CEO EVOLUTION:
Knowing When and How to Transition Founder Leadership to Growth Leadership

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EXECUTIVE SUMMARY

Startup founders typically have deep passion for the companies they have launched. They usually have committed significant time, talents, and money to their entrepreneurial ventures and are heavily invested in the dream of leading the company to long-term business success.

Research and my own personal experience, however, have shown that only a small percentage of founder-CEOs have the skills and experience needed to ensure company growth and shareholder value beyond a startup's early stage. As a venture begins achieving a solid foothold in the marketplace, it needs different leadership capabilities—among them tighter integration, coordination, and team structure—than were required when the company was established.

Founder-CEOs commonly have a hard time asking themselves if their talents are best suited to lead their companies forward into the next stage of growth, and an even harder time admitting that it might be time to transition to new leadership. But this introspection and the ability to let go are critical if a maturing company is to continue creating maximum shareholder value.

Once the decision has been made to hire a new CEO, the founder-CEO and the board should work together closely to plan strategically for the transition. Generally, six months of transition time is ideal. During this period, the founder-CEO can determine whether he or she should maintain some continuing role in the company or transition out entirely.

There are seven key steps for successfully managing the transition from the founder-CEO to new leadership:

- Determine the next-level strategy and the CEO skill sets and experiences needed to scale the company. The right replacement CEO will complement the existing team's skill sets and experiences and be able to scale the company through its next stages of growth.

- Select the CEO for leadership, interpersonal skills, and a knack for creating a supportive culture of collaboration. Because the new CEO will be charged with leading the startup to strong and sustainable approach, he or she should have a proven ability to create value or clear business acumen that allows for flawless, strategic execution of the business model.

- Break away from the past. As a company grows, its management team skills also need to evolve. The board and founder-CEO should evaluate whether any team members have become resistant to change and then make the hard decisions about whether or not these individuals should be part of the company's future.

- Facilitate close connections between the founder, the new CEO, and the team. In many startups, teams are loosely structured. As part of the transition, these "tribes" need to become a single, cohesive team that works across multiple functions.

- Transfer knowledge. To avoid creating a knowledge vacuum for the new CEO—and the confusion that comes with it—relevant company knowledge should be captured and transferred.

- Minimize the handover period. Ideally, the handover to the new CEO should last about two weeks.

- Define the strategic significance of the transition and keep communication channels open. A successful transition relies on transparency and real engagement so the internal team understands the new CEO's strategy for taking the company to the next level.

INTRODUCTION

Many founders dream not only of building and running the next breakthrough company, but also of staying with the startup throughout the entire growth cycle. They aspire to become the next founder-CEO celebrities who have made it in Silicon Valley or in one of America's other entrepreneurial hotspots. When it comes to examples of successful startup ventures growing into titans helmed by founder-CEOs, Bill Gates, Larry Ellison, and the late Steve Jobs often come to mind. While these founder-CEOs have become the poster children for tremendous, long-term entrepreneurial leadership success, research suggests that they are the exception, rather than the rule.

Before we delve into the intricacies of this subject matter, let me mention two assumptions governing this paper:

- First, the focus of this article is on founder-CEOs of companies that have raised capital from venture capitalists, angel investors, and strategic partners. Smaller companies that are either self-funded or funded primarily by family are excluded.

- Second, of primary interest to this paper are companies that create maximum shareholder value in which, presumably, growth and profitability are the paramount criteria. Many lifestyle or small businesses generate modest results, even if they are not run with optimum efficiency. Therefore, they will not be included in this discussion. The companies in question are judged by the following criteria: return on investments, capital raised, time to exit, and exit valuations.

Research conducted by Noam Wasserman at Harvard Business School, who examined responses submitted by 10,000 founder-CEOs from more than 3,000 U.S. startups, found the following patterns:[1]

- It was rare for founder-CEOs to run their companies in the long term. In fact, less than half retain their CEO titles after three years. Less than 25 percent of the CEOs who saw a successful exit strategy resulting in an IPO were founder-CEOs.[2]
- When a founder-CEO stepped down, the value of a company's equity increased.

Interestingly, these numbers suggest that the classic wisdom that a founder-CEO is the best candidate to run and turn a startup from zero to hero is the exception rather than the rule.

