



Factors affecting the equity-split decisions at business start-up in South Africa

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ABSTRACT

The issue of the division of equity is one that founders of joint ventures inevitably face during the start-up phase of business development. Whilst this is an issue of great importance in that it shapes the capital structure of the business (Roberts and Zender, 2008) and impacts on the future productivity of founder members (Holstrom, 1982), it is an area that has received little systematic attention in academic literature. Hellman and Wasserman (2011) conducted a large scale study of equity splits in start-up's and noted that the three factors of (1) the value of the idea, (2) past entrepreneurial experience and (3) capital contribution played a significant role in determining the division of equity.

This study employs a qualitative research methodology to investigate the process of equity negotiation with the aim of identifying further factors that may guide decisions in equity negotiation. The key findings of the research are that the dynamics of the interpersonal relationships that exist between founder members appear to influence equity negotiations, in that preserving goodwill in these relationships was a factor that motivated founder members to lean towards equal equity splits. The two phenomena that are associated with a need to preserve goodwill within the relationship are the existence of a relationship prior to entering into business, and the business venture being based on a shared idea.

Keywords: Start-up, equity split, factors influencing equity negotiation.

DECLARATION

I declare that this research project is my own work. It is submitted in partial fulfilment of the requirements for the degree of Masters of Business Administration at the Gordon Institute of Business Science, University of Pretoria. It has not been submitted before for any degree or examination in any other University. I further declare that I have obtained the necessary authorization and consent to carry out this research.

Name: York Arnim Vigoni Zucchi

Date: 02 September 2011

Signed:



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CHAPTER 1: INTRODUCTION

1.1 Research Title

Factors affecting the equity-split decisions at business start-up in South Africa

1.2 Introduction

Partnerships in entrepreneurial ventures offer opportunities for founder members to pool their knowledge, skills, experience, and capital to strengthen the potential of a business venture. Furthermore shared risk offers personal support in the face of the stressors that are associated with the start-up phases of business ventures. Sharing risk and responsibility also means sharing in the upside (profit) and decision making authority. Both of which are heavily influenced by equity splits. These are factors that make joint ventures desirable but lead to the need to negotiate equity in partnerships between co-founders.

1.3 The problematic issue of equity negotiations

Whilst previous literature (Holstrom 1982, Gulati & Wang 2003, Hauswald 2006) has addressed equity splits in a systematic manner; it appears that there are a number of obstacles that entrepreneurs face when agreeing on how equity should or could be shared. The objective factors that make equity negotiations complex include, the difficulty in calculating the value of the venture as well as quantifying the worth of the founder members' contributions. Contributions can take the form of skills, networks and commitment amongst other intangible contributions. More subjective factors that potentially become obstacles in equity splits include the dynamics of the interpersonal relationships between

founder members, and the possibility that intensive equity negotiations may sour relationships between founder members.

As a result of this there is a tendency for the co-founders of start-ups to agree upon equal splits; with up to a third of start-ups utilising a model of equal equity splits (Wasserman, 2011).

The division of equity in start-ups is a critical issue in that the outcomes of equity negotiations not only inform the capital structure of the business, but have also been shown to have an impact on the productivity of the founder members; in that investments in ventures provide incentives to founding members. (Holstrom, 1982). With this in mind the thorny issue of equity negotiations has far reaching effects in business ventures; arguably the most pertinent of which is the survival of the business venture.

1.4 The importance of understanding equity splits

Given the potential impact that equity splits can have on a business venture it becomes important to understand the ways in which equity is divided, specifically the factors that are used to measure the value of founder contributions which could inform equity splits. In addition to this it is also important to develop an understanding of the process of equity negotiations as interpersonal dynamics that exist between founder members have been shown to impact on equity splits (Holston, 1982). Additionally previous research findings suggest that that higher levels of team heterogeneity (difference in skill

sets) are associated with a greater tendency for equal equity splits (Wasserman, 2011).

Although it is generally accepted that equity negotiation is an issue of importance in the start-up phases of shared business ventures (Evans & Leighton, 1996; Wasserman 2008); there is little research that has looked into the factors that shape equity splits, and little research that has explored how the process of equity splits practically unfolds in start-ups. The seminal author in the field of equity splits is the associate Professor of Harvard Business School, Noam Wasserman who has researched and published in the area since 2000. The critical nature of the equity split process and the void that exists around equity negotiations literature has prompted the need for this research as well as demonstrates the need to explore the issue of equity splits in an effort to generate new insights into the process.

1.5 Objectives of the research

The fundamental objective of this research is to generate an understanding of the factors and processes that shape equity negotiation and equity splits in start-ups. Given the very limited amount of research that has been done in this area; this study was purely exploratory with the outcomes focusing on the identification of concepts and processes that inform equity splits. As an exploratory study the research used a qualitative methodology to explore the area of equity splits.

The research findings will aim to assist entrepreneurs in understanding the process of equity negotiation and assist them in gaining a better understanding of the dynamics involved. From an academic perspective the research explores an area which has not been researched in particular depth.

Qualitative research methods differ from quantitative methods on the grounds that the data is analysed primarily through interpretations made by the researcher (Pidgeon, 1996). The objective of this form of research is not to test hypotheses but to rather describe processes or generate low-level theories that can then be explored through quantitative studies. In this regard the limited amount of available research in the area of equity splits lends itself to this form of enquiry so that ideas and understandings can be generated that may be both useful in contributing to the body of knowledge, but which may also be used to inform future studies (Saunders et al., 2009).

1.6 Specific areas of investigation

The key areas that were identified for investigation were to explore:

- The ways in which business relationships were formed.
 - Namely how the business relationships came into being in that the historical context of the relationship may influence the equity negotiation.
- The factors that were considered to carry weight when negotiating equity splits.

- It is of interest to explore the factors that the participants felt were relevant to the negotiation.
- Whether any factors specific to the South African context played a role in negotiations.
 - Given the socio-economic context of business development in South Africa and the need for BEE compliance it would be interesting to note if the participants felt that this was a consideration in their discussions.
- Retrospective thoughts regarding equity splits.
 - This allows people to reflect on and evaluate their decisions with the benefit of hindsight.

These areas were specifically identified as areas for investigation as they not only represent factors that could influence equity negotiation, but in mapping the process of forming business relationships, to negotiating equity, and then finally reflecting on the outcome of the equity negotiations offers an opportunity to explore the unfolding process of equity splits.

1.6 Overview of the research report

Chapter 2 is a review of the available literature on the area of equity splits in start-ups. As will be seen in this Chapter there is a paucity of research in this field. The lack of research in the field is noted to be one of the factors that allows this study to make a contribution to this area of research, and that furthermore it informed the choice of research methodology.

Chapter 3 discusses the research questions, which are the areas of investigation that were used to direct the study. This chapter introduces Chapter 4 in terms of the areas of investigation. Chapter 4 discusses the specific research methodology and documents the process of how the research was conducted. In addition to this it explores the strengths and limitations of qualitative research methods.

Chapter 5 explores the analysis of the data that was collected and uses the research methodology to develop a framework for understanding the process of equity negotiation.

In Chapter 6 the findings of the previous chapter are critically discussed with reference to the literature that is available in the field, and that was discussed in the Literature Review.

The research report is concluded in Chapter 7, where there is a review of the key findings of the study. This chapter additionally explores the limitations of the

current study, discusses the implications of the research and suggests avenues for future research.

CHAPTER 2: LITERATURE REVIEW

2.1 Introduction

The concern of the division of equity in start-ups is a fundamental issue in the founding phases of entrepreneurial businesses. At present there is little research available in this field, with Noam Wasserman (Wasserman, 2011) being the key contributor in the field. Whilst there is a lack of rigorous research into this topic, various studies have explored this topic, and the ideas that are articulated will be explored in this section. The review will map different aspects of equity negotiation, including factors that are considered in equity splits, the process of equity negotiation, models of equity negotiation and the effects of equity decisions.

2.2 The idea of equity splits

In joint ventures there is an inevitable point where the founder members are required to address the issue of how to distribute the equity of the start-up (Timmons & Spinelli, 2007). Recent research of a proprietary dataset of 1.476 founders in 511 entrepreneurial ventures in the USA (Wasserman, 2011) suggested that up to one third of entrepreneurs will split the equity equally in a process that is referred to as the “easy handshake route”, otherwise known as the Rule of N, where the equity is split equally amongst the number of founder members.

The equal division of equity is an issue that has been subject to critical debate (Gulati & Wang, 2003; Gage, 2004; Granovetter, 2005), with advantages and

disadvantages being listed for equal and equal splits. These will be discussed at a later stage, however the idea of unequal equity splits raises the question of what factors would be considered to be significant in weighting equity splits.

2.3 Factors that shape equity splits

One of the first studies to be conducted that addressed the issue of equity split was research by Evans & Leighton (1989) in which it was suggested that prior knowledge and/or education paired with work experience are factors that influence the division of equity. The study explored factors that were associated with successful entrepreneurial ventures where it was noted that age, education and experience were factors that were associated with success of the business. The study did not focus specifically on the division of equity but the role of knowledge and work experience were noted to play a role in equity negotiation.

