
Board Lifecycle
in Startups

Agenda

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3. Board of directors over the lifecycle of a startup
   I. Early-stage
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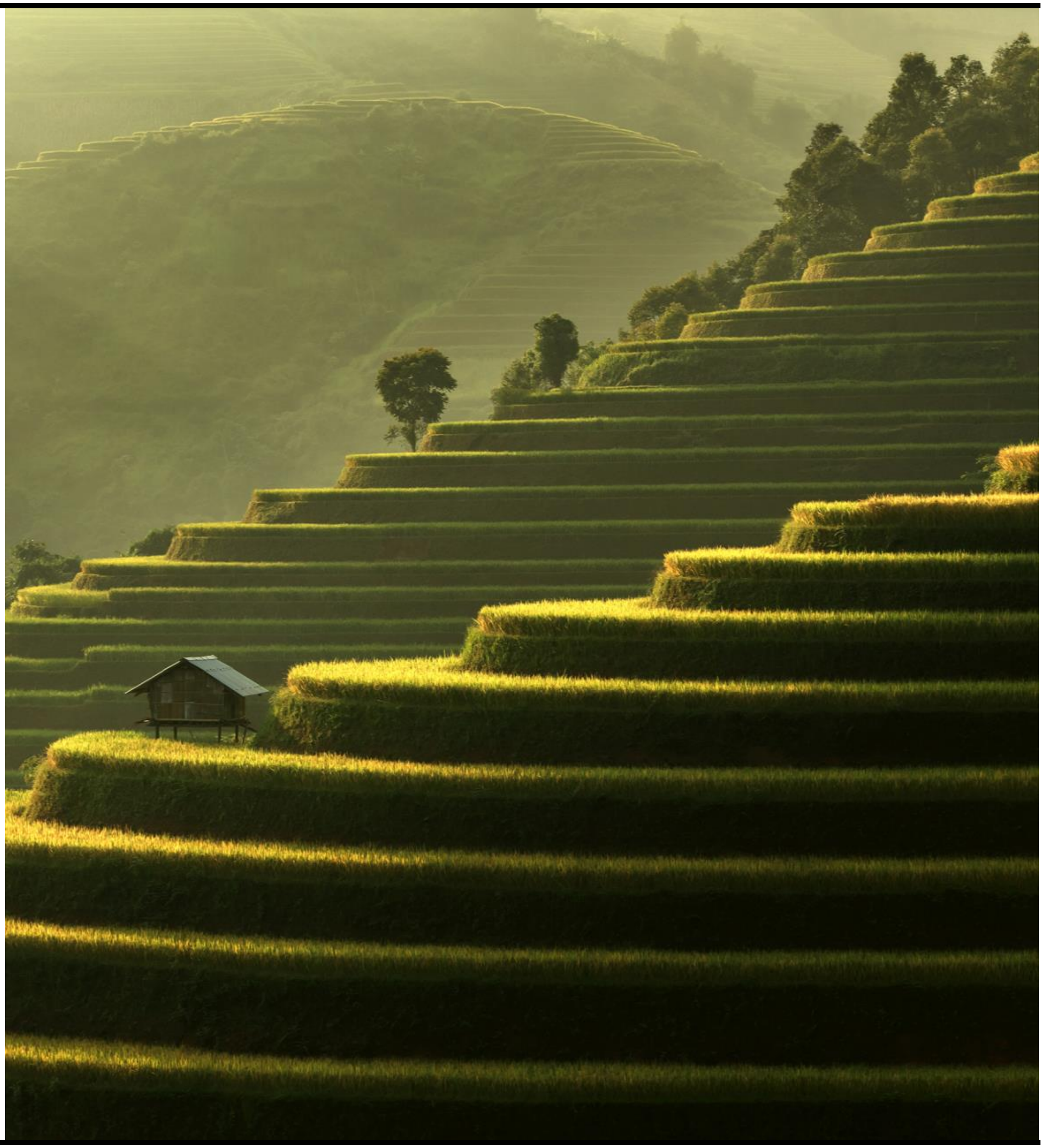

What makes startup boards interesting?

The board of directors:
- Essential for governance
- Important duties

The Finnish startup ecosystem

Startup-specific structures

Significance of startups in the business world

Roe (2004), Hermalin & Weisbach (2003)

Key differences

"The board has four members - they are regarded as unofficial advisors who support the CEO and executives in their work"

Startup boards

- Smaller
- Emphasis on supporting and advising
- Agency issues: founders, business angels and VCs

Corporate boards

- Larger
- Emphasis on monitoring and auditing
- Agency issues: owners and executives

Hermalin & Weisbach (2003), Ikäheimo (2021, audio podcast), Rosenstein et al. (1993), Fried et al. (1998)

Key concepts

Angel investor

- High net-worth individuals who actively seek investment opportunities in the venture landscape
- Often entrepreneurs as well
- Might want to join the board to contribute to the success of the startup company

