Business Wealth and the Composition of Ownership Teams in New Firms: The Role of Homophily and Diversity

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Although there is a growing body of research that suggests a positive association between racial diversity and positive business outcomes, there is a long-standing literature on homophily—the general tendency for individuals in organizations to associate and bond with similar others. But do business organizations benefit from either diversity or homophily? This paper investigates this question. Using data from a nationally representative sample of more than 1,700 business startups from the Kauffman Firm Survey, the multivariate analysis examines the relationship between the diversity or homophily of the founding ownership teams of business startups and their net worth (wealth). The analysis shows that, net of firm characteristics and human capital characteristics, startups with racially diverse founding teams have higher net worth than their homophilous counterparts. The implications of these findings are explored.

INTRODUCTION

In recent years, diversity has become a central issue in the leadership of business organizations (Herring 2017; van Knippenberg and Mell 2016; Ely and Thomas 2001; Richard 2000). Arguments for such diversity go well beyond moral and social justifications. Indeed, one of the central arguments for including diverse leadership is that diversity is economically beneficial to business organizations because it helps them better understand their customers, provide better services, and outperform their competitors (Herring 2009). This is in contrast to other accounts that either see diversity as being unrelated to business outcomes (Kochan et al. 2003) or detrimental to business success (Sacco and Schmitt 2005)

A growing body of research points to the association between "trait diversity—diversity in stable characteristics such as demographic background, functional or educational background, or personality" (van Knippenberg and Well 2016:136)—and positive business outcomes (e.g., Levine et al. 2014; Singal 2014). There is a long-standing literature on the practices and processes of homophily—the general tendency for individuals to associate and bond with similar others (e.g., Ibarra 1992; Kandel 1978; Lazarsfeld and Merton 1954; McPherson and Smith-Lovin 1987; Ruef, Aldrich, and Carter 2003). However, there remains a dearth of research examining the impact of homophily on business outcomes (Kleinbaum et al. 2013). Because previous studies have examined the correlation between diversity and performance outcomes in long-standing business organizations (Henderson and Herring 2013; Herring 2009; and Hartenian and Gudmundson 2000), it has been difficult to establish the temporal order in the diversity-performance link. It could be that successful firms indulge in the luxury of having a diverse workforce or it could be that diversity leads to success. The current project moves toward overcoming this limitation by examining the link among diversity, homophily, and wealth in nascent businesses. It seeks to understand the degree to which diverse or homophilous founding teams (i.e., ownership teams) in business startups are beneficial to business performance. The analysis uses nationally representative data from the Kauffman Firm Survey to examine the relationship between the racial composition of the founding ownership teams of business startups and their business wealth, net of other firm characteristics and human capital characteristics of the owners. In essence, it addresses the question: do business startups benefit from diverse or homophilous ownership teams?

LITERATURE REVIEW

Social Identity and Homophily in Organizations

There are several important research efforts that examine the link between diversity, networks, and founding teams of organizations (e.g., Aldrich, Carter, & Ruef, 2002; Carter, Simkins, and Simpson 2003; Roberson and Hyeon 2007). Often, in accounting for why organizations have such low levels of diversity, these researchers point to the roles of "social identity" and the "homophily principle" in the self-replicating behaviors of organizations.

Social identity theory suggests that those who are in positions to select organizational leaders usually choose those who are most similar to themselves (Ashford and Mael 1989). This framework argues that informal networks created around homogeneous group membership often result in homophily that acts to prevent diversity (e.g., Kanter 1977). McPherson and Smith-Lovin (1987, 370) define homophily as "the tendency for people in friendship pairs to be similar." They argue that homophilous behavior occurs among individuals in all sociodemographic groups, including race, gender, age, and religion. They also argue that work-related ties, for example, are more likely to be homophilous based on socioeconomic statuses. They further argue that most relationships originate in intimate group settings where people congregate, such as the workplace. Moreover, these relationships tend to be homogenous. Lastly, they argue the more similar those in any given organization are, the more likely their social ties are to be homogenous. They found that at a given level of diversity, the larger the group, the more homophilous the group will be. McPherson and Smith-Lovin (1987) also suggest that organizations have a tendency to create specialized niches that result in organizational homogeneity.