Since the findings of this study Noam Wasserman has been one of the seminal authors who has contributed to understanding the factors that influence equity splits. The initial findings emphasised the role of the following factors (Wasserman, 2008; Hellman & Wasserman, 2010):

1. Idea generation: namely who proposed the concept behind the business venture
2. Prior-entrepreneurial experience: this refers to the value that is associated with prior experience and success within entrepreneurial ventures. In some respects this idea is a refined concept that was

offered by Evans and Leighton (1989) who noted that prior work experience affects equity splits. Prior entrepreneurial experience refers to not only the tacit knowledge regarding the practicalities of how to enter into a start-up, but also incorporates the value of networks and reputation.

3. Founder Capital Contribution: this is the idea that the contribution of capital in the start-up phases should be taken into account when dividing equity. Thus the capital investment of founder members is rewarded.

These findings address the factors that would account for the negotiation of unequal equity splits, and with this in mind it is interesting to explore both the processes that influence equity negotiation, and the models that are offered to calculate or negotiate equity.

2.4 The process of equity negotiation

The process of equity negotiation is complex (Nyhart & Dhanesh, 1989) and it involves interpersonal dynamics regarding rating the contributions that co-founders make with respect to their ideas, experience and the capital which they have to invest in the venture. Ashcroft (2004) notes that the process of negotiation is one that people may avoid as they often perceive it to be a skill in which they are not well trained.

Wasserman (2011) notes that up to a third of co-founders in start-ups opt for the equal sharing of equity (based on a proprietary dataset comprised of 1.476 founders in 511 entrepreneurial ventures in the USA).

Hauswald and Hege (2006) argued that high incidence of equal splits suggests a lack of formalised processes for the making decisions regarding equity splits which may leave founders vulnerable to not engaging with the issue at hand. This argument is supported by recent research into this area which describe the negotiation of equity as a “black box”, suggesting that little is understood about what happens in the actual process of equity negotiation (Hellman & Wasserman, 2010). The lack of systematic research into this area suggests that there is no scientific way or shared understanding of how to divide equity in start-ups.

The USA based research that has explored the team dynamics that appear to be active in equity decisions typically arrive at the same conclusion: heterogeneous teams (namely teams who differ in terms of skills sets, prior experience, differing capital contribution, and differences in personality styles and traits) will tend to divide equity unequally; whilst homogenous teams (that is teams with a greater level of similarity) will divide equity equally (Wasserman, 2008).

The research into team dynamics suggested that factors beyond valuing the individual contributions of members may influence the process of equity negotiations. Hellman and Wasserman (2011) noted that in addition to the

factor of team heterogeneity that larger teams, quick negotiations, and teams that were related by a familial connection had a tendency to lend themselves to equal equity splits. It therefore appears that as the complexity of equity negotiations increases, as indicated by these factors, so there is a difficulty in engaging with equity negotiations.

Two explanations for this is that an increased team size and navigating the complexities of family relationships may result in a process where it may appear that there is no way or known method to divide equity, or that there is a reluctance to engage in what could be a personally challenging process – especially where family is involved.

This introduces the next component of equity negotiations that is discussed in the literature, namely frameworks for equity negotiation.

2.5 Frameworks for equity negotiation

There is a general criticism of equal equity splits, which are based on a number of factors, including the idea that they are not always “fair”, and that co-founders can inadvertently “give up” equity of substantial financial value in a process that is not representative of the individual’s contribution to the venture.

Wasserman (2006), on his blog site “Founders Frustration Blog” suggested that the following be carefully considered before entering into equity negotiations:

1. Past contributions: refers to the generation of ideas.
2. Future contributions: includes projections of what roles each founder member will play in the future of the venture.
3. Opportunity Costs: this takes into account the potential loss of earnings, amongst other factors, that would occur in committing to the business venture.
4. Relationships: namely the consequences that one would risk in a relationship if there was a conflict regarding equity decisions, and whether there is trust within the relationship.

In interactions that followed this post, Demmler (2006) proposed what is referred to as the “Founders Pie Calculator”. Whilst this is not intended to be a generalisable solution to equity splits the intention was to create a measure that could be negotiated and would guide equity discussions. The “calculator” works by founders rating themselves and other members on 0-10 point scale on the dimensions of:

1. Contribution to the Idea
2. Contribution to, and development of the business plan
3. Domain expertise
4. Commitment and Risk
5. Responsibilities (past and future)

Demmler’s calculator is an approach that attempts to create a quantified evaluation of the contributions of founder members, whilst the points that are

raised by Wasserman (2006) serve as factors that should be considered prior to- and during equity negotiation. Wasserman (2006) is the only author who appears to have taken into consideration the value of the relationship and the fact that equity negotiations can present a threat to the stability of the relationship. In addition to this, the issue of “trust” that is raised by Wasserman (2008), suggests that factors beyond what an individual can contribute should play a role in equity negotiation, and that beyond this equity negotiations have an impact on the future relationships between founder members.

2.6 The effects of equity negotiation

The division of equity has two areas where there is a notable influence on the business venture. The first is that the division of equity is of key importance to the capital structures of the firm (Kaplan & Stromberg, 2004; Rob & Robinson 2009). The influence of the equity split on the capital structure of the venture lies in that it may determine dividend pay-outs, decision making processes, tax implications and access to funding amongst others (Timmons & Spinelli, 2007; Roberts & Zender 2008).

The second major finding is that share division has an influence on the future productivity of founder members (Holmstrom, 1982). Dissatisfaction with equity splits may result in a decreased commitment to the venture and may sour relationships between founder members. This is especially relevant where there are equal equity splits, but an unequal or disproportionate contribution to the business venture. (Holstrom, 1982)

2.7 Recent developments regarding equity negotiation

Given the impact that equity negotiations can have on both the capital structure of the venture and on the productivity of founder members it has been suggested that founder members enter into “dynamic founder agreements” (Wasserman, 2006). The idea behind these agreements is that the equity shares be negotiated after a period of time (commonly after a year) where there is a review process regarding the value of the founder members’ contribution. It is suggested that a framework be agreed upon to assess the value of individual contributions, but that this framework should be dynamic to accommodate unanticipated changes in the venture.

Whilst it is acknowledged that renegotiating equity splits is likely to be difficult issue, particularly with reference to the relational aspects; the use of this model is encouraged to allow for shifts in roles and changes in contributions over time, so that founders can be appropriately rewarded for their commitments to the venture.

2.8 Decision Making and Equity Split Decisions

Equity negotiations and equity split decisions inherently rely on the decision making processes. Furthermore it is recognised that decision-making processes are complex and multidimensional, and importantly are unique to the situation. Furthermore the situation at hand will often dictate the key decision obstacles. During decision making concerning wealth one of the dominant factors is risk. However it has been shown that more risk is taken in decision making when a large share of wealth is attached to share value. As such decisions made by an

individual primarily receiving wealth from share returns are more likely to have a risky approach to decision making (Coles, Daniel & Naveen, 2006).

In terms of equity negotiations where the vast majority of founder members potential wealth is derived from shareholding, the findings of Coles et al (2006), suggest that decision making may tend to be risky. Thus founder members may be willing to make riskier equity split decisions. While there is no empirical evidence to support this, the notion is conceivable.

2.9 Entrepreneurial Team Formation

Entrepreneurial teams are formed for a multitude of reasons however authors such as Harper (2008), note that the primary reasons are economic, the benefits of joint entrepreneurial action and interdependence. From this it can be deduced that founding members will primarily either offer an economic value (direct or indirect) or offer entrepreneurial action or support through skill sets and knowledge.

However, in the case of friendships or close personal relationships, entrepreneurial team formation is known to be less precise. Close personal relationships offer teams less tangible benefits that often allow entrepreneurial ventures an early performance advantage; most notably facilitated through a quick decision-making process and through general enhances to a team's early stage performance (Francis & Sandberg, 2000)

While close personal relationships stand to have positive effects or negative effects on a venture, what is important is that the close personal relationship potentially has benefits that allow ventures to outperform in the start-up process (Francis & Sandberg, 2000). Francis and Sandberg (2000) go on to recognise that close personal relationships are a legitimate basis for forming new entrepreneurial teams, and note that over time teams built on close personal relationships have the benefit of holding teams together as well as may stimulate heroic efforts during difficult times.

Watson, Ponthieu, and Critelli (1999) note that entrepreneurial teams are incentivised to adopt founding teams and team dynamics that are most likely to result in entrepreneurial success. With Watson et al (1999) finding that teams who rate themselves as a successful team rated the success of their company equally as successful regardless of the financial profitability of the company; so strong is the perceptual correlation between team and success. Thus it can be deduced that teams will naturally compose their founding members in a manner that the team feels will give the entrepreneurial venture the best chance of success. Furthermore, Lechler (2001) found that quality social interaction within entrepreneurial teams is crucial for the new venture success, prompting founding members to favour a socially conducive environment over one that has little conflict. Thus it is the quality of the social interaction that is important not the lack of conflict and entrepreneurial teams should naturally take this into account when developing teams.