As someone who has served as an independent director of startups and has helped these companies become profitable ventures, my own experiences have borne out the veracity of the research findings. For instance, I worked with an interesting health care

[1] Wasserman, Noam. "The Founder's Dilemma." *Harvard Business Review*, February 1, 2008. Web. March 28, 2015.
[2] Wasserman, Noam. "Rich Versus King: The Entrepreneur's Dilemma." Harvard Business School (2006): 1–7. Web.

company that was developing a promising first-generation technology solution. Within a year, it became obvious to me that the founder-CEO did not have the relevant experience and expertise to lead and scale the company. I, along with the other board members, quickly recognized that to realize the potential of this company, we would have to change our tack and identify a CEO that possessed a deeper knowledge of the market with experience in closing deals. Sensing the change in dynamics, the founder-CEO refused to give up control and, instead, took pre-emptive action. Just a few months ago, using his controlling equity stake, he replaced two board members, strengthening his control of the board by appointing his wife and an individual who resides in a far-distant country to fill the two vacant seats. While he was no longer at risk of being deposed by his board, the challenges facing the company—i.e., inability to be accountable for closing deals, growing, and scaling—remained.

It's important to recognize that this founder's resistance is not an anomaly. Across many early-stage companies, this type of scenario occurs frequently. According to Wasserman's study, almost 80 percent of founder-CEOs are reluctant to give up control over their companies.[3] In the sections below, I'll explore the factors that motivate founder-CEOs and provide some ideas for working with them.

UNDERSTANDING THE FOUNDER'S DILEMMA

At the crux of the matter, a founder's resistance to change is simply due to his inability to let go and accept that he is no longer the right person for the job. While a founder's passion is vital to take the leap of faith to start a company, passion can be lethal if it is not kept in check and complemented by relevant skills and experiences. These natural predispositions can lead founders to view situations through rose-colored lenses. They often overestimate their own chances of success and have excessive attachment to their ideas, abilities, and knowledge. Likewise, they often underestimate their competitors, don't fully understand the resource requirements, and fail to anticipate and plan for emergencies.

A study conducted by a Purdue University strategy scholar, Arnold Cooper, and his two colleagues offers an important clue. A group of 3,000 entrepreneurs were surveyed in 1988 and were asked the following questions:[4]

- Asked what they thought were the chances of their businesses succeeding, the respondents asserted that they had an 81 percent chance at success.
- In a follow-up question that asked these founders to estimate the odds of success for a business to similar to theirs, they claimed such a business would have only a 59 percent chance of success, clearly indicating the inherent founders' bias.

Many founders wrestle with this internal conflict. It's understandably difficult to give up control of a project the founder has spent time and energy building. But a smart founder,

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[3] Wasserman, Noam. "The Founder's Dilemma." *Harvard Business Review*, February 1, 2008. Web. March 28, 2015.

[4] Cooper, Arnold C. "New Business in America. The Firms and Their Owners." (1990): n. pag. Web.

one who is concerned about optimizing the future prospects and value of his company, understands that there must be a trade-off between creating market value and preserving control over the company. Unfortunately, many founders don't realize that these decisions are not mutually exclusive, and trying to realize both objectives usually results in achieving neither.

To appreciate this phenomenon, it is crucial to understand the complexities of the founder's role throughout the development stages of a startup:

- *Early-stage:* In the beginning, a startup's growth is tied closely to the founder-CEO, who is usually at the center of decision making and integrating the different pieces of the business model. The CEO may act as an ad hoc dictator, operating without industrial-strength or definitive processes and structures. He or she often relies significantly on this deep intuitive understanding of the industry and the company's vision and opportunity. Operations and decision-making are fluid and dynamic as founder-CEOs learn how real-world implications affect their firms.

- *Mid-stage:* The first signs of growth follow, creating a need for tighter integration, coordination, and team structure, as more cross-functional work needs to happen. Processes need to be established, as do key performance metrics. At this crucial moment, founder-CEOs need to be brutally honest and ask themselves if they are still qualified to steer the ship or whether it is best left to someone who is more capable and experienced. Often, the firm's board of directors will sense that all is not well and counsel the founder-CEO about changes considered necessary—either in operations or key personnel. The likely cause of concern is most often the CEO himself.