Social identity theory suggests that informal recruitment maintains homosocial reproduction because individuals often inform those like themselves about employment opportunities within their companies (Kalleberg et al. 1996). Therefore, organizations that have transparent and public recruitment practices are more likely to have racial diversity because greater efforts to achieve inclusivity will result in higher levels of diversity. Overall, formalized recruitment and retention policies targeting racial minorities may provide greater representation of such minorities within establishments, especially when these minority groups are integrated in information dissemination. The formation of new businesses is often the result of collaborative efforts among individuals with shared goals for success and the desire to combine resources to enhance profitability (Ruef, Aldrich, and Carter 2003; West 2007). Given the level of risk and investment required of new business owners, they are likely to partner with those in their established social networks who they trust and share common values (e.g., family, friends, colleagues, etc.) (Ruef, Aldrich, and Carter 2003).

Most research on homophily has focused on its salient dimensions, causes, and correlates (Cook 2001; McPherson Smith-Lovin 1987). There is, however, research suggesting that homophily leads to efficiency in terms of convergence time in decision making (Golub and Jackson 2010, 2012). Homophily is also associated with greater network returns for men (Ibarra 1992). There is also evidence that homophily significantly increases adoption of innovative health behavior, especially among those most in need of it (Centola 2011). Still, there is a dearth of empirical research examining the impact of homophily on the performance of new businesses.

Diversity and the Performance of Business Organizations

The "value-in-diversity" perspective has been used as a framework to help explain the positive relationship between diversity and successful business outcomes (Cox 1993; Richard 2000). For the most part, proponents of this view suggest that diversity in the corporate setting, for example, represents a compelling interest that will help meet customers' needs, enrich understanding of the pulse of the marketplace, and improve the quality of products and services offered (Hubbard 2004). With respect to diversity among business leaders, established companies manage the racial makeup of their top leadership groups in response to social pressures and and political norms (Rose and Bielby 2011). Because of the putative competitive advantages of diversity, companies increasingly have relied upon demographic heterogeneity to increase their profits (Herring 2009). Research also suggests that diversity at the highest levels of the organization leads to increased performance (Henderson, Herring, and Prados 2017; Williams and O'Reilly 1998). This research suggests that diversity has a positive relationship to corporate profits and earnings (Ryan, Hawdon, and Branick 2002).

There is competing research suggesting that diversity may hinder organizational performance at the individual and macro levels (Williams and O'Reilly 1998). This "diversity as process-loss" perspective suggests that demographic diversity, particularly racial diversity, has been shown to increase conflict among coworkers and increase turnover (Skerry 2002; Tsui, Egan, and O'Reilly 1992). These arguments reveal the complex relationship between diversity and performance within organizations. Despite this complexity, diversity may increase the "bottom-line" or other performance outcomes of business organizations.

A third view suggests that diversity can have both positive and negative effects on organizational functioning. Diversity may be valuable or detrimental to organizations when change in the composition of such organizations does not make incumbent members of these organizations feel comfortable. Heterogeneity on many salient social categories can fuel conflict, distort communication, and reduce performance at the same time that it can increase the number of contacts, add information, mobilize creativity, and spur innovation (DiTomaso, Post, and Parks-Yancy 2007). Ironically, research on this issue also shows that homogeneity on important social categories can lead to greater liking and trust, improved coordination, clearer communication, and better performance, but also to less ability to adapt and innovate (DiTomaso, Post, and Parks-Yancy 2007). Such results suggest that diversity may be both conducive to productivity *and* counterproductive in work group processes.

Race and Business Wealth

Wealth can be thought of as the total sum of what is owned (Keister 2000). It is often measured as "net worth"—total assets minus total liabilities (Conley 2001; Keister 2000; Oliver and Shapiro 2006; Semyonov and Lewin-Epstein 2011; Shapiro 2004). Similarly, business wealth or equity refers to all assets that a firm can buy or sell that can be used to create income or have the potential to generate income in the future. Such assets include technology, natural resources, land, buildings, productive facilities, and even human capital (Herring and Henderson 2016; and Henderson, Herring, Horton, and Thomas 2015).