2.10 Black Economic Empowerment

Black economic empowerment (BEE) at its core is intended to redistribute assets and engage sectors of the population that were previously side-lined (Roger & Roger, 2008). The South African government has adopted policies to enforce as well as encourage business to become more represented and diversely run and owned. Central to the incentives are rules and restrictions that limit non-compliant business from accessing markets and industries (specifically those controlled by the government). Furthermore businesses that are compliant have access to capital that non-compliant businesses do not. These policies have prompted businesses to become more compliant, in an effort to access these protected markets (Roger & Roger, 2008).

In an effort to become compliant business are incentivised to seek non-white owners and founding members to ensure that the company's equity is recognised as diversely held, and as a result the company is permitted to enter certain markets that are restricted.

As a result non-white owners have the added benefit of providing a firm with access to markets that are otherwise closed (Southall, 2006). This factor that non-white owners bring to venture has increases the value of a non-white owner to an organisation.

It stands to reason that entrepreneurial teams recognise this benefit and the trend for inclusion of non-white owners and managers in previously white organisations is representative of the value that non-white team members bring,

above the skills and knowledge that they possess. Founding members are valued on the value they bring to the team and venture (Evans & Leighton, 1989; Wasserman, 2008), and to stands to reason that BEE partners add special value that adds to the member's value. The intricacies of equity split among races is unknown, however is reasonable to assume BEE has an effect on equity negotiations.

2.11 Conclusion

Whilst there is a vast amount of “noise” in the field of equity negotiation in start-ups with there being numerous sources of opinions in the form of advice columns and popular blogs; there is very little systematic and rigorous academic research that has been conducted in this field. Outside the work of Noam Wasserman it is difficult to identify other academic authors who have contributed directly to this topic. Thus emphasising the need for further research in this area.

The paucity of research in this field is demonstrated by the limited number of referenced articles in this literature review, and in difficulties in finding research from allied fields that is applicable to equity splits. With this in mind this issue was identified as being an area in which research could make a novel contribution to the field of knowledge.

This chapter explored the literature landscape in terms of equity splits and equity negotiations. The following chapter puts forward the research questions and their motivations.

CHAPTER 3: RESEARCH QUESTIONS

The primary objective of this research is to generate an understanding of the factors that play a role in the negotiation of the split of equity between founder members in South African start-up businesses. In view of the fact that there has been very little research into the topic, the questions are primarily exploratory, and are aimed at identifying factors which influence this process.

The research findings that were discussed in the literature review (primarily the work of Wasserman, 2008) have been used to identify areas for investigation and exploration. These areas included:

- Heterogeneity/homogeneity of the team
- The value of the idea
- Past entrepreneurial experience
- Capital contribution

In addition to this, questions were raised regarding the process of the equity negotiations; from engaging with a business concept to having a shared agreement of the equity split. Real-world accounts of historic equity split processes were used to identify themes and trends that may have influenced the equity split as well as provide which may give insight into previously unidentified factors and dynamics at play in equity negotiation.

Research Question 1

Could you describe the relationship between founder members of your start up, prior to entering into negotiations regarding equity split?

The aim of this question was to gain an understanding of the relationships that existed between the founder members prior to equity negotiations. Wasserman (2008) found that heterogeneity/homogeneity of teams played a role the division of equity. This question explored whether the findings of Wasserman (2008) are applicable to equity negotiations in South Africa, where there is possibly greater cultural diversity in founder teams.

Research Question 2a

What were your understandings of the factors that would inform the equity negotiation upon entering into the process?

This question explored the underlying assumptions that were held by founder members when entering into negotiation. It adds a deeper level of understanding of the roles that individual differences played in the division of equity. Other than team heterogeneity (Wasserman, 2008); Hellman and Wasserman (2010) noted that idea generation, prior experience and founder capital investment were key factors in determining the equity split.

Research Question 2b

Do you feel that there were any factors specific to the socio-political environment in South Africa that had an impact on equity negotiations?

This question aimed to explore whether the participants felt where factors including race, culture and black economic empowerment (BEE) compliance influenced the division of equity in the start ups

Research Question 3

What did you experience as being the major obstacles in the negotiation of equity split?

This question sought to identify factors that influenced the equity split. Specifically it aimed to uncover areas of disagreement that are faced by founding members during equity negotiations as well as identify the factors that were most problematic.

Research Question 4

In retrospect do you think that the negotiation and equity split were satisfactory to you, and what advice would you offer entrepreneurs regarding equity negotiation?

Many people need time to reflect on experiences to determine whether they were favorable or not. In addition to the value of reflecting on the process, this question may also identify key factors in equity decisions that were not taken into account in the initial negotiations, but possibly emerged with time and the growth of the venture.

Chapter Conclusion

The research questions that discussed in this chapter have been designed to address areas of exploration that offer the best framework for identifying the factors that direct equity negotiation. Thus while they are discussed as research questions, they were broken down into a series of simplified questions that were included in the interview schedule. This process is discussed in the methodology chapter which describes the theoretical framework that guided the study, and describes the research process.

CHAPTER 4: RESEARCH METHODOLOGY

4.1 Choice of Methodology

The primary objective of this study was to identify factors that influence the decision making process regarding the division of equity between founder members in South African start-ups. The research process was initiated by reviewing the available literature. Given that there is a lack of research in this field, this study sought to not only identify and describe the factors that are central to equity negotiations, but also aimed to develop a theory that accounts for the process of the division of equity. For this reason a qualitative methodology, namely Grounded Theory, was employed as the research methodology, as the approach would allow for the emergence of new ideas and theories.

4.2 Grounded theory

Grounded Theory is a unique qualitative methodology that was created by Glasner and Strauss (1967). The term “Grounded Theory” refers to both the method and product of the research, in that the research aims to provide a contextually rich account of the area of study, which is – through the analysis of the data – used to articulate a theory that addresses the research questions (Denzin & Lincoln, 2005).

Essentially this research methodology offers a framework with flexible analytical guidelines that inform both data collection and data analysis. It is through these techniques that Grounded Theory is able to build inductive theories through the

successive levels of data collection, analysis and finally conceptual development. One of the major strengths of this methodology is that it provides the tools for each step of the research process, namely data collection, analysis and conceptualisation (Pigdeon, 1996; Denzin & Lincoln, 2005).

The process of Grounded Theory is somewhat circular in that there is a feedback loop between data collection and data analysis. Data collection is referred to as ‘theoretical sampling’ and the initial stages of data analysis is called ‘constant comparison’.

Within the paradigm of Grounded Theory data collection is an active process, driven by the emergent findings of the initial analysis. The process of data selection - theoretical sampling – is markedly different to random sampling which aims to provide generalised descriptions of the research question. Theoretical sampling is explicitly motivated by conceptual and theoretical concerns, with new cases being selected for their potential in generating new theory or enhancing the emergent understanding in the research process (Pigdeon, 1996).

The key mode of analysis in Grounded Theory is ‘constant comparison’. This involves the repeated comparison of emerging categories of data and theoretical propositions. This process promotes sensitivity to the similarities and differences in the exploration of the data and facilitates both conceptual and theoretical development (Pigdeon, 1996). The process of constant comparison is initiated with the coding of transcripts and/or source material, but also utilises

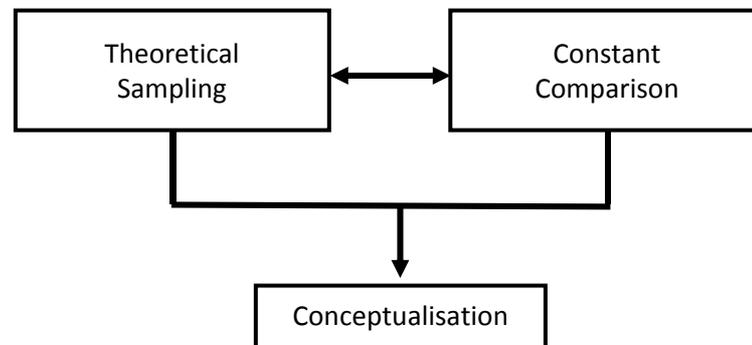
theoretical memo's – which are notes made by the researcher which contain reflections, emerging hypotheses, modifications to existing categories, and links to the available literature. This offers a way of externalising the data analysis, and stimulates additional theorising (Pigdeon & Henwood, 1996).

Theoretical sampling and constant comparison provide the predominant means whereby theory is generated and initiates the building of conceptual and theoretical depth – thus they are more than mere tools of data selection and analysis, but a key element in the process of grounded theory. Furthermore the initial stages of the research process are interactive with new cases being selected based on the analysis of the early data that has been gathered. In this regard the development of theory is an emergent process, whereby concepts and themes “emerge” from the data analysis and are extended by further data collection (Pigdeon & Henwood, 1996).

The constant comparison ultimately leads to the linking of emerging categories, where the analysis becomes concerned with the interrelationships between categories with a focus on their wider theoretical relevance (Pigdeon & Henwood, 1996).

The following diagram maps the process of Grounded Theory:

Diagram 4-1: The process of Grounded Theory



4.3 Suitability of Grounded Theory to the research question

The primary aim of the study is to develop insight into the factors that influence equity negotiations in South African Start-ups. From a review of the literature, it was noted that very little research has been conducted in this area. For this reason the aim of the study is not to test pre-existing theories, or to quantify factors involved in equity negotiations, but rather to contribute to the field by identifying factors that entrepreneurs regard as being relevant to equity splits. This allows for the elucidation of tacit or 'local' knowledge, and draws on lived experiences of equity negotiations to clarify factors that were deemed to be important in these decisions.

