Understanding "founder's mentality" to generate outperformance

Mugunthan Siva | India Avenue Investment Management | 12 October 2016

At this year's PortfolioConstruction Forum Conference titled "The long and short of it", the overwhelming majority of participants stated that long-term thinking is required when investing. We feel this to be crucial with regards to horizon-based investing and riding out volatility, especially when it comes to gaining exposure to the fast growing, but more volatile emerging markets. However, in practice does this really occur?

Having worked at some of the big four banks, I know all too well how business direction can change multiple times within a short timeframe. This can create poor engagement and a lack of organisational focus that can be expensive to resurrect. Most importantly, it tends to destroy brand and shareholder value.

So why does this happen? Management is often incentivised to make short-term decisions for their immediate personal gain. They are commonly paid in terms of stock options that vest over a short-term period of one to three years, and cash bonuses for yearly performance. Senior management are therefore not incentivised to make strategic investments that are long-term accretive to the business as to do so would incur immediate expense for no immediate profit. This is at complete odds to company management often claiming shareholder wealth generation is their ultimate priority.

This agency problem differentiates the drive of the owners of a business to that of management.

However, in the case of founding management, there is naturally a longer term view as they have built the company through hard work, passion and a drive to create something significant. Founding management instinctively and intricately knows all facets of the business, its products and its target market, the unique selling proposition and the barriers to entry. Founding management is usually continuously looking to innovative, make bolder and more strategic investments and maintain loyal employees.

Chris Zook, partner at Bain & Company's Boston office wrote a piece in the *Harvard Business Review* titled "Founder-led companies outperform the rest — here's why". He and his team at Bain & Company studied publicly listed companies globally over the last 25 years in an attempt to identify those that generate sustainable long-term earnings growth. What they found is that sustainable, profitable growth is very challenging. Currently, only 1 in 10 companies has been able to achieve sustainable, profitable growth over a decade.

Interestingly, when they tracked this globally, a disproportionate amount of companies that met the criterion had a founder who is still either running the business or is involved with the Board of Directors, or the company had the founder's focus and principles still firmly in place.

After interviewing over 200 founder-led companies, Chris and his team identified "founder's mentality", epitomised by three characteristics and underlying attitudes that emerged consistently.

1. **Business insurgency** – A sharp sense of purpose without which a business lacks direction and is uninspiring. According to Bain & Company, 13% of employees worldwide are disengaged. Yet engaged employees are 3.5 times more likely to devote personal time to innovate compared to unengaged workers.

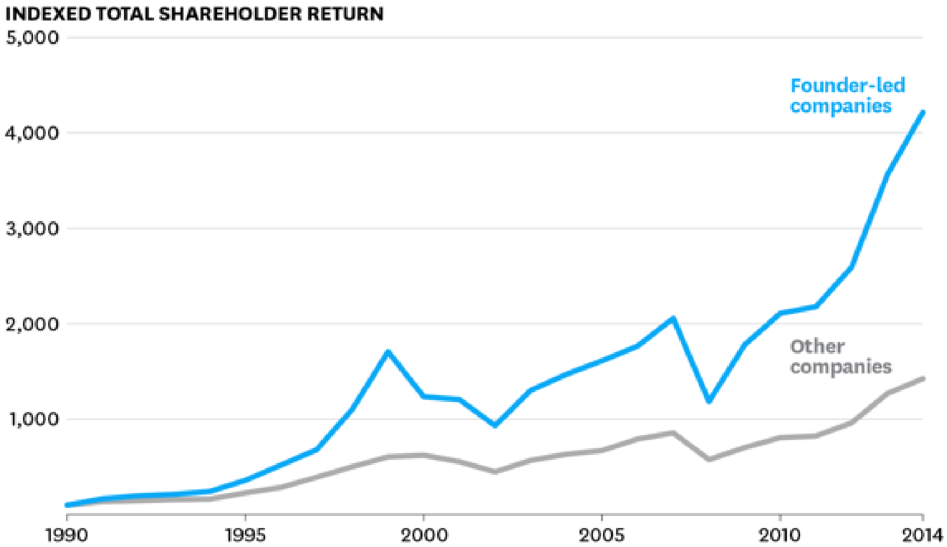
2. **Front-line obsession** – A deep understanding of the product/service and love of detail and curiosity at the front line. Founder-led companies are more likely to remain in touch with their customers and bureaucracy is less likely to take over.

