The Effect of the Investor-Founder-Relationship on Founders' Compensation

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Bachelor of Science

Remy Rickenzo Goldstein
remy.goldstein@cdtm.de

Purpose/Motivation: The vision to create value for a customer or user with a novel product or service intrigues many people, either entering their professional careers or attempting to change their current job. This phenomenon appears in entrepreneurs who found new ventures to bring such products and services to market. A rapid growth in investment activity has enabled many new ventures to flourish within the German Entrepreneurial Landscape (GEL). Last year alone, founders in the GEL raised more than € 9.2 billion from investors in financing rounds (Prüver & Turner, 2020, p. 19). The result of a financing round manifests itself in two ways. First, founders receive the means to grow their venture to the next maturity level. Second, a relationship evolves between investors and founders. While the prospect of starting up a venture seems promising, founders must put their livelihood at stake daily for their venture to survive. The highly confidential nature of compensation – defined as "the sum of all incentives and rewards, pecuniary and non-pecuniary" (Pepper & Gore, 2015, p. 1053) – is reflected in past research on founders' compensation. Nevertheless, they leave open what role the relationship between investors and founders plays regarding founders' compensation, thus providing evidence of a dearth of theoretical foundation to explain this relationship in its intricate mechanisms. Therefore, the derived research question I ask is: What is the effect of the Investor-Founder-Relationship (IFR) on founders' compensation?

~~Theories/Hypotheses:~~ **not applicable to my thesis.**

Approach/Methodology: I conduct a theory-building multiple-case study on founders' compensation (Eisenhardt, 1989b, p. 534). This method is particularly relevant for "research areas for which existing theory seems inadequate" (Eisenhardt, 1989b, p. 549). I chose semi-structured interviews to conduct my qualitative research to help answer the research question. The semi-structured approach allowed me to combine "closed- and open-ended questions" with "follow-up why or how questions" to explore "unforeseen issues" while adhering to a general agenda of topics (Adams, 2015, p. 493). The setting is the *German Entrepreneurial Landscape*. The sample size is 10, five are investors, and five are founders. Through purposeful sampling, I selected the interviewees based on their respective experiences to ensure representativeness, heterogeneity, and the possible comparison between interviewees (Maxwell, 2008, p. 235).

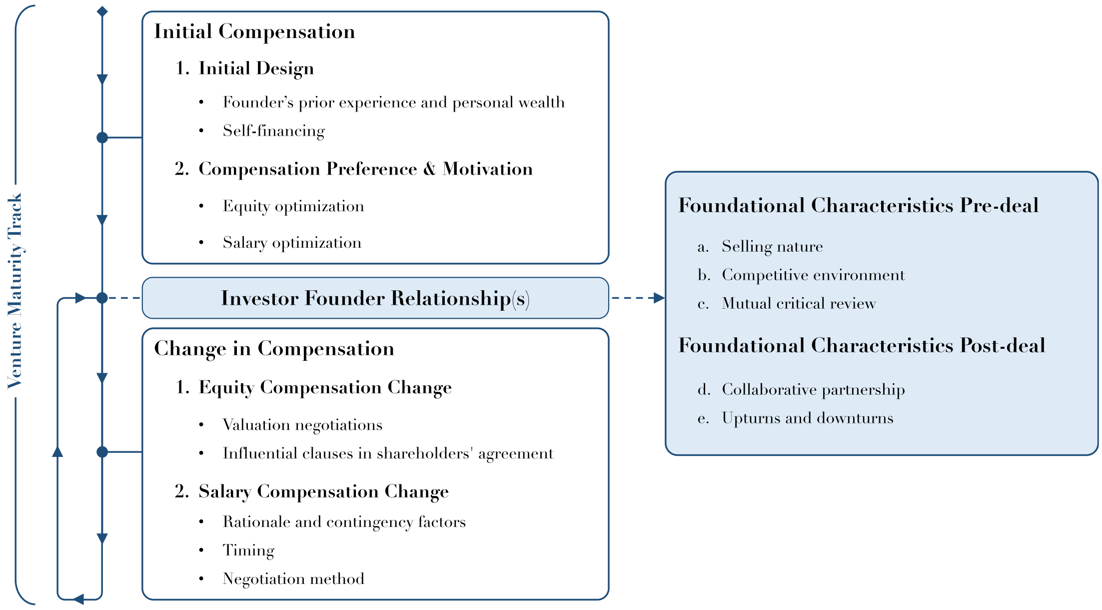
Findings: Key finding include: First, founders' initial compensation design divides between equity compensation and salary compensation. Contingency factors for initial compensation design are founders' prior experience and personal wealth, while self-finance is crucial for future compensation. Second, founders' either optimize for equity or salary depending on experience and age. Equity compensation serves as the primary motivation and compensation preference for my sample founders, while salary compensation is mostly seen as a hygiene factor by investors and founders. Third, I identify two guiding principles for a change in compensation. First, with each new investor, founders' equity compensation – based on owner-ship percentage – is naturally diluted, and in shareholder agreements, three of the most common clauses which influence founders' equity compensation are vesting schedules, leaver scenarios, and veto-rights. Second, salary compensation may increase before the first investor enters but strongly depends on several contingency factors once more investors join. I highlight the rationale and contingency factors, timing, and negotiation method for a salary increase. Consistent with prior research, I find founders' equity to reduce and salary to increase with venture maturity.