Grounded Theory provides a structured, but dynamic framework, in which the equity negotiation process can be explored, and is sufficiently rigorous to allow

for the description of a theory to account for the decision making processes within equity splits.

4.4 Limitations of Grounded Theory

Perhaps the strongest criticism that has been offered against Grounded Theory, is one that it shares with most of the qualitative methodologies – namely that it is an interpretive process which can be biased by assumptions and beliefs that are held by the researcher. In this regard it is important for the researcher to have insight into their own beliefs and potential biases, and to suspend their ideas regarding the topic. In this way the researcher can create a space where their own beliefs are open to critical interrogation and where the data can “speak for itself” (Marshall & Rossman, 2006). Grounded Theory offers a unique safeguard in this respect where the researcher’s memo’s become texts for critical analysis, and in this way the researcher can become aware of their own potential biases (Denzin & Lincoln, 2005).

The inherent limitations of grounded theory were acknowledged and accounted for. To this effect, the researcher attempted to make an objective interpretation of the findings in an effort to reduce personal biases.

4.5 Population

The population consisted of entrepreneurs or founding members of start-ups in South Africa that met the following population criteria:

- (1) The start-up had been in existence for less than 3 years

- (2) There were multiple founding members or multiple equity owners
- (3) Founding members involved in companies that had failed within 3 years were also included in the population

The population criteria were set for the following reasons:

- less than 3 years the information is still fresh which limits retrospective bias and respondents are able to more accurately recall historical events
- need more than 1 founding member to have an equity split, may have silent partners
- it is important to study failures as often they have the richest information of problem situations and have had a chance to reflect on decision making

4.6 Unit of Analysis

The unit of analysis for this study was the founding members of start-ups. The unit of analysis is the elements of the population (Saunders et al., 2009). Consequently, the founding members of start-ups were subject to the population criteria. Founding members were deemed the most accurate source of information required for this study. This was considered important for this study as the study was concerned with understanding the factors that shape equity negotiation.

4.7 Sampling Method and Sample Size

The research made use of non-probability sampling. As a result the findings of the research could not be inferred across the population, however this limitation

was deemed necessary in order to gain rich qualitative data from a small sample that was require for the purposes of this study. Specifically purposive (or theoretical sampling) sampling was used in this study, which allowed the researcher to select cases that best answer the research questions (Saunders et al., 2009). Purposive sampling is also noted as being suited to grounded theory, where each case is deliberately selected because of what it may contribute to the overall study. Cases are therefore selected to add depth to the study or to introduce contradiction that the study may explore (Glasner & Strauss, 1967).

Seven research participants (sample size) were selected, based on them having experience of equity negotiations in start-ups in the past three years. They were identified through business networks and online social networks (such as LinkedIn) and were selected in accordance with the principles of Grounded Theory: namely that their experiences that could meaningfully contribute to the research topic. The sample size collected was considered sufficient for the purposes of this study

4.8 Research Instrument

The research made use of a semi-structure interviews that were conducted face-to-face with respondents

Semi-structured interviews were used to allow for an exploration of the responses provided by the respondents in a conversational format. This format

encouraged the sharing of personal experiences that might have been more difficult for the respondents to discuss in a written format.

A semi-structured interview schedule was developed through a process of ‘unpacking’ the research questions that allowed the interview to naturally track the process of equity negotiation – from the point of making the decision to enter into a start-up, through to reflecting on the outcome of the equity negotiation.

Table 4-1: Overview of research questions

Research Question	Items included in the interview schedule
1. Could you describe the relationship between founder members of your start up, prior to entering into negotiations regarding equity split?	<ol style="list-style-type: none"> 1. How did you meet your business partner? 2. When did you formally decide to enter into business together? 3. At which point in the business negotiations did you start to address the issue of how you would divide the company’s equity?
<p>2a. What were your understandings of the principles that would inform the equity negotiation upon entering into the process?</p> <p>2b Do you feel that there were any factors specific to the socio-political environment in South Africa that had an impact on equity negotiations?</p>	<ol style="list-style-type: none"> 4. What did you initially identify as key markers for the equity split? 5. Other than these markers , what were the other factors that were considered when negotiating the division of equity? 6. Is there anything that is specific to the South African context that influenced your equity negotiations?
3. What did you experience as being the major obstacles in the negotiation of equity split?	<ol style="list-style-type: none"> 7. What were the major sources of difficulty in the equity negotiations? 8. Were you satisfied with the outcome of the negotiations?

Research Question	Items included in the interview schedule
	9. Do you think that the equity negotiations had an impact on your working relationship with your business partner?
4. In retrospect do you think that the negotiation and equity split were satisfactory to you, and what advice would you offer younger entrepreneurs regarding equity negotiation?	10. In retrospect is there anything that you would do differently in the negotiation of equity? 11. What advice would you have for people in Start-Up's regarding the negotiation of equity? 12. Is there anything that you feel is important in the negotiation process that has not been covered in this interview?

The research questions 2a and 2b were addressed through the same items on the interview schedule as the interview sought to track the narrative of the participant's experiences.

The questions were developed to best answer the research objectives through an iterative approach. Initially a number of questions were generated and these were gradually refined into the questions that have been presented. Furthermore the research questions were developed in a manner that allowed them to best meet the research objectives.

The interview schedule was piloted with one entrepreneur to ensure that questions were understandable and that the information gained from the interview was suitable in terms of addressing the research questions.

4.9 Data collection

Participants were contacted through business networks, interview times were arranged. Interviews were conducted with the appropriate briefings; including stating during the interview that the data collected was confidential and that the information collected would be used in a research report. During the interview a neutral and open environment was created to avoid leading respondents, which was beneficial in order to reduce response bias and allows for the extraction for rich qualitative data)

The interviews were recorded with the participant's consent, and were transcribed for data analysis. Saunders et al (2009), recommend a process of "data cleaning", whereby the transcripts are read whilst listening to the recorded interview. This is done to ensure the accuracy of the transcribed material.

Reflective notes and memos were made following the interviews and during the transcription process to aid the data analysis.

4.10 Data analysis

The data analysis was conducted through the use of interpretation, conceptualisation and summarisation of the emergent themes and categories (Saunders et al., 2009). In Grounded Theory this process is referred to as constant comparison. It is an approach which does not make use of pre-existing theory to inform the data analysis, but rather allows for the emergence of themes (which can later be used to inform theories). A key aspect of the data analysis is the search for 'negative case studies' to ensure the validity of the

conclusions that are drawn (Wellman & Kruger, 2001). Negative case studies are instances where there is a contradiction between the emerging themes and case material – it is useful to use in refining hypotheses, and allows for more stringent interpretation of the data, thereby ensuring the validity of the findings.

In practical terms, the data analysis was initiated through the coding of the transcripts. This is a process in which themes are identified and organised into meaningful units of analysis. Once the coding was completed the themes were grouped into categories that appeared to be related.

The relationships between these categories were then critically explored to ensure that the hypotheses that were being developed were both logical and valid.

4.11 Validity and reliability of the study

One of the criticisms of qualitative research methods is that proving or establishing validity and reliability of the research findings is complicated by the fact that the data analysis is generated through interpretation of themes and categories, and the researcher is immersed in the process (Henwood, 1996).

In addressing the concerns of validity and reliability in qualitative research and grounded theory in particular, the following should be noted:

- 1) Whilst the empirical testing of validity and reliability are limited through interpretative and not quantitative process, a critical reading of the report

allows the researcher and reader to subjectively assess the validity and reliability of findings (Henwood, 1996).

- 2) Qualitative methods primarily concern themselves with the exploration of new ideas and the construction of inter-subjective meaning. As such qualitative methods mark a clear movement away from priorities of valid representations associated with empirical methods (Henwood, 1996).

Thus whilst the concepts of validity and reliability are problematic within qualitative research methodologies, it is important to note that the critical reading of the findings gives a sense of their face validity. Furthermore the shift to interpretative methods introduces a primary research concern of exploring meaning and new ideas.

A final cautionary comment on the issue of validity and reliability is to exercise hesitancy in applying the research findings in a generalised manner as the research findings are contextually bound to the data that generated them.

4.12. Limitations of the study

4.12.1 Population Validity

Due to the sampling technique used in this study the extent to which the findings can be generalised to the population are limited (Saunders et al., 2009). As a result while the study attempts to explore the phenomenon with relation to the population, the sampling techniques prevent accurate extension

of the findings. This limitation is acknowledged however is considered acceptable for the purposes of this study.

4.12.2 Researcher Bias

Due to the qualitative nature of the research analysis and research instrument, the findings of the study are subject to the personal basis and experiences of the researcher. The influence of researcher bias is acknowledged, and was limited for by actively attempting to reduce bias and preconception during data collection and data analysis (Saunders et al., 2009).

