Founder-Led Companies

A growing number of companies are led by founders, and we believe for good reason.[1] According to Schroders, seven percent of globally listed public companies with market capitalizations over $500 million are still run by their founders.[2] The trend is even more pronounced with newer public companies. Among globally listed IPOs over the past five years, 30% are led by their founders.[3]

We believe, over time, founder-led businesses on average have outperformed public companies in a variety of ways, as illustrated below.

Founder-Led Public Firms: By the Numbers

Quantitatively and qualitatively, we have found clear evidence over the years to convince us that founder-led public companies outperform other public companies:

- A 2010 study performed by Joel Shulman of Babson College and published in the *Journal of Risk and Financial Management* found that the equity performance of founder-led public companies significantly outperformed benchmarks from 1998 to 2010. The study also found that founder-led businesses dominated their peers in risk and return metrics, including rate of return, sharpe ratio, sortino ratio, alpha, active premium, information ratio, and up capture ratio.[4]
- In 2006, 26 Fortune 500 companies boasted founder-CEOs. The stocks of these 26 companies returned an average of 18.5% percent annually from 1995 to 2005. Their profit growth was also superior, increasing an average of 19.6% percent, vs. 11.7% for the Fortune 500.[5]
- A 2007 study concluded, "An equal-weighted strategy that invested in firms where the founder served as CEO from 1993 to 2002 earned an abnormal return of 4.4% annually in excess of the market."[6]
- In 2009, Fortune's editorial staff considered 12 candidates as best CEOs of the decade, and "not a single one of the 12 was hired to run a company by its board of directors." In other words, they were what we consider founders.[7]
- Founder-led companies on average have grown revenue faster than their peers over the last five years,[8] and have 31% more patents.[9]
- A 2010 University of Pennsylvania study showed that small cap company founder CEOs consistently beat professional CEOs on a broad range of metrics, including return on investment.[10]
- Finally, in one of the most comprehensive studies on the subject, Bain and Company found that over a 25-year period from 1990 to 2014, founder-led public companies performed four times better than all other public companies over that time period.[11]

Why Do Founder CEOs Outperform?

A number of theories have attempted to explain founder-led company outperformance. From our perspective, we think the following 11 aspects make the most sense:

1. The Founder's Mentality

In his book *The Founder's Mentality*, Chris Zook of Bain and Company identified three key elements that distinguish founder-led firms.

- **An extraordinary sense of insurgency**. According to Zook, founders are very clear about the "big why" of their companies' purpose—and the company is at war with the industry on behalf of underserved customers.
- **A frontline obsession.** Zook says founders are so committed to developing customer loyalty and advocacy that they empower frontline employees with the authority to solve problems and invent better solutions and products.
- **An owner's mindset**, which includes an aversion to bureaucracy, a bias for action, and a strong cash focus.[12]

2. Better-Aligned Management Incentives

We believe founder CEOs almost always own a large amount of equity in the business. Typically, the net worth of a founder is closely bound up with the companies they create. With their own wealth at risk, they have extra motivation to make the business succeed. A UVA study suggests CEOs with high insider equity ownership outperform managers with little to no inside ownership,[13] while a Stanford Business School analysis found that high CEO equity ownership delivers superior stock market returns.[14]

Because of the large ownership stakes, we believe founders tend to think of what is best long term for a business. Founder and investor Travis Wiedower offers an interesting take on this. He notes that professional CEOs tend to own far less stock than founders do. They can be fired at any moment, and their average tenure is only eight years. As a result, they have more reason to focus on next year's bonus than the company's performance 20 years from now. By contrast, a founder CEO with a large equity stake typically has greater incentive to plan for the long term, as well as more job security to ensure they stay around to enjoy it. Wiedower finds that founder-led companies spend more money investing in the future through R&D and patents than companies run by professional or "agent" CEOs.[15]

3. Top-Down Culture

In our opinion, starting and growing a company from nothing to a $10 or $20 million dollar business is a feat in and of itself. We believe founders are accustomed to wearing multiple hats, are likely good at a variety of tasks, and generally go the extra mile for customers based on these roots.[16] This culture naturally imbues down, and has been termed the "founders touch".[17] This effect can promote a culture of flexibility, long-term thinking, innovation, commitment to customers, and employee loyalty.

4. Irreplaceable Knowledge and Moral Authority

No one knows a company better than its founder, according to Ben Horowitz of Andreessen Horowitz. Founders are the ones who identified the original market opportunity, innovated a new solution, discovered competitors' strengths and weaknesses, and have personal knowledge of every employee hired, every product made, every customer won. In Horowitz's view, this "pyramid of knowledge" is impossible to replicate, and serves as the foundation for new innovations going forward.

