unproven potential they may promise. Why risk a crisis of leadership as a firm moves from its creative stage to the operational stage? What if the entrepreneur cannot lead, delegate, respond to changing threats in the marketplace, or deal with a broader constituency of stakeholders? Investor anxieties are heightened when a key intervening variable, time, is factored into the analysis. Time dominates the technology sector's vernacular like few other variables with phrases such as 'first-mover advantage', 'time-to-market', 'time-to-exit', and 'cycle time' setting its cadence. Viewed as a precious, diminishing resource, time adds speed to the entrepreneurial equation, removing the margins of error and placing a premium on skillful execution. The need for speed further encourages investors to value proven experience over the time needed for inexperienced founders to become experienced. It propels the entire sector to what Garage Venture's Guy Kawasaki calls "a driving thirst for serial rather than cereal entrepreneurs".

Founder Perspective

While Canadian investors may thirst for the sweet nectar of serial entrepreneurs it is the unsweetened cereal entrepreneurs they most often get.

Tempting as it may be to summarily typecast, founders are actually a varied lot. For many, entrepreneurial pursuit is a calling, a gravitational force which defines their very being. It is an existence lived at the edges, with one foot reaching for the stars while the other dangles precariously over a deep precipice. Time is an arbitrary construct for these pursuers of the new and different. For others, entrepreneurial pursuit is opportunity driven, a mercenary endeavor, a shot at independence after a life of corporate servitude. Founders variously seek glory, power, knowledge, financial gain or the simple desire to make a difference. For many founders, the business side of entrepreneurial pursuit must always be secondary to technological innovation, while for others, divining market and customer opportunities will always dominate their considerations. A glorious few value both.

When inexperienced founders extend beyond family and friends to the community of professional investors, it is

junior, silent partners that they seek. It is their business, only they know its pulse, where it is going and how to get it there. Investor interest validates their vision, and strengthens their resolve to marshal it to the goal-line. The transitions which follow determine the fate of the entrepreneur as he or she copes with new expectations, new relationships, and the pressures to adapt while concurrently executing to their ambitious plans. Some succeed, many do not.

For founders, it is a jarring, somewhat surreal realization that the more money invested in their start-up firm, the more investors involved, and the more equity given up, the greater the likelihood that they will be replaced by a professional manager. The phenomenon might even be conceptualized as a U-shaped curve. If the founder's firm grows too slowly they will be replaced and if they grow too fast, it will be expected that such growth will overwhelm or overload the founder's adaptive capabilities, and they will be replaced.

Such a perspective, cynical as it may sound, is far removed from where most founders begin their entrepreneurial journeys.

The Not-So-Trivial Matter of Founders

Though the complexities of the founder syndrome may reinforce the urge to embrace risk management as the safest approach to dealing with it, it is important to keep in mind the inconvenient fact that founders matter, sometimes a great deal. Ask anyone who has spent even a moment contemplating the second acts of such figures as Apple's Stephen Jobs, Nike's Phil Knight or even Magna's Frank Stronach. There is an undeniable 'something' about many of these individuals that is not so easy to categorize or dismiss.

Consider just a few realities as they apply to founders. First, although they may not get it right with their first endeavors, this does not mean that founders won't eventually get it right. While some entrepreneurial endeavors are born of eureka moments, others take form via experimentation and learning. Many entrepreneurs get better and wiser over time, arriving at their most important contributions gradually (this is similar to artists of all types – think of spaghetti western veteran turned Oscar-winning auteur Clint Eastwood as an example). Consider Goldcorp's Ian Telfer. Before starting what has now become the world's sixth largest gold producer, he helmed a firm called VenGold. In the late 90's, reeling from the Bre-X fiasco and low gold prices, the firm struggled to find a formula for survival. Desperate, Mr. Telfer morphed his cash-rich company into a dot com which he named Itemus. Though the new entity pursued numerous market opportunities and business models it suffered the same fate as many technology organizations and went bankrupt in 2001. Undeterred, Mr. Telfer promptly dusted himself off and founded what is now Goldcorp. In a recent interview celebrating his being awarded 'business person of the year', Mr. Telfer credited his success to "kicked-in-the-head experience and visceral instinct".

It could be argued that a founder losing his or her job or company is an important character-building 'kick in the head', a test of their mettle, their resilience, the amplitude of their ambition. While this is true, one must be careful that such a blow does not result in the kind of trauma that leads to a talented person abandoning an entrepreneurial career altogether. To fracture a well-worn phrase, 'what kills you does not make you stronger'. This is not an incidental concern. As someone who is brought in to conduct searches to replace founders, I bear witness to the bitterness, the sense of betrayal, and confusion which characterizes so many founder partings. Some never come back. Equally concerning is the scenario where the entrepreneur, soured yet strengthened by the aforementioned experience, pursues a different path to founding and funding his or her next venture.