4.12.3 Sample Bias

The sampling technique used (non-probability) in this study create a bias towards the personal business networks used (Saunders et al., 2009). This limitation is acknowledged however considered acceptable for the purposes of this study. Users of this research sound be aware of the sample and context in which this study took place and avoid population inferences.

4.12.4 Social Desirability Bias

Administering questionnaires face-to-face has the potential of attracting social desirability bias. Social desirability bias occurs when respondents consciously or unconsciously manipulate responses to create a favourable impression. The presence of this bias was acknowledged in the research and limited by creating a neutral and open environment interview environment and the researcher avoided leading questions (Saunders et al., 2009).

4.12.5 Respondent Retrospective Bias

Retrospective bias occurs when respondents are asked to recall historic events. As respondents in this study were asked to recall events up to 3 year ago the ability for respondents to accurately recall historic events is impaired. This bias was controlled for in this study by limiting the amount of time from start-up to 3 years. This amount of time was considered sufficient to limit the amount of retrospective bias.

4.12 Ethics of the research

The privacy and confidentiality of the research participants and their interviews was respected at all times through not recording any of the identifying information in the written transcripts. The participants provided informed consent for the recording of the interviews, with the understanding being that the recordings were solely for the purposes of transcription, and that the recorded material would be erased after the submission of the research report.

CHAPTER 5: DATA ANALYSIS

5.1 Introduction

This chapter presents the qualitative results of the data collection. The results are presented according to the research questions that they address. However before the research questions are examined the description and composition of the sample is discussed.

The aim of Grounded Theory is to allow emergent themes to be identified in the data, through the rigorous comparison of concepts that are described. Following the identification of the key themes that emerge from the data; ideas can then be conceptualised to form a model or low-level theory that describes the phenomenon at hand. As such the findings presented in this chapter the methods of Grounded Theory, however draw on the structure of the research questions to facilitate the analysis.

5.2 Description of the Respondents (Sample)

Seven respondents (business people) with experience in start-ups in the past three years were approached and asked to participate in the study.

The following table summarises the demographics and history of the participants. The table is intended to provide the reader insight into the sample and context of the study. While not part of the research objectives this information was deemed important as due to the choice of methodology the composition of respondents had a large impact on the findings of the study. Readers and users of this research should not the composition of the study as

well as recognise that the results are representative of the sample surveyed alone and cannot be accurately inferred to the population.

Table 5-1: Demographics and history of participants

	Gender, age and race	Previous Experience and Skills	Circumstance of Start-up
1	Male, mid 50's, white South African	Senior Management	<p>The participant was looking for BEE partners to join him in establishing a new venture, which was an extension of an established business. He has developed the core idea of the business.</p> <p>The venture consisted of a small team, with heterogeneous skills.</p> <p>The equity split was 49/51 percent split in favour of the BEE partner.</p>
2	Male, late 20's, white South African	Media and Journalism	<p>Met his business partner through previous working experience. They went into business with a shared idea, following frustration experienced in working in corporate environments.</p> <p>There were 2 founder members, with heterogeneous skills, who decided upon an equal split.</p>
3	Male, early 40's, white South African	Incubator and entrepreneur	<p>This participant has been involved in numerous start-ups. He has met all of his business partners through social and business networks. He typically finds partners to join him in start-up's the develop ideas which he has generated.</p> <p>Equity was discussed late in the business venture with a small team who had heterogeneous skills. The participant values equal equity splits.</p>

	Gender, age and race	Previous Experience and Skills	Circumstance of Start-up
4	Male, late 40's, white South African	Entrepreneur and strategy consultant	<p>The start-up's was formed on the basis of an idea that was generated by the participant. He met his business partner through previous work experience.</p> <p>The venture had two founders with heterogeneous skills, who decided upon an equal split.</p>
5	Male, late 40's, white South African	Entrepreneur and CEO within the property sector	<p>This participant was approached by a large corporate to be involved in a start-up. The idea that the new start-up was based on was generated by the group who approached him.</p> <p>The team involved many founders, with heterogeneous skills. An unequal equity split was negotiated.</p>
6	Female, mid 30's, black South African	Marketing and Media	<p>Through a social network this participant formed a start-up which involved the development of a shared idea.</p> <p>The founder team consisted of four members with heterogeneous skills, who decided upon an equal split.</p>
7	Male, mid 30's, black South African	Telecoms	<p>This participant was approached to join a start up by family members, who invited him to assist in the development of a business venture which had been formulated by one of the other partners.</p> <p>The team consisted of 3 founders who formed a heterogeneous group, and decided upon an unequal split.</p>

All of the start-ups were based in Gauteng, and were either successful businesses, or had closed for various reasons at the time of the interview.

The entrepreneurs 5, 6 and 7 were involved in failed businesses.

The sample was considered relatively representative of a broad range of business, previous experience and ages of founding members. However in terms of gender and race the sample was skewed, with female respondents only accounting for 1 of the 7 responses and black respondents' only accounting for 2 of the 7 responses.

5.3 Findings of the research Questions

The following section presents the qualitative findings of the research questions. The findings are presented in a manner that condenses the data presents them in reoccurring themes, as well as provide graphs that visual represent relationships in the data.

Furthermore, the findings presented explore (RQ1) the ways in which relationships were formed, the process of entering into business, (RQ2a) approaches to the division of equity, (RQ2b) socio-economic factors that impacted on the division of equity, and (RQ3) advice that would be offered based on the experiences which the participants had had.

5.3.1 Research Question 1

The following section presents the research findings to research question 1. The findings are presented in two parts. Firstly the ‘forming of relationships’ and secondly ‘entering into business’. The question was primarily concerned with the dynamics of the relationships that existed between founding members.

Forming relationships

When analysing the ways in which the relationships have been formed two processes emerged in the findings:

1. The first is where an existing business is looking to extend or start a new venture; they approach a prospective partner through recommendations, networks or through head hunting processes.
2. The second route whereby partnerships were formed was through people with a previous relationship deciding on embarking on a joint venture where the vision for the business is co-developed.

The point of interest in exploring the ways in which the business relationship started is to identify the ways in which the history of the relationship had a potential impact on the negotiation of equity splits. This will be a theme that will be referred to through the course of the data analysis. Before looking at the ways in which the participants approached the equity splits, the process of entering into equity negotiations will be briefly discussed.

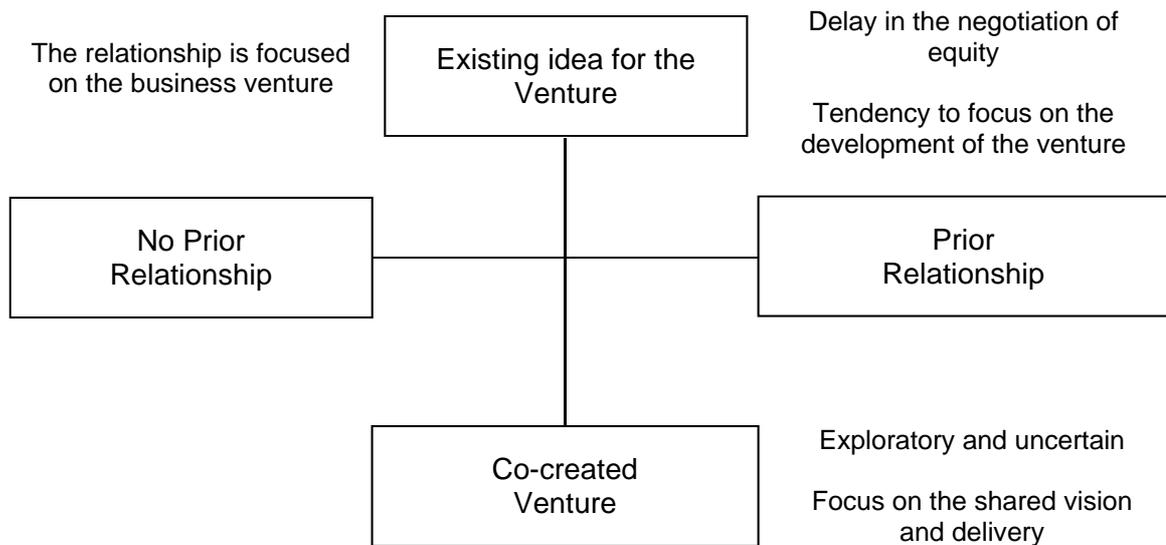
Entering into business

As was discussed in the previous section; two paths in terms of entering into a business venture emerged. In the first instance a business venture already existed and people were recruited through various networks into the business during the start-up process. In this process it appeared that there were clearer understandings of what the purpose of the relationship was. However, in the second instance the venture was the product of a joint or co-created vision; And as a result it appears that there was a greater focus on the formulation of the business vision, and less attention to the relationship.

The second factor that played a role was where there was a relationship (personal or collegial) prior to entering into business. The new relationships which were formed for the sole purpose of developing a start-up appeared to have clearer parameters than those where personal relationships out-dated the business interests.