- *Mature growth to exit strategy:* As the company develops, products become more robust, technology matures, revenues grow, and the next stage of planning begins for growth and expansion into new products/service lines. These signal the company's readiness for another stage of growth, or its readiness for exit. The founder-CEO needs to be sensitive to the various constituents to whom he or she is responsible—shareholders, customers, and employees. More than ever, having the right CEO becomes critical as the company gears up for more institutional funding and, possibly, the right exit strategy. Equally important is making the right hiring decisions. Mature growth usually requires a different blend of talent/experience to transition the company to its next stage. Or, it may be time to simply allow the company to be acquired by a firm better positioned to exploit the foreseen opportunities.

At every stage of the startup's development, founder-CEOs need to ask tough questions to determine what is right for the company. The board must help the CEO recognize that the best decisions are the ones that serve all shareholders, not just large investors, management, or the ego and lifestyle of the founder-CEO.

I speak from my personal experiences as a successor to a founder-CEO of a company that was on the brink of incurring substantial losses. Although I was not a founder-CEO, I am guilty of the same mistakes made by these founder-CEOs. I failed to pivot at the right time and to engage in transition planning.

During my tenure from 1989–1998, my team and I employed several measures to streamline the company's cost structures. As a turnaround CEO, I also made changes to the company's culture and replaced the company's proprietary technology with a PC-based technology platform. In twelve consecutive quarters, the measures we took resulted in the company becoming profitable again. But, soon after, the market realities began changing drastically. The company was operating in a mature market that was rapidly shrinking in value. It was the ideal window to engage in a more aggressive M&A strategy, but I was not the right person to handle that.

In hindsight, I should have stepped aside when the turnaround was completed and could have chosen to be chairman of the board instead. However, because I did not do that, I failed to create value for the shareholders. Our competitors bought out the company for a small sum of money. Not only did the company suffer valuation losses, but I also incurred significant personal financial losses. Had I recognized the shift that was happening in the market and had I been honest that another equally qualified candidate would have been a better fit to see through the transition, I would have been able to create value for the shareholders, including myself.

Therefore, every founder-CEO needs to go through self-introspection to decide if he or she is the right candidate to take the company to the next level. If all the evidence and signs point to bringing in a new CEO, the founder-CEO needs to decide how he or she plans to stay involved with the startup. The founder-CEO can explore various options, including staying involved by finding a continuing role in the company. If he or she chooses to leave, it is crucial to start negotiating exit terms with the board.

The litmus test for initiating a transition is:

> **Can the founder-CEO contribute to the value creation of the maturing company?**

If the answer is no, would a more experienced and professional CEO with the right skill sets and track record be a better fit to lead the company? If this is the case, should the founder-CEO remain with the company in a new capacity (e.g., CTO, director), or should he or she plan a transition out of the company?

We'll explore issues bearing on this last question further in this paper.

WHAT THE RIGHT PERSON LOOKS LIKE

While every startup is unique and faces different challenges, the CEO role is vastly different at an early-stage startup than at a mature-stage startup. Despite this, there are certain must-have qualifications that make a CEO the ideal person for the job.

- *Be a visionary:* He or she must be able to shape a winning vision that can capture more market value than the current products offered by competitors.
- *Be agile and respond to changing market realities:* The CEO needs to keep up with various economic and market trends and be agile enough to respond to these changes.
- *Build a team that is committed to the vision:* The CEO's job is to ensure that he or she picks the right team with needed experience that is contributing toward building the vision of the company.
- *Be financially savvy:* It is important that the CEO has a sharp financial acumen to keep the startup on budget and profitable through the peaks and troughs. The CEO needs to understand the domain extremely well and identify the key drivers to make the startup successful.
- *Be able to raise capital:* A successful CEO can sell the startup idea effectively and passionately to potential investors to raise enough capital to give a startup sufficient runway to realize its potential.

Essentially, every CEO needs to be the best salesperson in the company. He or she must be able to use his or her skills to sell the company's vision to attract investors, customers, employees, and strategic partners.

TIMING IS EVERYTHING

Once the inevitable has been established, the next piece of the puzzle is figuring out when the transition should happen. Transition planning can be a costly failure if it is done too early or too late.

As a rule of thumb, having six months of transition time is ideal. Anything longer than that, such as a year, is too long and will bring challenges that can derail the company's success. Initiating and managing transitions is incredibly time sensitive. The key to successful planning is to ensure that all elements of the plan are aligned strategically.