Business ownership is an often overlooked source of racial differences in wealth. A survey of Americans with incomes over $100,000 indicated that 70% of those with $3 million or more wealth had attained the bulk of their assets through business ownership (U.S. Trust 2013). In addition, business wealth is less for African American business owners than for other demographic groups (Thomas, Moye, Henderson, and Horton 2017; Cavalluzzo and Wolken 2002; Butler and Herring 1991). For example, the mean (median) value of net worth was $687,719 ($150,000) for White business owners compared to

$159,962 ($80,000) for African American business owners (Cavalluzzo and Wolken 2002). Moreover, African Americans are significantly less likely to be business owners than are Whites (Bates 2006). African Americans have historically engaged in entrepreneurial activities (Graham 2000); however, as Butler (1991) suggests, African Americans engaged in what he called the economic detour model of economic development. By this, he means that they could not conduct business in non-Black communities. Not only were African Americans forbidden from entering the traditional workforce without being discriminated against, they were also forced to endure discrimination in their business operations (Butler 1991). Such practices have contributed to racial disparities in business ownership and wealth inequality. Combined, these factors suggest that racial differences in business ownership may also be important contributors to differences in business wealth.

RESEARCH QUESTION AND HYPOTHESIS

Because of competing claims and the shortage of empirical research on the impact of diversity and homophily on business performance—especially among leaders in business startups—additional research is warranted. It is possible that diversity has many benefits as the value-in-diversity perspective suggests; it is also plausible that homophily—in many respects the opposite of diversity—has benefits that lead to better business performance, especially among business startups. It is also reasonable to believe that neither diversity nor homophily are systematically associated with the performance of new businesses. Although the current research cannot adjudicate all of the claims about diversity nor homophily, this paper does examine whether business startups benefit from diverse founding teams. It uses nationally representative data from the Kauffman Firm Survey to analyze the relationship between the racial composition of the ownership teams of business startups and their wealth in a nationally representative sample of firms.

Are business startups harmed or helped by having a racially diverse or homophilous founding ownership team? Proponents of the value-in-diversity model suggest that businesses with more racially diverse funding ownership teams should perform better than those with more homophilous ownership teams, net of other firm characteristics and the human capital attributes of their principle owners. On the other hand, proponents of the "diversity as process loss" perspective would suggest the opposite: firms with more diverse founding ownership teams would suffer in their performance compared to those with more homophilous founding ownership teams, net of relevant characteristics. Given these expectations of the "value-in-diversity" we can derive the following hypothesis: Hypothesis 1: Net of other factors, new business startups with racially diverse ownership teams will have greater wealth (net worth) than those with racially homophilous ownership teams.

On the other hand, the "diversity as process loss" perspective would suggest precisely the opposite hypothesis. Specifically, net of other factors, new business startups with more diverse ownership teams will have less wealth (net worth) than will business startups with racially homophilous ownership teams.

Below, we provide an assessment of whether the racial diversity or homophily of ownership teams of business startups is related to business wealth. We test the hypothesis using nationally representative data from the Kauffman Firm Survey. The analysis also examines this relationship net of firm characteristics and human capital characteristics of new business owners.

Data and Methods

Data

The Kauffman Firm Survey (KFS) is a nationally representative study of startup businesses in the United States. In 2004, this survey collected information on 4,928 firms. The data contain detailed information on the firms and background information on the owners of these new firms. Background information on the owners (up to 10) includes race, ethnicity, gender, age, education, and work experience. We used only the data from the 1,754 firms with multiple owners. The owner with the largest equity share in the firm was designated as the "primary owner." When two or more owners held equal shares, hours worked in the firm was used to create a rank ordering. The businesses in the sample are all startups, (i.e., less than a year old); thus, it is more possible than usual to treat the "history" of each business as a constant. We are able to take advantage of this fact by using the Kauffman Firm Survey data in the analysis.

Operationalizations

The analysis included business net worth or wealth as the dependent variable. The central independent variable is racial diversity (or homophily) of the founding ownership team. In addition, there are several firm characteristics: total number of owners, company size, industrial sector, legal form of incorporation, gender of principal owner, education of principal owner, age of principal owner, and principal owner's years of experience in the industry. The operationalization of these variables are presented below.

Business Performance

Wealth (Net Worth). Business wealth, net worth or equity is the amount of the funds contributed by the owners (and stockholders) plus the retained earnings (or losses). It was coded as the amount of investment from all sources—including spouses or life partners; parents, in-laws or children of owners of the business; individuals unrelated to the owners; other companies; government agencies; and venture capitalists—invested in the business minus liabilities from all sources. Amounts were coded from $.01 to $1,000,001. In the multivariate analysis, we transformed these values by taking the natural logarithm.