If these two factors are conceptualised as being interactive the following can be seen:

Diagram 5-1: Relationship matrix



From the data gathered in this research it appears that in the situations where there is an existing idea for the venture that is being developed, and there are no prior relationships or business connections it seems that the relationship lends itself to a dynamic that is more formal and business orientated. Where there is an existing idea for the venture, in which colleagues, family or people who are connected through a business network the initial relationship tends to focus on development of the venture and at the outset, does not address equity negotiation. In the cases where there was a prior social or working relationship, where the venture was co-created the initial business relationship was exploratory and uncertain, and tended to focus on the shared vision and delivery issues.

Thus it appears that the history of the business relationship had a powerful role in shaping the dynamics of the business relationship. This in turn appeared to have an influence on the ways in which the division of equity was negotiated.

5.3.2 Research Question 2a

The following section presents the research findings to research question 2. The question was primarily concerned with factors that influence equity division and the approaches that are adopted by founding members.

The approaches to the division of equity

The interviews conducted were summarised. The following section provides a summarisation of the themes that emerged. The summary provides insight into the ways in which equity negotiations were conducted as well as shed light on the factors that influenced them.

Previously established idea for the venture, with no prior working relationship

There was a thorough screening process prior to engaging in business.

Equity was divided in a 51/49% split in favour of the party who were joining the start-up.

There were a clear set of principles which determined the split, which were directed towards gaining buy in, ensuring goodwill and commitment.

A clear exit strategy was negotiated

There was clarification around issues of equity and control with reference to decision-making.

Whilst a number of principles were used to direct the equity split, the factor that was emphasized was maintaining goodwill in the relationship

- “we were happy to give 51%... the partner was excited. We wouldn’t have it any other way.”

A shared venture where there was a prior working relationship

There was a verbal agreement of a 50/50% split.

This was made on the basis that it was fair, and that equity should rightly be equally divided between the co-founders of the business

- “we had an upfront verbal agreement”
- “we didn’t have an in-depth discussion because things moved quickly”
- “we both wanted to make sure that it was going to be fair”

Previously existing business idea was developed into a venture, with the relationships being formed through social and business networks

Equity was negotiated after the fact based on an idea of fairness

- “get on with it, get things done”
- “let’s get the work done then divide it all up”

There was an idea that it is easier to negotiate equity after the fact, if the people involved participated with a shared principle of fairness.

With the notion of fairness in mind there was a leaning to equal equity splits, either 50/50 or 33/33/33.

The argument against having an unequal equity was that it introduces power dynamics that can be destructive.

The equity split was made with the purpose of preserving the working relationship.

An existing venture that had been identified and the new business relationship followed on from a previous working relationship

50% equity was offered.

Equity was separated from power in terms of decision making.

Equity is viewed as what you offer to get “buy in”:

- “it is the price you are willing to pay for commitment”

The division of equity is seen as a reflection of personality:

- “when you allocate it (equity) it has to do with who you are, and how you would like to be treated in the company”.

In this way the equity split is seen to be both personal, and as a factor that could potentially shape the company culture.

With regard to relationships, the equity split is about achieving commitment and buy-in.

***The participant was approached (head hunted) to assist in develop a business venture, which was based on ideas of other founder members:
No prior connection in terms of the relationship***

The equity split was formally negotiated from the outset

The negotiation is described as being goal directed and rigorous (some of the equity was given, the rest was bought).

It appears that both parties knew what they brought in terms of capital, skills, networks and credibility.

Described the negotiation with terms like

- “non-negotiable”
- “deal breaker”

This is the one case study where the negotiations were assertive and where there was no explicit focus on preserving a relationship of goodwill.

A business venture which was a shared idea between friends and colleagues

- “we never really negotiated equity”

Equity was decided upon by a vote in which it was decided that an equal partnership between the four co-founders was fair.

The more complex issues of equity were not considered

A prior business idea where the participant was a family member who was invited to join the venture

It appears that equity was formally discussed, but based on capital investment, and was at the discretion of the senior partner.

This was acceptable to the participant because there was a sense that it was a valuable experience, that the business was operated in good faith, and that personality factors were involved.

- “for a junior entrepreneur experience is a pull factor”
- “knowing it was fair”
- “it has to do with my personality. You know, why fight for equity at the beginning when we really don’t know what the outcome is going to be”

Interpreting the findings and themes observed in Research question 2a

Based on the data it appears that whilst skills, experience, networks, reputation and capital contribution informed the equity split; the idea of maintaining goodwill with in the working relationship was a central factor that directed the

equity splits. The maintenance of goodwill was considered to be important in two regards: the first being a more strategic position in which goodwill was seen to result in positive factors such as commitment to the business and ensuring “buy in”. The second reason for maintaining goodwill seemed to come from more personal reasons, involving a preferred way of conducting relationships and acting in an ethos of fairness.

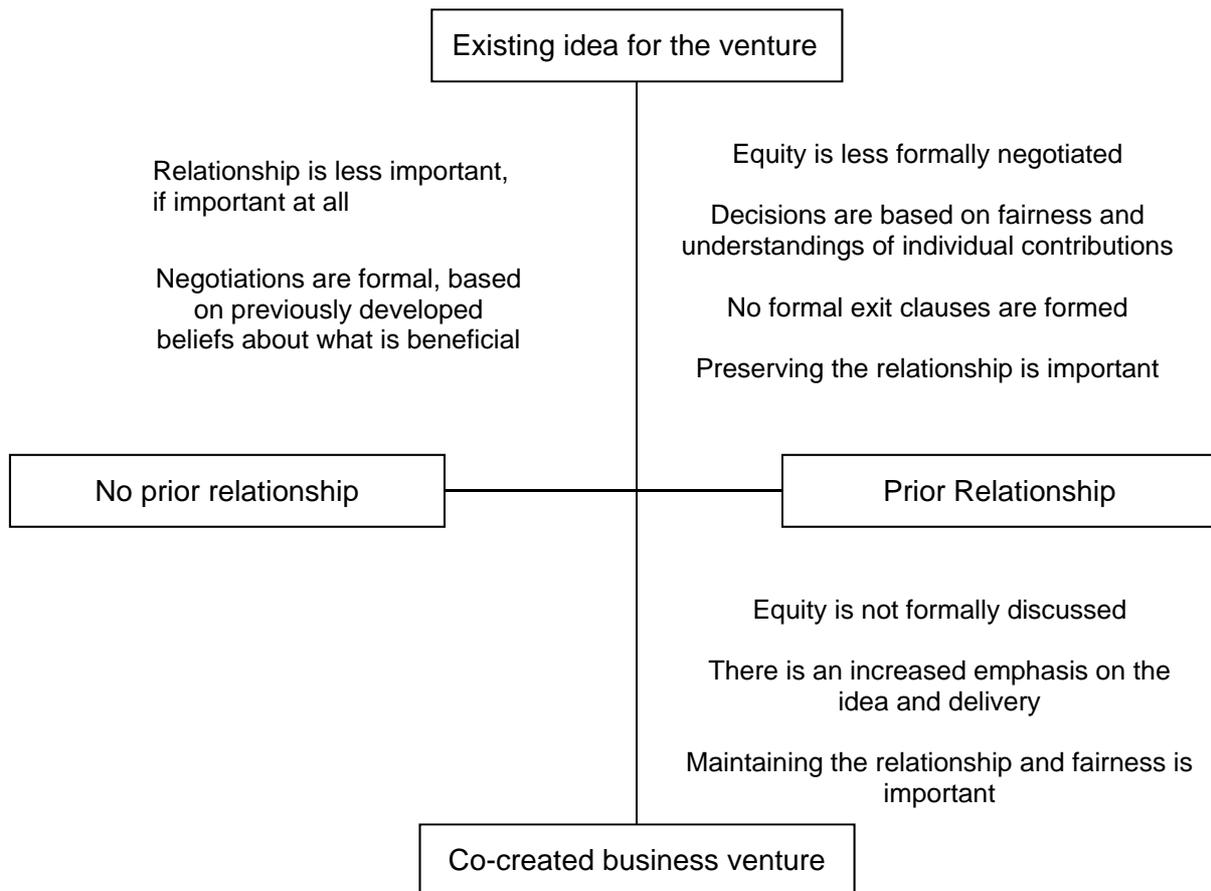
What can be inferred from the data is that as the level of the relationship deepens – which is mediated by having a prior relationship, and by engaging in a shared business venture, so there was less of a tendency to negotiate equity, and increased tendency to adopt principles of “fairness”. With reference to this the only case study which did not make references to the working relationship, and where there were intense equity negotiations is one where there was no prior relationship, and where the participant was being invited to develop a business venture which was the idea of the other party. The absence of a relationship with the new business partners or being party to developing the initial idea of the venture seems to reinforce the notion that the relationship has a significant role in directing equity negotiations.

With reference to the data there were opposing ideas regarding how to split equity with regards to the partners having equal equity versus having a major shareholder. The most common approach was to equally divide equity between the founder members as this was considered to be fair, and avoided the introduction of power differentials which were thought to be potentially destructive. The opposing view point was to allow for an unequal share of equity

(51/49 split). This was done to create goodwill and commitment from the new partner. Thus, whilst there are seemingly disparate approaches to sharing equity, these differences can be understood with reference to the principle of sustaining goodwill within the relationship.