Research Limitations: This work is a theory-building multiple-case study on founders' compensation. I took an empirical and qualitative approach, so it is necessary to be highly transparent about the limitations involved. The limitations can be categorized into three main areas: Sample, analysis and emergent theoretical framework, and theoretical concepts.

Research Implications: The first research question arises from my analysis and emergent theoretical framework – *to what extent could my emergent theoretical framework serve as a generalizable concept to understand founders' compensation?* Secondly, when analyzing founders' *initial* compensation, I stress the importance of founders' *self-financing*. A question emerges – *how large is the effect of self-financing on founders' compensation, future fundraising, and venture success?* Thirdly, a pivotal question arises on the Investor-Founder-Relationship – *is a novel theoretical framework needed to explain the relationship between investor and founder?*

Practical Implications: I chose three areas to highlight practical implications. First, rules of thumb for capitalization tables include that every investment round leads to roughly a 20-22 percent dilution. Second, as founders search for and speak to new investors, it is necessary to understand investors '„*time schedules*“ and „*investment motivation*“. Third, founders face extreme uncertainty when starting up, which is why an initial confirmation or signal for market demand can be the difference between founding and failing.

Contribution: I contribute to research on founders' compensation. I build a theoretical framework (Figure 1) that functions as a pathway to understanding founders' compensation. I also contribute to behavioral agency literature providing a critical appraisal of (Behavioral) Agency Theory. While juxtaposing theory and practice, I find several expectations met, yet conclude that a novel theoretical framework is needed to portray the Investor-Founder-Relationship (IFR) in its intricacies. I contribute to such a future framework by providing a thought-provoking impulse, by setting the IFR's first foundational characteristics.



Paper type: theory-building multiple-case study

Further readings:

For compensation composition for executives and founders:

Bengtsson, O., & Hand, J. R. M. (2011). CEO Compensation in Venture-backed Firms. *Journal of Business Venturing*, *26*(4), 391–411. doi:10.1016/j.jbusvent.2009.11.001

Ewens, M., Nanda, R., & Stanton, C. (2020). The Evolution of CEO Compensation in Venture Capital Backed Startups. In *Harvard Business School Entrepreneurial Management* (No. 20–119). doi:10.2139/ssrn.3607524

Hall, R. E., & Woodward, S. E. (2010). The Burden of the Nondiversifiable Risk of Entrepreneurship. *American Economic Review, 100*(3), 1163–1194. doi:10.1257/aer.100.3.1163

He, L. (2008). Do Founders matter? A study of Executive Compensation, Governance Structure and Firm Performance. *Journal of Business Venturing*, *23*(3), 257–279. doi:10.1016/j.jbusvent.2007.02.001

The entire research summary must not exceed 3 pages. The formal requirements are Times New Roman, 12 pt., line spacing 1,5.