MANAGING THE TRANSITION

The key steps to manage the transition are outlined below. The founder-CEO should work closely with the board to find the right replacement and to manage this transition.

- **Determine the next-level strategy for the startup and the CEO skill sets and experiences needed to scale the company**

  The right CEO has experience scaling and managing a company that has reached its strategic objectives. The goal of appointing a replacement CEO is to complement the current team's set of skills and experiences in scaling the company through its next stages of growth.

  Here, Yahoo! offers a unique perspective. Founded in 1994 by Jerry Yang and David Filo, the early co-founders hired Tim Koogle as the CEO. At that time, Yahoo! was still a young startup with no sales to boast of. From the very beginning, Koogle saw huge monetary opportunity in the large Internet audience base. He sought to establish Yahoo! as a new media source that delivers free content to the large audience base while selling advertising space to capture market value.

- **Select the CEO for leadership, interpersonal skills, and a knack for creating a supportive culture of collaboration**

  The most important strategic implication is that the new CEO will have a larger and more crucial role in designing the company's ecosystem. An ideal CEO can interface effectively with proven C-level executives and make tactical adjustments to emerging challenges that will lead the startup to strong and sustainable growth. Hiring a CEO who has the ability to capture more value for the company through approaches proven at the level of established enterprises is the key to ensuring a profitable venture.

  This key step may seem like a rosy solution, but it is fraught with risks. Unfortunately, as many times as not, new CEOs experience a significant failure rate. The fear of a CEO not working out is often the reason a founder-CEO is so resistant to making a long-term bet on a professional CEO.

  Michael Watkins, a renowned thinker on executive leadership, highlighted the reality of this failure risk. In his book, *The First 90 Days*, Watkins' research showed that an astounding 58 percent of external CEOs hires flounder in their new roles within eighteen months.[5]

  Typically, causes for the high failure rate in the new CEO's performance are in no way simplistic and often are compounded by many complex realities. The failure can

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[5] Watkins, Michael. *The First 90 Days: Proven Strategies for Getting up to Speed Faster and Smarter*. Boston: Harvard Business School, 2013. Print.

be the result of a wrong hire or a company making the transition so late that even a superstar CEO would have failed.

In theory, hiring the right CEO translates to hiring someone who has the right relevant experience. Of course, no one is tailor made for the job, so boards should be willing to consider someone who may not have the relevant experience, but who has sharp business acumen and the ability to execute the business model.

For example, Mark Zuckerberg, Facebook's founder, brought in Sheryl Sandberg, who was known for her management and people skills. Although Sheryl wasn't hired for the CEO role, she assumed the COO role at Facebook. Her skill sets were instrumental in helping Facebook scale up. Rather than just being a social networking platform, Sandberg turned the platform into a moneymaking machine by setting it up as an advertising channel. The success of Facebook's business model has put it in close competition with the other three Internet titans, Google, Apple, and Amazon, in the online marketing space. Sandberg has been credited for being the key player in building out Zuckerberg's product vision and strategy.

- **Break away from the past**

  In the process of shaping the management team and company, a common challenge is the likelihood that one or more of the company's top-notch personalities are no longer a huge advantage for the organization and are impeding growth. With this realization, founders and board members will have to address this difficult dilemma—let these "big dogs" who contributed to initial success go or let them stay on?

  One important point to note is that it is always necessary to examine status quo bias. As the company grows, its management skills need to evolve with it, and resistance to change (e.g., status quo bias) needs to be overcome. It is especially true when the big dogs' influence and status diminish and they may try to undermine the new leadership.

- **Facilitate close connections between the founder, the new CEO, and the team**

  It is equally important to start building a truly empowered executive team based on the right chemistry and relationship with the new CEO.

  For many startups, the reality is that teams have been structured very loosely and often work in informal ("tribal") groups. A key part of the CEO transition is to bring these groups together and to transform the team into a cohesive one that works across functions. The management team needs to be able to make real decisions and effectively run the business together with the CEO.

- **Transfer knowledge**

  The single most important factor in managing this transition is ensuring that relevant knowledge is documented to the greatest extent possible. Creating binders with information on all the company's customers, major contracts, investors, products, technologies, sales, and marketing activities is one method for achieving this goal. Partners should assist with essential knowledge capture and transfer, which can be built into the company's wiki or intranet so that the information is readily accessible by the new CEO and any other new team members.