Another interesting point is that exit clauses were only negotiated in the two case studies where there was no prior relationship. It would seem that negotiating exit agreements may oppose a sense of creating goodwill within the relationship, and is a part of the territory of the more formal business negotiations that appear to take part between people who do not have a previous working or social relationship.

Diagram 5-2: Relationship matrix documenting equity negotiation



Top left quadrant reflects the equity negotiation process when no prior relationship existed and the partnership is based purely on an existing idea.

Top right quadrant reflects the equity negotiation process when an existing ideas exists and there is a prior relationship between the partners.

Bottom right quadrant reflects the equity negotiation process when a prior relationship exists and the it is based on a current businesses relationship.

5.3.3 Research Question 2b

The following section presents the research findings to research question2b.

The question was primarily concerned with discovering if social-economic

factors in South Africa have an impact on equity negotiations and equity split decisions.

Socio-economic factors that are involved in equity splits

With reference to the South African context one of the factors that was of interest in equity negotiations was whether Black Economic Empowerment (BEE) compliance had any impact on equity negotiations. In order to achieve BEE compliance there are a number of different avenues involving partnerships, equity and other areas including training and skills development. In the cases that have been used in this study it was noted that BEE compliance is important for government deals. The first participant who was interviewed deliberately sought out a BEE partner to ensure compliance. The remaining case studies involving white entrepreneurs the issue of BEE was not addressed in the business ventures which they were pursuing.

Finally it was noted in interview 7 that racial and cultural diversity is not only important for BEE compliance, but also can be seen as being a significant factor in terms of penetrating particular markets. It was argued that knowledge of cultural norms was an important skill with regard business negotiations.

5.3.5 Research Question 3

The following sections presents the research findings to research question 3. The question was concerned with identifying the major obstacles to equity negotiations.

Major obstacles to equity negotiations

- The wish to maintain a good relationship by being 'fair' with the equity split.
- Difficulty in quantifying the qualitative aspects that each partner brought to the joint venture.
- Being uncomfortable with discussing aspects that pin down the value of each contribution to the joint-venture in monetary terms.
- Difficult in predicting the contribution towards the business that each partner will have in the future.
- Difficulty in specifying the role that each partner will play in the context of a start-up, where roles and responsibilities mix depending on the circumstances.

5.3.4 Research Question 4

The following section presents the research findings to research question 4. The question was primarily concerned with unpacking retrospective advice from entrepreneurs, in terms of equity negotiations and equity splits decisions.

Advice that is offered

It is interesting to consider the advice that was offered by the research participants, as it draws on past experience of the entrepreneurs. Data collected was analysed for recurring themes. The findings of the data analysis are presented below:

- Not giving equity away when you could gain equal buy in from salaried employees
- Having a clear understanding of the immediate and potential value of the equity that is being offered
- Considering the values of the people you are entering into business with
- Evaluating skills and knowledge
- Having a clear understanding of the field you are entering into
- Discussing equity up front in a thorough way, and documenting the agreement
- Developing exit clauses with regard to buy/sell agreements and reasons to terminate the business with regard to unacceptable conduct
- Keeping an alignment with regard to expectations
- Having a review period with clear expectations prior to equity negotiations
- Ensuring that equity promotes a good relationship

The above advice is noteworthy in that it primarily suggests practices that were not adhered to by the participants who had relationships with their business partners prior to entering into a new venture.

The themes that emerged covered a variety of areas, however relationship preservation, fairness and clarity were predominant reoccurring underlying themes. Many founding members suggest advice that protected themselves

and others around them, in an attempt to mitigate possible equity issues. Advice givers seeking to ensure that founding members retain as much equity as possible are in the minority, with the majority focusing on promoting a robust understanding of equity as well as promoting solid relationships and values.

It raises the question of whether people would enter into equity negotiations differently with the benefit of past experience, or when in the face of the dynamics attached to a relationship, people act in ways that are not in consistent with the knowledge they have.

Given that one respondent (interview 3) who noted that he did not believe in negotiating equity upfront but acted in accordance of principles of fairness, it may be that the relationship is more powerful factor than it is given credit for. He made the following comment:

“if you have to reduce a partnership to writing you shouldn’t have gone into partnership”.

5.4 Chapter Conclusion

From the data analysis it appears that the dynamics of the relationships that exist prior to entering into business had a significant role in shaping the equity negotiation of the cases described by the participants. The key finding was that maintaining goodwill in relationships that had existed prior to the business venture was an important consideration in equity splits.

This chapter presented the findings of the research in terms of the research questions as well as examined the description of the sample in an attempt to provide context to the findings. The following chapter discusses the results and draw on literature to examine the results of the research questions.

CHAPTER 6: DISCUSSION OF RESULTS

The aim of this chapter is to critically compare the findings of the data analysis with the ideas and concepts that were discussed in the literature review. This will be done by contrasting the findings of the literature review with those of the data analysis. These will be discussed in accordance with the research questions which focused on: the formation of the business relationship, factors that were involved in the equity negotiation, obstacles that occurred during equity negotiations and finally advice that is given with regard to equity splits.

Before proceeding with the discussion of the results it is important to note that the comparison of the findings of the literature with those of the data analysis is essentially a process of contrasting what has been identified in the academic realm of study, with what occurs in the lived experiences of people who embark on joint ventures which require equity negotiations. The value of this process is to allow for the formation of a dialogue between “expert knowledge” and “lived experiences”, with the possibility of seeing where knowledge can be drawn on in the lived process of equity negotiations, and conversely where they lived experiences of these negotiations can inform directions for future research.

6.1 Research Question 1: The formation of partnerships

The findings of this study suggested that there were three primary ways whereby partnerships were developed:

1. The partnerships were formed where one party had a clear business venture in mind, and additional partners were head-hunted for the positions that were needed to be filled.
2. Partnerships were formed between people who were known to one another, through family, social or collegial networks. The partners were recruited into joining a business venture which had been previously identified.
3. The third way in which partnerships were formed was where people who had an established working or social relationship co-developed the idea that lead to the business venture.

The relationship matrix presented in Diagram 5.2 argues that as there was movement through the quadrants of the graph – from no prior relationship working on an idea that was generated by an individual through to there being an established relationship where partners were working on a shared idea so there was an increasing investment in maintaining goodwill within the relationship. The literature reviewed by Francis and Sandberg (2000), agrees with these findings and add a possible explanation, by noting that the large potential upside of close relationships especially in the start-up phases allows teams with an early stage performance advantage facilitated through a fluid decision making process.

Furthermore the findings of this research question were supported by Harper (2008), in that team formation is directed by economic or joint entrepreneurial action. The three scenarios observed were the product of founding members seeking joint entrepreneurial action. While there were difference, in each case observed founding members sought other founding members to act in joint entrepreneurial action.

While not empirically observed, it can furthermore be assumed that teams chose founding members that provide the venture with the best chance of success. This would be in conjunction with Watson et al (2009), who note that founding teams will be constructed to be ensure venture success. While empirical evidence was not secured in this study; anecdotal evidence suggested this to be true, as the majority of founding members gave their founding team dynamics much thought and introspection.

6.2 Research Question 2a: Factors Influencing equity splits

The formalised research into equity splits identifies three key factors that influence equity splits, namely: the value of the idea, past entrepreneurial experience and capital contribution (Hellman & Wasserman, 2008). In addition to this finding it has been noted that team dynamics play an important role in equity splits with heterogeneity/homogeneity, the size of the team and the presence of family relationships being factors that may steer negotiations to equal splits. An additional factor that influence equity splits was the rate at

which founders went into these negotiations and concluded them, with faster or more rushed equity split negotiations tending to be associated with higher levels of equal equity splits.

In the case studies that were used in this research it was noted that when close-relationship (or higher level of emotional commitment) existed there was a significant impact on the negotiations of equity. When close interpersonal relationships existed so there was a tendency to refrain from engaging in equity negotiations; and a tendency to split equity equally based on a principle of “fairness”.

In the instances in the case studies where equity was formally negotiated the factors identified by Hellman and Wasserman (2008) were systematically drawn upon to negotiate the division of equity, suggesting that these factors play a key role in assessing the value of one’s contribution to a start-up. In this research the formal negotiation of equity was associated with there being no prior relationship suggesting less of a need to maintain goodwill.

In the cases where there was hesitancy in engaging in equity splits appears that maintaining goodwill within the relationship played a key role in deciding upon equal equity splits, but this does not mean that force of team homogeneity was not at play since there would have been an experience of similarity based on an established relationship, but not necessarily in terms of similar skills. It is unclear whether the size of the teams had an effect on the equity split.

The key difference between the findings of the literature review and this research is that the literature review outlines factors that have been demonstrated to be of value in negotiating equity, whilst this research describes the process of engaging in equity decisions which appear to be powerfully motivated by the dynamic of protecting the relationship.

6.3 Research Question 2b: Black economic empowerment

The findings of the research were found to be supported by the literature review (Southall, 2006). When moving into 'limited' markets BEE and impact of BEE on ownership becomes a relevant factor, that holds value to the negotiation process. Unfortunately the portion of the sample that this occurred in was too small to find meaningful findings. However in instance where it did occur the literature supported the potential role of BEE in equity split decisions and negotiations. Furthermore it appears that business respond to BEE and are incentivised to seek non-white owners and founding members to ensure that the company's equity is recognised as diversely held.

