

**FOUNDER/CEO TURNOVER: A SOCIAL CAPITAL APPROACH TOWARD
REDUCING THE PERFORMANCE IMPACTS IN ENTREPRENEURIAL
STARTUPS**

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ABSTRACT

CEO succession is a significant event for all business organizations. However, such activities can be more disruptive for entrepreneurial startups due to the critical role Founder/CEOs play in the organization and the relatively fragile state of a new venture. A social capital perspective suggests that the ability of the firm to perform might be conditional upon the efforts made at increasing the social capital within the organization. This study examines the impact upon performance of Founder/CEO turnover and the offsetting social capital developed within the firm.

There has been a wide variety of research that has examined the impact of the departure of a CEO on firm performance (Begley, 1995, Daily & Dalton, 1992, Jayaraman, Khorana, Nelling & Covin, 2000, Wilard, Krueger & Feeser, 1992). Unfortunately, the evidence from these various streams of research has not provided a consistent set of findings (Jayaraman, e. al., 2000). Entrepreneurial startups present the opportunity to examine a setting where the performance impact of CEO turnover may be particularly dramatic. New ventures offer such insights as these organizations would appear to be more dependent on the Founder. The role of a Founder/CEO in a new venture setting is critical not only for their leadership but also for the web of relationships which they build. It is this ability to develop relationships that help a new firm overcome a liability of newness (Freeman, Carroll, & Hannan, 1983; Li & Guisinger, 1991). Therefore as a setting, the examination of entrepreneurial startups offers the potential to provide fresh clarity on the overall impact of CEO turnover.

The potential loss of a Founder/CEO would suggest that a priori there could be actions that would protect the new firm. The actual loss of a Founder/CEO has organizational impacts that should cause an entrepreneurial firm to address the loss of social capital associated with that individual. We would expect, *ceteris paribus*, that those organizations that can overcome the loss of social capital will outperform those firms that are unable to recover that social capital. However, we might also expect that those firms who are able to retain their Founder/CEO would outperform, at least in the short run, those firms that are forced to deal with a CEO transition easily in their company's life.

This study examines the means available to the organization to offset the loss of social capital associated with the loss of the Founder/CEO. While it has been implied

that organizations can replace social capital, the loss of the Founder/CEO appears to be a unique blow to the organization. This manuscript will examine the actions available (both a priori and ex post) to offset the loss of social capital. Potential mitigating factors might include: 1) efforts to keep the Founder/CEO in place for the first three years of the company's life; 2) efforts to prevent multiple CEO changes during the early years of existence; 3) increasing the size of the management team; and 4) ensuring the presence of founding teams that extend beyond the Founder/CEO. These individuals can provide the organization additional social capital connections and may be able to offset the social capital loss when the Founder/CEO leaves.

We hope that this study will make three contributions to the literature. First, the manuscript extends the application of social capital by examining the means to replace social capital. The manuscript also provides fresh insight to the understanding of how organizations overcome the loss of a CEO by examining the topic from a social capital perspective, a perspective not previously employed. Finally, we hope that this manuscript provides fresh insight into entrepreneurial organizations and how they survive their initial years of newness (Stinchcombe, 1965).

THEORY

Social Capital and New Ventures

Although multiple definitions exist, we suggest that social capital is the degree to which an organization has relationships that allow it to collaborate and cooperate (through such mechanisms as networks, shared trust, norms and values) to achieve

mutual benefits (Putnam, 2000). Social capital can be a unique resource for the new venture.

That resources such as social capital are critical to the firm has gained increasing prominence in recent years (Florian, Lubatkin, & Schulze, 2003; Tsai & Ghoshal, 1998; Yli-Renko, Autio, & Sapienza, 2001). Specifically, an argument suggests that if the firm can develop resources (be they tangible or intangible) that are immobile, valuable, rare, inimitable, and non-substitutable they could lead to a rent-generating competitive advantage (Barney, 1991, Conner, 1991). Social capital would appear to have the potential to be a particularly powerful means to develop competitive advantage for the firm. Social capital is considered an intangible asset, in other words it does not have a physical presence. Other intangible assets would include the firm's brand image, culture, knowledge, as well as expertise held by the firm. Such assets are much more difficult to observe, replicate or substitute and thus have a greater potential to provide a competitive advantage.