Venture capital

- Independent, for example professionally managed mutual funds typically focused on private equity
- Investments into young, high-growth companies that involve high uncertainty and risk

Gompers and Lerner, (2001), Morrissette (2007)

Board of directors over the lifecycle of a startup

1. Early stage
2. Growth stage
3. Late stage

- Umbrella terms for a variety of smaller steps along the startup lifecycle path
- The stages differ a lot and pose different requirements for executives and board of directors

Early stage

- The early stage usually involves significant individual efforts from the founders, contributions from friends and family
- The board size is still small (on average 3.6. members) and entrepreneurs are still controlling the firm
- Investment is still low, and angel investors often get on board at this stage (Kesim and Salamzadeh, 2015)

Kesim and Salamzadeh (2015), Ewens and Malenko (2022)

Early-stage – insights from the field

Interviewee I: Co-Founder and CEO

- Board consists of four (4) members: founder and unofficial advisors supporting the operative functions
- Board to be kept small to avoid counter-productivity from unnecessary bureaucracy
- Board serves the purpose of helping the team thrive
- Board is expected to be reformed when additional investors come on board

Interviewee II: CEO of Startup Säätiö

- Board usually consists of founders at the beginning, and only regulatory annual meetings are held
- Founders' focus is on operative executions instead of governance
- Possible angel investors might insist on having a seat on the board
- Board's activity and annual planning tend to increase quickly as the company starts to retain funding from external sources

Angel investors' "sweat equity"

- Interviewee I: Angels bring in experience and knowledge, networks and the ability to help the company overcome some of the early-stage problems the company might face.
- Interviewee II: Angels can at best be very helpful, and it is important to pick the angels carefully and ask for their advice and support

Growth stage

- Growth stage is often characterized by teamwork, prototyping and product development & entries into new markets
- Management might seek for different kinds of support mechanisms such as startup accelerators or incubators
- Higher amount of investment in the firm (e.g. venture capital) and valuation starts to gain relevance
- More investors leads to more structured board work, and board size has been shown to increase from 3 to 4.8 members with the first investment of venture capital

Kesim and Salamzadeh (2015), Rosenstein et al. (1993)

Growth stage - insights from the field

"The most important function of the board in every phase of the startup lifecycle is to maintain focus and support growth."

- CEO at Startup Säätiö

Interviewee II, CEO of Startup Säätiö:

- Venture capitalists often have large stakes in the company and want to be involved in board work
- One seat on the board usually goes to the "lead investor", i.e. VC with the largest financial contribution and lead in negotiations
- There might also be seats for "board observers" who get to attend meetings and speak up
- Board activity might differ a lot depending on the nature of the business
- Board activity includes much more than official meetings - VCs can provide help in a variety of issues, e.g. recruitment, bottleneck problems, introductions to new investors etc.
- Experience from different situations makes VCs valuable board members

Late stage

- Late stage is usually defined by the increasing formality of the company, with further series of funding being attracted by the company

- At the start of this stage the company is usually
  - Fully staffed
  - Experiencing fast growth
  - Considering an exit

- At the end of this stage board starts to resemble that of a fully fletched and mature company

Changing Board composition and practices

- Change from informal meetings, calls and only mandatory board meetings to more formal board meetings being held regularly
- Change from reactive, to proactive board work
- Inclusion of "Annual Clock" and other board work related tools
- Recruitment of independent directors to appease more traditional investors
- Ends with the board fully operational

"As the firm grows, the "professionalism" of the board grows. For example, you cannot process HR the same way in a company of 10 employees as you do in a company of 100 employees."

- CEO of Startup Säätiö

Own interviews conducted, Silicon Valley Bank (2021)

CEO Replacement

"it seems possible that replacing executives is one of the key mechanisms by which investors attempt to "fix" struggling startups"

- VC-packed startups management is most likely replaced after 2nd round of financing.
- Still, the replacements can occur even after six rounds of financing.
- Replacements especially occurs in the struggling startups, where more than one of the management members is replaced four times more likely than in non-vc-packed companies.
- The replacement of the CEO is strongly correlated with an increase in the role of investors on the board of directors.
- Despite the negative association to the quick CEO replacement the venture capitalists bring value to the internal organization of the firm.
- Venture capitalist may help the startup to build its internal organization, including human resources and stock option plans faster than non-VC-packed startup.

Hermalin and Weisbach (1988), Lerner (1995), Jenter and Lewellen (2010) and Hellman and Puri (2002)

Conclusions

- Key differences between startup and corporate boards are related to size, emphasis on tasks, and agency issues
- In the early stages board work is done only as a formality
- Investors from Venture Capital firms taking board positions in the growth stages and the board work starts to gain formality
- CEO and other executive directors are more like to be replaced in venture capital-packed startups after couple rounds of financing
- In the late stages formality is increased, independent directors are recruited, and fully functioning board is formed