Founders also have the moral authority to make major changes when necessary. They know the business better than anyone else does. Moreover, since they originally made the decisions that shaped the company, stakeholders trust them to overturn those decisions when the time comes.[18]

5. Purpose and Long-Term Commitment

In our opinion, there are profound differences in the perspectives of professional CEOs and founder CEOs. We think professional CEOs tend to be primarily motivated by job-related rewards, such as compensation, reputation, career advancement, and job security, which can be measured and doled out on fairly short-term time scales. By contrast, for many founder CEOs, their company may be their life's work, with their emotional commitment exceeding their equity stake many times over. We believe they often seek to build something of significance and purpose, and they naturally take a long-term view of their companies. It is our opinion that these different perspectives drive significant differences in the way these two types of leaders run their companies.

6. Pride

According to Rudiger Fahlenbrach of Ohio State, pride can affect executive behavior, leading to a difference in performance that in turn leads to more motivated, more loyal, and harder-working employees. As Fahlenbrach notes, "A founder walks into his company's headquarters, and it may be his name that is above the door. Not only is that motivating for the founder, but it may be motivating for employees as well. They may be very happy to be working for a visionary in their industry, and that makes them work a little harder."[19]

7. Social Capital

Company founders build up a storehouse of social capital by creating a company and providing jobs and a sense of purpose for their employees. As a result, they may have an easier time inspiring and leading the organization, which lead to better products, happier customers, and smarter decision making throughout the company.[20]

8. Frugality

We believe there is a fundamental psychological difference in the way agent CEOs and founder CEOs look at spending. To a professional manager, a budget is a budget; to a founder, a budget feels like personal money. Founders learn frugality during the early days of the business, and retain that attitude even after their companies become large businesses.[21] The result can be closer attention to the bottom line, greater reinvestment in the long-term, and less temptation to fritter away cash on flashy acquisitions.[22]

9. Healthy Paranoia

Founders tend to have a healthy paranoia about their business. They understand their company's strengths, but because they are so protective of their creation, they rarely downplay the risks of being disrupted. This paranoia drives them to stay on top of emerging industry trends and constantly rebuild their competitive defenses, so their business can remain sustainable in the long run.[23]

10. Smarter Capital Allocation Decisions

Management's job is to run the day-to-day business and make careful decisions on capital allocations. With profits, there are five ways they can allocate it. They can re-invest in the business, acquire another company, pay down debt, pay out a dividend, or buy back their own stock. In our opinion, hired management has more of an incentive to boost short-term profits to receive bonuses, even if it may be problematic or downright disastrous in the long run. We believe founders tend to take a longer-term view when it comes to capital allocation, as they spent so much time building the business, do not want to ruin it for short-term reasons, and want a prosperous future.

11. Innovation

Founder CEOs innovate from day one when they start their businesses, and we think the evidence suggests that their instinct to innovate persists. Founder CEOs tend to invest more in R&D than non-founder CEOs, which inherently leads to increased spending in the short term, but greater sustainability in the long term.[24]

Not All Founders Are Created Equal

Although it is clear founders as a whole tend to outperform the broad market, one can do better picking the best of the founder-led companies, versus passively investing in the group as a whole. As Warren Buffett famously said, "When a management with a reputation for brilliance tackles a business with a reputation for bad economics, it is the reputation of the business that remains intact." Thus, we believe it is important to take into consideration industry margins, competitive products/services, etc.

Further, we feel it is important to: 1) look at the founder's long-term track record; 2) look for a strong business model with clear long-term competitive advantages; and 3) carefully assess the price of the business, as price always matters. In our opinion, a wonderful business, run by a founder CEO with a long track record of compounding the business value, at a great price, is the trifecta.

What We Have Found

Anchor Capital has found that many of the best businesses we have historically invested in have been founder-led, have had strong long-term track records, and were selling at attractive prices. Anchor Capital has started Founders Value with internal capital in order to invest in a concentrated portfolio of attractively priced founder-led businesses that have had a long history of compounding earnings, cash flows, and book value, and have the ability to continue to do so in the long run. Over the long run, we believe that this portfolio of businesses will outperform both their peers, and the broad market.

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ANCHOR CAPITAL ADVISORS LLC
One Post Office Square
Boston, MA 02109-2103

telephone 617.338.3800
facsimile 617.426.6871
email info@anchorcapital.com

ANCHORCAPITAL.COM