WeWork debacle exposes why investing in a charismatic founder can be dangerous

By Greg Putnam

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WeWork went from unicorn darling with a nearly US$50 billion valuation to a cautionary tale for gullible investors worth just $8 billion in a matter of months. It did so in part by wrapping its real estate sublet business in the cloak of a tech startup destined to "change the world."

WeWork CEO Adam Neumann once proposed his company could some day eradicate world hunger. Reuters/Eduardo Munoz

Were investors like SoftBank and JPMorgan duped by the hype of a charismatic founder, as happened with Elizabeth Holmes and Theranos?

As a lecturer in finance and someone who managed investments for 20 years, I believe that there was some of that, coupled with behavioral biases that lead people to make bad decisions. But I also think something else was going on that should give investors pause the next time they stumble across a visionary founder promoting a “change the world” branding strategy.

‘We’ will change the world

WeWork was founded in 2011 as a co-working venture.

But Adam Neumann crafted and pitched a vision for his company that went well beyond office sharing and real estate. He said the “we” culture he was building would change the world.

“The influence and impact that we are going to have on this Earth is going to be so big,” he told staff during a music festival-like retreat, where he suggested the company could “solve the problem of children without parents” and even eradicate world hunger.

Such statements weren’t uncommon from him. But moreover, they fit neatly in the messianic-like Silicon Valley tech world, where companies believe their inventions can actually “free the world.”

Neumann’s ambitious plans hit reality recently as investors soured on the company in the runup to a planned initial public offering. On Oct. 23, existing investor SoftBank agreed to rescue the embattled company with billions in additional capital in exchange for increasing its ownership stake to 80%. The deal pushed out Neumann, who will get US$1.7 billion despite burning through earlier investments.

Neumann’s “exit” package may be unusual in its scale, but otherwise similar fates have befallen numerous other founders, such as Theranos’ Holmes and Uber’s Travis Kalanick. Even Elon Musk, CEO of Tesla and founder of SpaceX, often seems to be one outrageous tweet away from his own ignominious end.

Each of these leaders embodied varying traits that inspired almost cult-like followings among investors who forked over billions to be a part of their rise. In cases like Tesla and Uber, the companies have managed to become successful despite their CEOs’ shortcomings. Theranos and WeWork are examples of what can go wrong when the founder is both owner and executive in a venture capital-backed startup.

Principals and agents

Finance scholars like myself think about this in terms of the principal-agent relationship, an issue that is crucial to the management of almost every business and organisation.

The principal is a party or group that enlists the agent to manage some asset or process in their best interest.

In a healthy corporate structure, the alignment of principal and agent is accomplished through governance and executive compensation policies that provide management incentives to act in the best interest of owners. For example, the CEO’s compensation might include stock in the company that vests over some period of years and is dependent upon specific performance targets.

In the case of WeWork, Neumann was acting in both roles: He was principal as the investor with the controlling stake and agent as the executive tasked with running the company. Even the prospectus for the company’s ill-fated IPO included language that would have given him control for life.

Why it’s a problem

You might wonder what the problem is with this arrangement given that it’s common for managers to be owners, as is the case with small businesses and family-owned companies.

When it’s their own money at stake, surely they’ll be looking out for their own best interests, right? In those situations, yes, and the downside risk is assumed by the owner-managers.

The difference between those types of companies and the likes of WeWork and Theranos is that startups typically have significant outside investment capital. SoftBank, for one, was also a principal in WeWork. In such situations, the interest of a founder like Neumann may not necessarily align with those of the company itself and its other investors.

During WeWork's buildup, for example, Neumann borrowed hundreds of millions of dollars against his stock in the company, leaving himself and WeWork exposed depending on the shares' future valuation. He also charged his own company $5.9 million for trademark rights to the word "we" – a sum he gave back after intense criticism.

Even in leaving the company, he was able to negotiate a generous go-away package, including the ability to cash out almost $1 billion in stock and receive a $185 million consulting fee. This at the same time that the company's future is uncertain and it's laying off 2,000 workers – which it delayed doing because it couldn't afford their severance.

Unemployed workers and wasted capital are the collateral damage when investors fall prey to the principal-agent problem. And unfortunately, I don't think this will be the last time.

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