  Inattention to this detail can be disastrous for the company in transition. Founders hold vast amounts of information, and once they hand over the reins to the new leadership, the new team can experience a knowledge vacuum if the flow of information has been obstructed. This can result in chaos, confusion, and a situation where the management team is scrambling to operate effectively.

- **Minimize the handover period**

  A handover period for retaining and transferring knowledge is a golden opportunity to ensure that all tacit knowledge from the founder is transferred to the new CEO and that there are no knowledge gaps. The ideal period for handover should be approximately a couple of weeks. Depending on the complexity of the transition, a longer time may be required, but to avoid drawn-out delays and unexpected obstacles, the handover period should not exceed thirty days.

- **Define the strategic significance of the transition and keep communication channels open**

  Finally, it is important to guide the rest of the team on coping with the transition, especially if most of the team members have been there from the outset. The new structure, roles and responsibilities, and information about how the new management intends to take the startup to the next level need to be carefully presented and "sold." Ultimately, a successful transition will depend on honest and real engagement.

A CAUTIONARY TALE

During the search to bring in a CEO, the biggest caveat is to realize the importance of hiring someone that not only shares fundamental values about people and leadership, but also creates value by bringing complementary skills to the table. If this process is based on a shaky foundation, success and failure will be progressively arbitrary, despite the best intentions and efforts.

Therefore, avoid these pitfalls in steering a company through a transition period, remembering to take into account:

- **Don't settle**

  Qualifications, substance, and verifiable achievement are essential requirements. The biggest mistake is to rush through this process and settle for a candidate who may look better on paper than he or she is in reality. Again, the key is to look for someone with the right experiences or someone who has the business sense to lead the company beyond the ground-up stage.

- **Don't undermine your own efforts**

  On the flip side, there may be a tendency to be overprotective of what has been built and block what might otherwise be a promising hire. The board and founder-CEO should be proud that the company has come to a point where enough value has been created to entice a great CEO to grow it into something more valuable.

- **Expect deviations from the plan**

  There is always the chance that a key management hire may not work out. Be prepared for the worst. If that happens, it is better to admit to the hiring mistake and rectify the situation as soon as possible. The founder-CEO and board should take the right steps to mitigate any damage done and replace the hire with a candidate who is potentially a better fit for the early-stage company.

THE ROAD AHEAD FOR THE FOUNDER

I have found from personal experience that only one out of five founders stays with a company from start to finish. Most founders have to back down and give way to a new CEO. While the majority of these founders moved on, some found ways to stay relevant and be a continuing part of the companies' success.

Research by Wasserman on the succession paths of founders in technology startups reflects these realities.[6]

- 37 percent of founder-CEOs moved on and did something completely different.
- Another 23 percent of these founders took on another role that reports directly to the CEO.
- A significant 40 percent became directors of the evolving firms.

Therefore, giving up the founder role doesn't have to be an all-or-nothing situation. In all of these situations, founders have to rethink their involvement. A founder can still play a unique and helpful role to the replacement CEO. Here are some ways that a founder can still contribute:

[6] Wasserman, Noam. "The Founder's Dilemma." *Harvard Business Review*, February 1, 2008. Web. March 28, 2015.

- **Capitalize on strengths**

  If a founder has an attraction and interest toward a particular area that plays to his or her strengths, he or she should speak to the board and openly discuss how he or she can contribute in that area.

- **Be a mentor**

  The founder is well positioned to provide honest counsel to the newly hired CEO. There is a huge opportunity to help influence and shape the development of the company to the founder's vision while leaving the implementation details to the CEO.

CONCLUDING THOUGHTS

The very act of building and managing a startup from the bottom up is both a challenging and gratifying endeavor. The founder's vision and the promise of increasing returns often hold the key to building a successful company. However, because the magnitude and character of development challenges are often great, founders may misjudge not only the rules of the game, but also their objectives in playing it.

The best CEOs for the job will leverage their skills to execute the vision flawlessly, enabling the founder's vision to flourish. Letting go of the reins of the startup is not easy because, after all, founders have been intimately and emotionally involved with its creation. But the success of a company's growth strategy hinges on bringing the right CEO on board and managing this transition to position the company to become a long-term winner.