Contrast intangible assets to the tangible resources such financial assets, capital assets, and land. Such resources have some physical presence and are acquired in the marketplace generally at or above market prices and in the full view of the competition. It is possible that tangible assets such as a unique location or a previously unknown source of capital could provide the new venture with the potential for economic rents, however, due to the nature of their acquisition, tangible assets do not commonly provide this type of opportunity to the new venture.

Therefore, intangible assets such as social capital would appear to have a greater potential to create a competitive advantage for the firm. This advantage is particularly

important for the pre-startup and initial founding period of the firm (Kogut and Zander, 1988; Nahapiet and Ghoshal, 1998; Schendel, 1996; Spender, 1996; Liebeskind, 1996). These assets include the social capital possessed by the firm (Nahapiet & Ghoshal, 1998). The social capital of an entrepreneurial venture may be either from the relationships and connections internal to the firm (Bolino, Turnley, & Bloodgood, 2002) or the relationships and connections external to the firm (Koka & Prescott, 2002). These relationships and connections can be developed by individuals prior to coming to the entrepreneurial startup or developed during the existence of the entrepreneurial venture (Hansen, 1995).

New ventures have a greater propensity to fail than do mature firms, in part, since they do not have well-established relationships and connections nor standardized efficient routines (Stinchcombe, 1965). Relationships and connections of individuals in the entrepreneurial startup are critical to helping to create and support these routines. The absence of relationships and routines has been recognized as resulting in a “liability of newness” for startup firms (Freeman, Carroll, & Hannan, 1983; Li & Guisinger, 1991). Thus, we believe that the social capital of the firm is an important part of the survival of the new entrepreneurial venture.

Development of Social Capital in the Entrepreneurial Ventures

One of the key sources of social capital for the firm is the Founder/CEO. This individual embodies the visible relationships and connections that form the basis of the new venture. Studies have suggested that investors bet on these individuals as often as they bet on an idea (Douglas & Shepherd, 2002). Additionally, in their role as CEO they will develop other relationships and connections as the spokesperson for the company.

However, the founder/CEO typically does not begin the firm by themselves; rather that person is part of a team (Ensley, Carland & Carland, 2000). The founding team is recognized for bringing resources to entrepreneurial startups (Bruton & Rubanik, 2002). These resources are critical to the firm and its' survival and there is some evidence that larger teams have the ability mitigate the liability of newness (Eisenhardt & Bourgeois, 1988; Eisenhardt & Schoonhoven, 1990). Although not specifically examined, the value of larger teams may lie in the fact that the larger team brings the individual team members' specific relationships and connections to the startup (Bruton & Rubanik, 2002). The impact upon the organization is potentially amplified with new ventures as their knowledge, planning and ability to evaluate the environment is more concentrated in fewer people in the organization (Baysinger & Hoskisson, 1990).

Therefore, in visualizing the range of individuals critical to the startup, researchers should not restrict their investigation to the Founder/CEO. It would seem quite logical that it would also include the top management team. Each unique member of the top management team brings their unique social capital to the new venture aiding not only the new venture's potential legitimacy but also providing additional communication channels within the organization (Florin, Lubatkin & Schulze, 2003; Sparrowe, Liden, Wayne, & Kraimer, 2001).

Social Capital and the Top Management Team

The loss of a CEO leaves an organization with a hole to fill in its internal and external organizational relationships (Kesner & Sebor, 1994). The loss of social capital would appear to be compounded when the CEO is also a founder of the firm and the firm

is in its formative years. Social capital theory would argue that this loss of social capital would have a negative impact on the firm and there has been some strong evidence of the negative impacts to performance of CEO turnover in older organizations (Dahya, McConnell, & Travlos, 2002). Florin, et.al. (2003:375) suggest that “superior human resources enhance a venture’s ability to attain, sustain, and even enhance its competitive advantage...” Therefore, it is hypothesized that:

Hypothesis 1: Turnover in the Founder/CEO has a negative impact upon the Performance of the firm.