Due to the (limited sample and not generalisable) study it appears that BEE has potential value in equity split negotiations, however it appears that it is market dependent, and the results suggest that BEE has less value in equity negotiations when the market is not heavily regulated and specifically BEE incentivised .

Entrepreneurial teams seem to recognise the benefit that team members bring, to an extent where the skills networks and knowledge members bring is specifically targeted and aligned to the purpose of the company, which are in line with the views of Evans and Leighton (1989), presented in the literature.

6.3 Research Question 3: Obstacles in equity splits

Obstacles in equity negotiation that were addressed in the literature included difficulties in estimating the worth or value of individual's contributions, how to measure the value of the venture, and how to develop equity agreements where initial equity splits could be addressed should they need adjustment (Wasserman, 2006).

In this study it appears that entering into equity negotiations itself was the primary obstacle, as such founding members tended to see equity negotiations as an obstacle, with only 2 of the 7 participants having a negotiated equity in a systematic manner. Again it was seen that as there was a greater investment in the relationship so there was less of a tendency to engage in equity discussions, and as a result equity splits were often not comprehensively negotiated.

This observation has two possible implications – the first is that if there was a more rigorous or scientific model that could be used that were accepted as a standard practice then some of the anxiety could be removed from equity negotiations, in that a model that is regarded as being “fair” could be employed without worries about compromising the goodwill of the relationship. The second, and contradictory implication, is that there is a profoundly human element in equity negotiations and the need to maintain goodwill within working relationships may override decisions to employ more systematic approaches to equity splits in favour of the face value of equal splits.

Furthermore the findings could be representative of the sample, and the context in which the sample took place. The tight-knit business environment and the nature of a small community that exists in South Africa may explain the tendency for founding members to shy away from intense equity negotiations. The environment may play as an influence on founding members, by persuading them to favour the value of a good reputation and personal brand over the risk of equity negotiations and subsequently business relationships turning sour. While this study did not empirically explore this element, it is noteworthy to consider the content in which a sample existed and take it in to account. As a result the environment may have an effect on equity negotiations and equity split decisions.

6.4 Research Question 4: Advice that is offered to entrepreneurs

The literature covers numerous pieces of advice that are offered to entrepreneurs regarding the ways in which to split equity, the first and foremost is to emphasize the necessity of having equity agreements in place. Additional factors range from assessing the value of the idea, past experience, capital contribution, evaluating opportunity costs, being cautious of how much equity is being given away and forming dynamic equity agreements.

In this research these were factors that were listed as advice that would be offered based on past entrepreneurial experience. There was also recognition of the need for equity negotiations to be conducted thoroughly and upfront. One

theme of “advice” that was given in the case study interviews, that did not necessarily pertain to negotiating equity splits, but is interesting to explore is the mention of ensuring that the co-founders are people who share similar values and ethics. This is consistent with the emerging understanding that preserving the relationship is a powerful factor at play in equity splits and ensuring shared values within the relationship is therefore important.

As noted, the themes of relationship preservation, fairness and clarity (understanding) were predominant underlying themes that emerged from the advice given. As discussed in the previous section, this may have occurred due to the context in which the study took place, where the small business community values reputations over extracting as much value as possible from a situation. This offers a possible explanation for the nature of equity negotiations observed in this study, and is a noteworthy point for future research. As such the social norms and environmental factors that are unique to an area may play a large role in influencing equity negotiations.

6.5 Summary

One of the most significant findings of this study is that one of the factors that drive equity splits is preserving goodwill within working relationships. In cases where there is little need to maintain or protect the relationship there is a significant alignment between the factors that were identified in the literature and the principles that were discussed in the case studies. As the commitment to the relationship was seen to deepen so equity splits were guided by a need to preserve the relationship.

CHAPTER 7: CONCLUSION

The aim of the study was to explore the factors that contribute to the decisions that inform equity splits in start-ups in South Africa. The area was identified as being an interesting area for investigation as there is a limited amount of research that has been conducted in this field in the international arena, with no studies been found to have been conducted in South Africa. Understanding equity negotiation in general is an important issue, given the impact that it has on the founders of the venture, and on the capital structure for the emerging business. Researching this issue within South Africa is of particular value given the increasing number of entrepreneurial ventures in the country, and the context of forming these ventures with a socio-economic history that is being addressed through measures such as BEE (Black Economic Empowerment) compliance.

7.1 Significant findings of the research

The central finding of the research was that the context in which the relationships of the new venture were formed played a significant role in the process of negotiating the division of equity. The role of the relationship does not appear to have been fully explored by which? Researchers, but this study found that the closer the relationship was between the founder members of the start-up the less likely these was to be a formal and systematic negotiation of equity. Furthermore the division of equity appears to have been motivated by maintaining goodwill within the relationship.

Preserving goodwill within the working relationship could be viewed as a strategic move to ensure motivation and commitment to the business venture, but the results of this study suggest that beyond this protecting the relationship that exists between partnerships could be related to personal values of fairness and harmony.

What is of interest with regard to advice is that it makes reference to the importance of formalizing equity negotiations in the early stages of start-ups yet few of the participants had done so. Whilst this may demonstrate the role of learning from early experiences, but it may also suggest that even with the awareness of the importance of systematic discussions regarding equity the pull of the dynamics of personal relationships may lead to people over-looking this.

7.2 Implications of the study

The fundamental implication of this study is to be aware of the power that the context of the relationship between founder members has a key role to play in the division of equity.

It suggests that whilst there may be a tendency to over-look equity division in start-ups where there is a prior relationship between founder members, and/or there being a shared idea; that thorough equity discussions are of benefit to the venture, and should not be negated.

Given that the overall objective of this research was to generate an understanding of the factors and processes that shape equity negotiation and equity splits in start-ups, in the South African context. There was one element or factor that emerged repeatedly throughout the study. That was the maintenance of interpersonal relationships and the preservation of fairness and goodwill. These are very soft interpersonal dynamics, and their impact on equity negotiations (from the findings of this study) are unprecedented, and appear to be the single greatest factor that dictates to equity negotiation. While this study sample limits generalisations, this finding is in stark contrast to the value arguments presented in the literature, and the findings suggest that founding members value relationships more than they value the skills and knowledge benefits brought by members. While this cannot be quantified, the anecdotal observation is a powerful one, that suggests there is possibly another level on which equity is negotiated, beyond that of the value that founding members

bring to the team. As noted in chapter 6 this may be a result of the context in which the sample existed, and further research into the area is required to fully understand the phenomenon observed.

The implications of this finding suggest that entrepreneurial teams should acknowledge that on balance equity will usually be split equally and equity negotiations almost skirted around to that effect. Furthermore this said founding members should caution against recruiting founding members who add limited value, as founding members regardless of their value add seemingly have claim to equal equity.

Furthermore, entrepreneurs should acknowledge the dynamics that exist in the South African environment and as such treat equity negotiations with sensitivity.

7.3 Limitations of the study

Population Validity

Due to the sampling technique used in this study the extent to which the findings can be generalised to the population are limited (Saunders et al., 2009). As a result while the study attempts to explore the phenomenon with relation to the population, the sampling techniques prevent accurate extension of the findings. This limitation is acknowledged however is considered acceptable for the purposes of this study.

Researcher Bias

Due to the qualitative nature of the research analysis and research instrument, the findings of the study are subject to the personal bias and experiences of the researcher. The influence of researcher bias is acknowledged, and was limited for by actively attempting to reduce bias and preconception during data collection and data analysis (Saunders et al., 2009).

Sample Bias

The sampling technique used (non-probability) in this study create a bias towards the personal business networks used (Saunders et al., 2009). This limitation is acknowledged however considered acceptable for the purposes of this study. Users of this research sound be aware of the sample and context in which this study took place and avoid population inferences.

Social Desirability Bias

Administering questionnaires face-to-face has the potential of attracting social desirability bias. Social desirability bias occurs when respondents consciously or unconsciously manipulate responses to create a favourable impression. The presence of this bias was acknowledged in the research and limited by creating a neutral and open environment interview environment and the researcher avoided leading questions (Saunders et al., 2009).

Respondent Retrospective Bias

Retrospective bias occurs when respondents are asked to recall historic events. As respondents in this study were asked to recall events up to 3 year ago the

ability for respondents to accurately recall historic events is impaired. This bias was controlled for in this study by limiting the amount of time from start-up to 3 years. This amount of time was considered sufficient to limit the amount of retrospective bias.

7.4 Directions for future research

The findings of the current study lend itself to future research which could provide valuable insights into the equity negotiation. The first avenue of research would be to develop a hypothesis test using a quantitative methods to ensure the validity of the findings, as well as provide more formalised research into the role that relationships impact on equity negotiations.

The second avenue of research would be to explore some of the reasons why there is seemingly a strong “pull factor” to preserve the harmony of relationships. It would be interesting to know if this is the product of a particular personality profile or a more universal human quality. Furthermore of value would be research into techniques that allow equity negotiations to be conducted whilst honouring founder members commitments to preserving goodwill within the working relationships.

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