Key Independent Variables

Racial Diversity/Homophily of Founding Ownership Team. To measure the racial diversity/ homphily of the founding ownership team, the races of various owners of startup firms with multiple owners were compared. When the members of the founding ownership team are of the same race, the ownership team can be considered racially homophilous. When the various owners were of different races, the ownership team is racially diverse and the firm was coded 1 for being racially diverse. When all owners were of the same race, the firm was coded 0.

Firm Characteristics

Total number of owners. Respondents were asked "how many individuals or entities owned [NAME BUSINESS]? Please include all individuals or entities who owned shares in the business." The total number of owners for firms with multiple owners ranged from 2 through 100.

Company Size. Company size was operationalized as the number of employees in the company. Respondents were asked: "Not counting owner(s), on December 31, 2004, how many people worked for [NAME BUSINESS]? Please include all full- and part-time employees, but exclude contract workers who work for the business either full- or part-time but are not on the business' official payroll." Responses were coded to reflect the reported number of employees.

Industrial sector. Industrial sector is a dummy variable coded into North American Industry Classification System (NAICS) 2-digit codes which classify business establishments according to type of economic activity.

Finally, respondents were asked about the legal form of incorporation of their business. Responses were dummy variable coded to indicate whether the businesses were partnerships, corporations, or limited liability companies, or some other form of incorporation.

Owners' Characteristics

To measure race, respondents were asked about asked which racial category best describes the primary owner's race. Responses were dummy variable coded to indicate the race of the primary owner of the business. In the multivariate analysis, other groups are compared with Blacks/African Americans.

To measure gender, respondents were asked: "Are you/primary owner male or female?" Answers were dummy variable coded 1 for female and 0 for male.

In order to measure the age of the primary owner, respondents were asked: "How old will you/primary owner be on your/his/her next birthday?" Age was coded as actual years.

Respondents were asked about the primary owner's years of experience in the industry: "How many years of work experience have/has you/primary owner had in this industry—the one in which [NAME BUSINESS] competes?" Experience in the industry was coded as actual years.

To measure education of the primary owner, respondents were asked: "What is the highest level of education you/primary owner have completed so far?" Responses were coded as follows: less than 9th grade=8; some high school, but no diploma = 10; high school graduate (diploma or equivalent = 12; technical, trade or vocational degree = 13; some college, but no degree = 14; Associate's degree = 14; Bachelor's degree = 16; some graduate school but no degree = 17; Master's degree = 18; professional school or doctorate = 20.

RESULTS

Do business startups benefit from racially diverse or homophilous founding ownership teams? Figure 1 presents information about wealth for business startups by whether their ownership teams are diverse or homophilous. This chart shows that, on average, firms with racially homophilous ownership teams are worth $129,526. In contrast, those with racial diversity in their ownership teams are worth $167,978 on average. This $38,452 difference is statistically significant at $p < .05$.

Consistent with Hypothesis 1, racial diversity in ownership teams is associated with greater net worth in business startups relative to homophilous ownership teams. Still, it is possible that other factors such as firm characteristics explain how racial diversity in ownership teams is related to the performance of business startups. To examine this possibility in a more rigorous fashion, we examine the relationship between racial composition of ownership teams in business startups and business wealth using a multivariate framework. We examine the relationship between the racial composition of ownership teams and amounts of business wealth, net of firm characteristics and human capital characteristics of principal owners.