3. **Owner's mindset** – The company thinks like an owner would and employees take personal responsibility for risk and costs. In founder-led companies there is less complacency, the company is not as slow to act and is less risk averse while employing a long-term mindset.

A great example is Facebook's founding CEO Mark Zuckerberg. He made a series of long-term strategic decisions and avoided taking any revenue that went contrary to improving the user's experience. By committing to his vision, he was heavily scrutinised in the short-term by the press and investors. Would a professional CEO have taken these risks and endured such attacks for unproven, long-term benefits?

Figure 1 below compares the stock performance of founder-led companies relative to others over the last 24 years. The outperformance of founder-led companies is substantial.

Figure 1: Founder-led companies outperform
Based on an analysis of S&P 500 firms in 2014.



Source: Bain & Company. © HBR.org.

Does this mean that all founders are CEO material and destined to succeed? It's not as simple as that. Managing a successful company requires a tremendous amount of ability as well as the right products/services for the ecosystem in which the company operates. While nearly all founders exhibit the the founder's mentality, not all have the skill to successfully implement it. Investor's selecting companies for investment need a deep understanding of not only the founder's mentality, but also their track record of implementation, strategic thought process/creativity and internal motivations – all of which are paramount in generating strong returns.

An example is India's equity market, which is ripe with companies where the founder is still heavily involved in the business. Approximately 45% of the Indian equity market today is owned by founders of the business. We feel this high level of ownership is the major reason why India enjoys one of the highest rates of return on equity in the world and has exhibited sustainable earnings growth of 14% per annum, with low volatility, over the last 15 years.[1]

Figure 2: Return on equity and earnings per share growth

MSCI Index	Std Dev of EPS growth since 2002 (%pa)	Avg ROE growth since 1996 (%pa)
India	13	18
China	19	13
Brazil	44	13
Russia	45	13
Emerging Markets	27	13
All Country World index	34	12
US	33	15
Developed markets	35	12

Source: Morgan Stanley research

In our view, India is an ideal hunting ground for investors seeking to generate strong returns through successfully identifying superior founder-led companies. Local investments experts with inherent and localised market knowledge of these companies and their respective founders are more likely to decipher which companies are most likely to deliver.

One example is Sun Pharmaceutical Industries, India's largest pharmaceutical company. Founder Dilip Shanghvi exhibits the "founder's mentality". In fact, he has often been described as a hands-on manager who believes in rolling up his sleeves and doing things himself.

From a start-up 30 years ago, selling niche products, the company is now the world's fifth largest generic pharmaceuticals company. Such success was not handed to him and his company on a platter. In the 1980s and 1990s, the large Indian pharmaceuticals were taking on multinational drug makers in established categories, as that was where most revenue was being made. Dilip Shanghvi decided to ignore this and focus on the long-term and untapped opportunity of niche generic drugs targeting chronic therapies for ailments in areas such as psychiatry, cardiovascular, neurology and oncology. He was not bothered about the immediate size of the market, but rather he focused on the long-term potential from both urbanisation in India and aging globally that would result in an increase in diseases. While the revenue opportunity was small in the beginning, less competition translated into higher margins that provided the resources to reinvest in the business and grow it to the leader it is today.

While conventional wisdom says the founding CEO should make way for a professional and experienced CEO once a company has achieved scale, this ignores the benefits of the founder's comprehensive knowledge, moral obligation to make the hard decisions to ensure business continuity, and total commitment to the long-term. We feel active management is required to identify founder-led companies with the ability, track record and right mentality. This is likely to generate outsized returns for investors in any market, not only India's.

ENDNOTES

1. Earnings growth since 2001 for BSE Sensex, Bloomberg and MSCI.

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