Michael Malcolm is the poster boy of this latter scenario. One of Canada's least known yet most successful technology sector entrepreneurs, Dr. Malcolm began his career as a professor of Computer Science at the University of Waterloo. An 'ideas person' who founded several small businesses while growing up, he established Waterloo Microsystems in the 1980s and over the next few years worked to build his first technology company. Looking back, Dr. Malcolm acknowledges that he made many mistakes. Though the firm did not go bankrupt it did not perform as expected and Dr. Malcolm left the firm. Frustrated both by what he did not know about running a successful enterprise and his experience with local investors, he moved to California and over the next few years purposefully sought out work assignments and people to fill-in his knowledge gaps. In the early 1990s he founded his next firm, Network Appliances which he eventually took public and which has a current market capitalization in excess of US $1bb. In 1996, with the financial support of Benchmark Capital and Technology Crossover Ventures, he founded CacheFlow which he also took public. At one point during the tech sector bubble Benchmark's $8mm investment in CacheFlow had increased in value to $539mm. In 2001, Mr. Malcolm left CacheFlow to found his current venture, Kaleidescape, a blossoming media server company which he believes will be his greatest success. Though Mr. Malcolm remains loyal to his Canadian roots by locating Kaleidescape's engineering organization in Waterloo and even staffing it with several former employees of Waterloo Microsystems and Cacheflow, he has never moved back to Canada nor used Canadian venture capital again.

Finally, Ian Telfer's notion of 'visceral instinct' is also an important consideration. Visceral instinct and the confidence to act on it are critical attributes in entrepreneurial pursuit and cannot be easily taught, if at all. Consider a recent article on Sheldon Adelson, titled The Man with the Golden Gut. Mr. Adelson is a proud high school drop-out who has started, by his own count, over 50 businesses. For him, "businesses are like buses. You stand on a corner and if you don't like where the first bus is going, wait ten minutes and take another. Don't like

that one? They'll just keep coming. There's no end to buses and businesses". In the late 1970's, nearing the age of fifty and with a few 'modest' successes to his credit, Mr. Adelson took another bus. While contemplating the fast-growing personal computer sector (in which he had no previous experience) he noticed the emergence of third party sales channels. He likened this distribution model to the automotive industry in an earlier era where no single company had the scale to set up national distribution, resulting in a network of dealers being established across the country. He reasoned there was an opportunity to create a "meeting place" where buyers and sellers from all facets of the industry could converge, interact and conduct business. He launched Comdex in 1979 which went on to become the most prominent technology exposition in the world. The story does not end there however. Though Mr. Adelson would eventually sell Comdex for $862 million it is actually another visceral instinct which better defines him. Mr. Adelson held Comdex in Las Vegas. At that time, the gambling Mecca catered exclusively to high rollers and weekend tourists. Mr. Adelson foresaw that there was far greater potential in filling Las Vegas with 'suits' Monday to Friday followed by leisure travelers/gamblers on weekends. Buoyed by Comdex's success he began to buy convention centers and subsequently casinos. Mr. Adelson is now one of the largest and most profitable casino owner/operators in the world.

The value of instinct, vision or 'gut feel' is integral to the entrepreneur. It is a source of true differentiation among the throngs of disruptive entrepreneurial pretenders. It is also particularly difficult to institutionalize in a company and thus, whoever has 'it', however idiosyncratic that person may be, is often integral to a firm's longer-term sustainability. This is why firms crafted by some of the best known entrepreneurial oracles have cult-like characteristics. In a recent article pondering the succession challenges of individuals such as Steven Jobs, Phil Knight, and Larry Ellison, a Harvard professor quipped that, "the difference between a cult and a religion is that only one outlives its founder".

In today's investment climate, firms are funded with the objective of exploiting their current technologies and the narrow windows of market opportunities they address. Entrepreneurs are evaluated on their ability to exploit the opportunities perceived to exist at a specific intersection of time and space. This is a short-term gambit sometimes with unintended consequences. Consider the last tech sector meltdown when scores of entrepreneurs were discarded in favor of fiscally savvy managers better-skilled at riding-out the economic storms which faced them. The pursuit of new ideas, products, and even markets were luxury items better left to the future, assuming one was to be had at all. Scores of CFOs became CEOs during this period and helmed firms as notable as Nortel. While the logic of those moves was unassailable under the circumstances, the decisions around releasing so many of the founders was not, as many firms emerged from the dark recessionary tunnels bereft of compelling visions and ideas for their futures. While many have attempted to acquire that vision by retaining firms like ours to recruit marketing or technology gurus, in many cases, the professionals they bought are but distant cousins to the entrepreneurial visionaries they discarded.

Conclusion

Peter Drucker once said that building a better tomorrow requires becoming the enemy of today. It was not the objective of the article to simply find fault with a very complex founder-investor ecosystem. Nor was its purpose to build a fanciful case for the endless coddling and nursing of founders. Performance matters and founders must be held accountable for the commitments they make to their shareholders. Furthermore, some founders will not, cannot and simply should not remain at the helms of their organizations. Many are better redeployed while others simply 'retired'. However, for the great many founders whose high potential future stories have yet to be written, the question of how best to harness and develop that potential, for both short and longer term benefit, is very important as is a regular assessment of how effective current assumptions and practices are in achieving those goals.

In Part II we will discuss elements of an alternative way forward.

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