We would go on to suggest that firms that suffer repeated replacement of the CEO in their formative years are continuously prevented from developing an effective base of social capital. A punctuated-equilibrium approach would suggest that such rapid changes would prevent the firm from developing structures that were essential to success. Furthermore, strategic change researchers have warned about the negative impact of repeated strategic change (Bamford, Rogers & Miller, 1999; Ginsberg, 1988; Hannan & Freeman, 1984). The new venture would never have the opportunity to establish the social capital necessary for sustained success. Therefore, we suggest:

Hypothesis 2: Firms in which the Founder/CEO remains for at least the first three years will outperform those that lose their Founder/CEO during the first three years.

Hypothesis 3: Repeated Turnover in the CEO position has a negative impact upon the performance of the firm.

Social capital theory suggests that firms might have the ability to recognize the potential for the loss of significant human capital and respond by actively seeking to fill the void (Florin, Lubatkin & Schulze, 2003; Sparrowe, Liden, Wayne, & Kraimer,

2001). For example, a Founder/CEO may have had relationships with key external constituents such as a key customer group. Those key relationships will be lost when the CEO leaves unless the startup has established individuals within the top management team as credible contacts with this connection. The new CEO will likely replace some of that lost social capital but social capital is not determined strictly by time. It is both possible and practical to hire individuals in other positions that have key relationships with the same constituent group contact lost when the CEO left or have relationships with another individual or group that will fill the same function. Therefore, we might expect that the startup firm will look for an individual or individuals who bring relationships with key constituent groups. The firm in fact may have to hire multiple individuals in the top management team to equate to all of the social capital possessed by a CEO that leaves the organization. The resulting social capital should moderate the negative performance effect of the loss of the Founder/CEO on the entrepreneurial firm's performance. Therefore, in terms of the top management team we suggest:

Hypothesis 4: The presence of at least one additional individual (beyond the CEO) in the TMT at founding will positively moderate the relationship between CEO turnover and the performance of the firm.

Hypothesis 5: The TMT size will positively moderate the relationship between CEO turnover and the performance of the firm.

METHODOLOGY

Data

The above hypotheses are examined using a database of all new banks formed in the United States (U.S.) between 1996 and 2000. This industry was chosen since bank formations provide researchers an opportunity to obtain high-quality secondary data at

the point of firm formation as well as the large number of new firms formed each year in a single industry. Banks, while regulated at the most basic operational level (checking/savings account), are given wide strategic latitude within the context of their industry. It is often difficult to establish the specific date in which a startup firm begins operations. However, the date of inception for banks is clear as regulations require that all banks be chartered prior to beginning operations. Additionally, limiting the investigation to a single industry also helps to increase the reliability of the investigation by limiting the impact of extraneous variables.

The prior research in this area has typically relied on evidence from older firms where the impacts of founding may no longer be of importance (Bamford, Dean & Douglas, 2004; Cooper & Gimeno-Gascon, 1992; Low & MacMillan, 1988). Indeed, empirical entrepreneurship research efforts have typically regarded firms up to eight years old as “new” ventures (Biggadike, 1979; McDougall, Covin, Robinson, & Herron, 1994). Research evidence (Jayaraman, Khorana, and Covin, 2000) has suggested that as the distance from founding increases, the impact on the organization of changes in top management decreases. Thus, this study sought to examine startup firms from the point of founding.

Data on new bank formations was gathered from the Sheshunoff BankSearch Database. Using data provided by Sheshunoff we identified the population of bank formations in the period from 1996 to 2000. Of these, we excluded subsidiaries of other banks or bank holding companies since they were not independent ventures. Also excluded were trust banks and credit card banks as these are established with unique missions and are not generally comparable to commercial banks. This yielded a sample

of 901 firms, of which we had full data on the CEO, top management team and performance for 798 firms.