FIGURE 1
Business Wealth of Startup Firms by Racial Diversity and Homophily

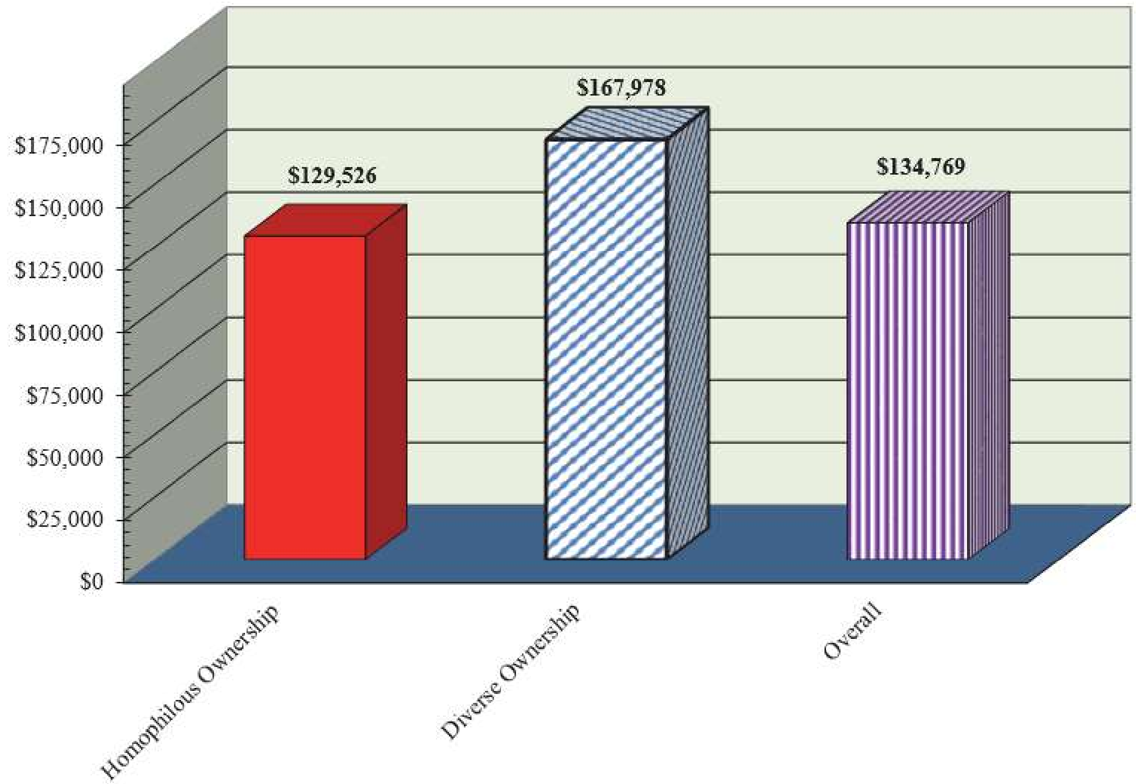

Table 1 presents some selected characteristics of startup firms that have racially diverse ownership teams, those with racially homophilous ownership teams, and for startup firms overall. This table shows that startups with racially diverse ownership teams have 3.2 owners on average. This is slightly larger than those with racially homophilous ownership teams and general startups (2.9 owners). Racially diverse and homophilous startup firms are similar in terms of their number of employees. Firms with racially diverse ownership teams and those with racially homophilous ownership teams are also similar in terms of their legal form of incorporation, industrial sector, and owners' characteristics (such as gender, work experience, education, and age).

TABLE 1
SELECTED CHARACTERISTICS OF BUSINESS STARTUPS BY RACIAL DIVERSITY OF FOUNDING OWNERSHIP TEAM

Characteristics	Racially Diverse Startups	Racially Homophilous Startups	Overall
Mean Number of Owners	3.2	2.9	2.9
Mean Number of Employees	2.7	2.6	2.7
% Partnerships	11.1%	12.8%	12.5%
% LLC	48.2%	42.9%	43.5%
% Retail	4.0%	6.2%	5.9%
% F.I.R.E.	8.0%	9.8%	9.5%
% Professional or Managerial Services	29.6%	18.9%	20.3%
% Black Primary Owners	9.2%	4.5%	5.0%
% Female Primary Owners	26.1	25.0%	25.1%
Mean Years of Work Experience	12.6	12.3	12.3
Mean Age of Primary Owner	12.7	45.9	45.9
Mean Years of Education of Primary Owner	45.5	15.5	15.5
N	225	1528	1763

Although the compositional differences in the characteristics of firms by the diversity/homophily of ownership teams appears to be modest, it is important to statistically control for such factors. Table 2 presents the relationship of racial diversity in ownership teams to business wealth. Model 1 presents the bivariate relationship. Model 2 presents this relationship, net of firm characteristics. Model 3 adds controls for human capital characteristics of primary owners.