Measures

CEO/Founder Change. The founding CEO is identified in the data provided by the Sheshunoff BankSearch Database and the CEO is further reported each year that the business remains in operation. A change was recorded as 0 for no change and a 1 if there was a change when the CEO left the organization. Multiple changes in subsequent CEO's were recorded as a separate data item

TMT. The number of unique members of the top management team were recorded for each year. The average number of TMT during the study period was recorded. The CEO was removed from this calculation.

TMT at Founding. The presence of at one unique member of top management in addition to the Founder/CEO was recorded as a dichotomous variable.

Controls. To control for the size of the firm we included: Average Assets at the time of Founding and a set of dummy variables for the year of formation (1996- 2000).

Performance. The average Net Interest Margin (NIM) was used as a standard performance measure of effective management in banking (Lindley, Verbrugge, McNulty, & Gup, 1992). Following extant research, we assumed a lag impact to performance and measured NIM two years after a Founder/CEO exit event or in Year 7 if no Founder/CEO exit occurred for that firm. There were no significant differences found in a year to year analysis of NIM.

RESULTS

Summary statistics and the correlation matrix for all variables are presented in Table 1. All variables were within the bounds of normal distribution.

Insert Table 1 about here

Hypothesis 1 suggested that having the Founder/CEO leave the firm would negatively impact the performance of the firm. Table 2 shows that this hypothesis was supported.

Insert Table 2 about here

Hypothesis 2 suggested that retaining the Founder/CEO for at least the first three years of the firm's existence would improve the performance of the venture relative to other firms that suffered a Founder/CEO turnover event. That hypothesis was supported.

Hypothesis 3 stated that repeated turnover in the CEO position would have a negative impact upon performance in the new firm. Table 2 shows that this was supported as well.

Hypothesis 4 suggested that the presence of at least one additional member of the Top Management Team in addition to the Founder/CEO would moderate the relationship between a Founder/CEO exit event and performance. This was not supported.

Finally, hypothesis 5 suggested that as the average size of the TMT rose, that this would also moderate the relationship between Founder/CEO turnover and the performance of the firm. This hypothesis was supported.

DISCUSSION

Prior research, while somewhat inconsistent, has not found a significant performance impact with CEO turnover. This has been especially true as firms' age. This is not as surprising a result from a social capital perspective as the theory would suggest that as firms age that the social capital of the organization would embed and disperse within the organization. The social capital loss of a Founder/CEO can be offset by the stability of other members in the TMT, legitimacy in the market, administrative history in the industry, and accumulated goodwill. Thus, beyond some impact from industry effects and/or small personal ability differences in a sufficiently sized sample there would be virtually no impact from the loss of a Founder/CEO or subsequent CEO exit event. This situation is quite different when we examine new ventures from the point of founding. Embedded within the Founder/CEO *is* much of the social capital of the organization. Indeed we found in this study that the loss of the Founder/CEO is strongly related with a performance loss for the firm. This situation appears to be effectively moderated with the addition of individuals in the top management team. As the number of individuals increases the ability of the new venture to maintain its performance also increases. Although we also expected that presence of at least one member of the top management team would also moderate the performance loss in the event of a Founder/CEO exit event, we found no significant findings.

Furthermore, we felt that the social capital of the new firm would be negatively impacted by repeated turnover in the CEO position. Indeed we find this situation to be true within our sample. This examination finds support for the observation that the social capital perspective is potentially valuable in explaining performance results from changes

in the Founder/CEO and TMT of a new firm. There is also evidence that the social capital perspective will provide an effective framework that might shed light on the question of the impact of the changes in CEO or Founder/CEOs of firms in new ventures.

We would suggest that the next step would be an examination of how firms react to the loss of social capital. Thus, richer examinations that employ qualitative methodologies that allow for the classification of the social capital of the Founder/CEO and the top management team would be valuable. This type of rich in-depth analysis will require a longitudinal investigation.

Anecdotal evidence suggests that entrepreneurial startups are clearly aware of their intangible assets including their social capital and seek to manage that intangible asset. Thus, as research on entrepreneurial startups progress, an area of potential insight appears to be in the management of intangible assets such as reputation and culture of the firm. It is these factors that may ultimately lead to the most defensible strategic advantage and the entrepreneurial startups seem keenly aware of this fact.

The evidence presented here suggests that social capital has the potential to provide insight into the analysis of entrepreneurial settings. Future research should continue to build on these findings and employ this theoretical lens to a greater extent. Particularly, it is hoped that this exploratory research can lay the ground work for the in-depth rich investigation of social capital and how it is impacted by the change in the CEO of the entrepreneurial startup.

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TABLE 1
Summary Statistics and Correlations

Variable	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11
1 Net Interest Margin	3.69	1.73	1.000										
2 CEO Change	0.31	0.46	-.135**	1.000									
3 Multiple CEO Changes	0.38	0.64	-.094**	.894	1.000								
4 # of Officers - Average	1.88	0.99	.058	.065	.074*	1.000							
5 Presence of Officers - At Found	0.54	0.51	-.044	.088*	.080*	.481***	1.000						
6 Assets at Founding	\$55,357	\$407,413	.002	-.001	-.003	-.069*	-.061	1.000					
7 Year of Formation - 1996	0.14	0.35	-.017	.157**	.221**	-.053	.142**	-.017	1.000				
8 Year of Formation - 1997	0.17	0.37	-.046	.179**	.141**	.028	-.067*	.014	-.183**	1.000			
9 Year of Formation - 1998	0.2	0.41	.086*	-.006	-.015	.088**	-.019	-.013	-.205**	-.228**	1.000		
10 Year of Formation - 1999	0.26	0.44	-.028	-.126**	-.121**	.006	-.023	-.010	-.244**	-.270**	-.303**	1.000	
11 Year of Formation - 2000	0.22	0.41	.002	-.127**	-.138**	-.073*	-.006	.025	-.217**	-.240**	-.269**	-.320**	1.000

t p < .10
 * p < .05
 ** p < .01
 *** p < .001

TABLE 2
Results of Regression Analyses

		Model 1		Model 2		Model 3		Model 4		Model 5		
		<i>B</i>	s.e.	<i>B</i>	s.e.	<i>B</i>	s.e.	<i>B</i>	s.e.	<i>B</i>	s.e.	
Founder/CEO Leaves												
Organiz.		-.129	***	.13								
Assets at Founding		.006		.00								
Formation Year - 1996		.008		.22								
Formation Year - 1997		-.002		.19								
Formation Year - 1998		.105	**	.17								
Formation Year - 2000		.019		.17								
CEO Leaves After 3 Years				.046	.39							
Assets at Founding				.006	.00							
Formation Year - 1996				-.005	.51							
Formation Year - 1997				.162	.49							
Formation Year - 1998				.046	*	.5						
Formation Year - 2000				.125	.62							
Multiple CEO Changes						-0.087	**	0.10				
Assets at Founding						0.005		0.00				
Formation Year - 1996						0.007		0.22				
Formation Year - 1997						-0.015		0.19				
Formation Year - 1998						0.101	**	0.17				
Formation Year - 2000						0.019		0.17				
Founder/CEO Exit								-0.126	***	0.13		
Additional Officer at												
Founding								-0.028		0.12		
Assets at Founding								0.005		0.00		
Formation Year - 1996								0.009		0.22		
Formation Year - 1997								-0.003		0.19		
Formation Year - 1998								0.105	**	0.17		
Formation Year - 2000								0.021		0.17		
Founder/CEO Exit										-0.13	***	0.13
Average Number of Officers										0.072	*	0.06
Assets at Founding										0.009		0.00
Formation Year - 1996										-0		0.22
Formation Year - 1997										-0.01		0.19
Formation Year - 1998										0.098	**	0.17
Formation Year - 2000										0.023		0.17
Overall	F	3.726	***	1.158		2.519	**	3.272	***	3.789	***	
	N	800		251		801		798		800		
Adjusted	R ²	.02		.004		0.011		0.02		0.024		

Standardized regression coefficients are reported

*P<.05

**P< .01

***P< .001