TABLE 2
OLS REGRESSION MODELS PREDICTING BUSINESS WEALTH OF STARTUP FIRMS WITH RACIAL DIVERSITY OF OWNERSHIP TEAM, NET OF FIRM CHARACTERISTICS AND HUMAN CAPITAL CHARACTERISTICS OF PRIMARY OWNERS[a]

Independent Variables	Model 1	Model 2	Model 3
Constant	7.419***	6.822***	2.726*
Racially Diverse Startups	1.109***	1.058*	.986*
Number of Owners		.112**	.107**
Number of Employees		.137***	.128***
Partnership		-.483	-.144
Limited Liability Company		.001	-.034
Retail		1.173	1.140
F.I.R.E.		-.226	-.384
Professional/Managerial Service		-.287	-.521
Race of Primary Owner (Black)			.376
Gender of Primary Owner (Female)			-.214
Work Experience of Primary Owner			-.026
Age of Primary Owner			.021
Education of Primary Owner			.232**
R^2	.004***	.028***	.037***
N	1753	1722	1713

*p < .05 ** p < .01 *** p < .001

[a]Coefficients are unstandardized. For the dummy (binary) variable coefficients, significance levels refer to the difference between the omitted dummy variable category and the coefficient for the given category.

Model 1 shows that, on average, racially diverse business startups are significantly more wealthy than are racially homophilous startups. Although this factor accounts for only a small portion of the variance in wealth, it is statistically significant and consistent with Hypothesis 1.

Model 2 also includes such firm characteristics as number of owners, number of employees, legal form of incorporation, and industrial sector. When these firm characteristics that are taken into consideration, the relationship between diversity and business wealth remains statistically significant in the predicted direction. In addition, the results show that as the number of owners increase and as the number of employees increase, the wealth of the new firm is significantly greater. There are no systematic differences by legal form of incorporation nor industry.

Consistent with Hypothesis 1, Model 3 in Table 2 shows that, net of firm characteristics and human capital characteristics, startup firms with racially diverse ownership teams have greater net worth (p<.01). Model 1 also shows that startups do not differ systematically in their business wealth by race. It also indicates that those with female owners are not statistically different from those with male primary owners. This model also shows that net worth increases with higher education. Business wealth does not vary systematically by other factors included in the analysis.

Overall, these results suggest that, net of firm characteristics and human capital characteristics, startups with racially diverse ownership teams have more wealth. The racial background and gender of the primary owner, however, are not systematically related to startup firms' net worth. The results suggest that there is a positive relationship between the racial diversity of ownership teams and firm performance in the earliest phase of business startup.

DISCUSSION AND CONCLUSIONS

The main objective of this research was to determine whether business startups are harmed or helped by having racially diverse or homophilous founding teams. The analysis showed that, net of firm characteristics and human capital characteristics, startups with racially diverse ownership teams had higher net worth. This finding clearly run counter to the expectations of skeptics who believe that diversity (and efforts to achieve it) would be *harmful* to business organizations.

One of the principal assertions put forth by critics of the value-in-diversity perspective is that diversity is linked to substantial costs that outweigh its benefits. The results from our analysis clearly run counter to the expectations of skeptics who believe that diversity are *harmful* to business organizations. To the contrary, the results from this analysis suggest that there is a *positive* relationship between the racial diversity of ownership teams of startup firms and their business performance and functioning.

It is likely that diversity produces positive outcomes for business startups over homophily because growth and innovation may depend on people from various backgrounds working together and capitalizing on their differences. Although such differences may lead to some communication barriers and group conflict, diversity increases the opportunity for creativity and the quality of the product of group work. Diversity provides a competitive advantage through social complexity at the firm level when it is positioned within the proper context. So, despite the potentially negative impact of diversity on internal group processes, racial diversity in ownership team appears to have a net positive impact on business organizational functioning.

Because of data limitations, it is admittedly premature to dismiss the possibility that the correlation between diversity and business outcomes occurs because more successful business organizations can devote more attention and resources to diversity issues. However, because all of the firms in this analysis are startups, it is much more difficult to argue that such diversity in ownership teams is a result of organizational largess. It is also possible that these relationships exist because of some other dynamic not accounted for in the models. Nevertheless, the results presented in this research effort are currently the best available, and they are based on a nationally representative sample of business startups.

This research provides empirical evidence that supports the value in diversity perspective that diversity in new firms has a positive relationship to their amount of business wealth. This finding suggests that organizational diversity at the highest levels should be a worthy goal. Still, a social justice perspective on critical diversity would argue for more inclusivity of racial and ethnic minorities not just because it enhances the wealth of business organizations, but also because it improves the social and moral fabric of society.

Future research should focus on the extent to which racially diverse business startups maintain their advantage over homogeneous startups over time.

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