GLOBAL EDITION

ENTREPRENEURSHIP

Successfully Launching New Ventures

Updated 6e

Bruce R. Barringer | R. Duane Ireland

Entrepreneurship

SUCCESSFULLY LAUNCHING NEW VENTURES

UPDATED SIXTH EDITION
GLOBAL EDITION

Bruce R. Barringer
Oklahoma State University

R. Duane Ireland
Texas A & M University

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Dedication

To my wife, Jan. Thanks for your never-ending encouragement and support. Without you, this book would have never been possible. Also, thanks to all the student entrepreneurs who contributed to the chapter opening features in the book. Your stories are both insightful and inspiring.

—Bruce R. Barringer

To my family: I am so proud of each of you and so blessed by your perseverance and never-ending love and support. I know that sometimes it seems as though "we lose ourselves in work to do and bills to pay and that it's a ride, ride, ride without much cover." But you are always in my heart, a gift for which I remain deeply grateful.

—R. Duane Ireland

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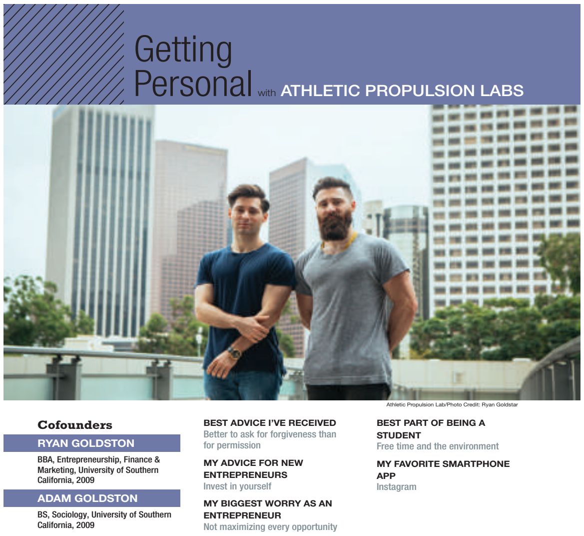
Preface

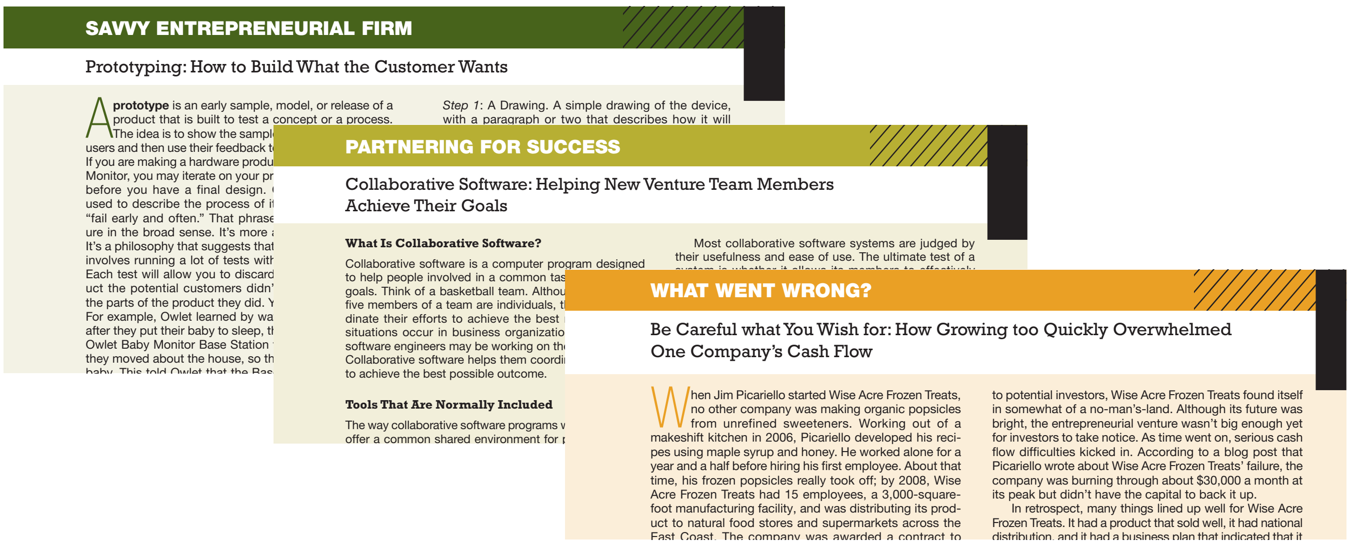
New to This Edition

This sixth edition is a thorough revision of our book. Each chapter has been revised for the purpose of presenting you, our readers, with a foundational understanding of entrepreneurship as well as with current examples of actions being taken by entrepreneurs and by entrepreneurial firms. We use insights from the academic literature and the experiences of practicing entrepreneurs to inform our explanation of entrepreneurship. To present you with specific examples of entrepreneurs' actions and the actions taken by entrepreneurial firms, we again use insights from entrepreneurs as well as from business people. These insights from practicing entrepreneurs and their firms and from business people were drawn from many sources including podcasts, blogs, newspapers, companies' websites, and popular business publications such as *The Wall Street Journal* and *Fortune* magazine among many others. As we'll explain later in greater detail, we also draw from the academic literature to make certain that we are presenting you with accurate and current descriptions of what researchers have learned about successful entrepreneurs and effective entrepreneurial firms.

Opening Profile Each of the book's 15 chapters opens with a profile of an entrepreneurial firm that was started while the founder or founders were in college or shortly after graduating. All "Opening Profiles," with each one being linked to an individual chapter's topic, are new to this edition. Each "Opening Profile" is based on a personal interview with the student entrepreneur or entrepreneurs who founded the company around which each profile is written.



Updated Boxed Features The majority of the "Savvy Entrepreneurial Firm," "Partnering for Success," and "What Went Wrong?" boxed features are new to this edition. The few features that are not new have been updated. These features alert readers to contemporary issues facing entrepreneurs and their firms. In addition, the content of the features suggest actions



entrepreneurs can take to deal with various contemporary issues. The boxed features appearing in this new edition of our book focus on many different topics such as how entrepreneurial firms can use collaborative software to help team members reach their goals, the need to develop and test a prototype of a product or service as a means of determining how to meet customers' needs, and how growing too quickly overwhelmed a firm's ability to properly manage its cash flow.

New and Updated End-of-Chapter Cases The majority of the end-of-chapter cases are new to this edition. For example, through Case 10.2 on p. 402, you will learn about how Kickstarter is becoming an increasingly important pathway through which entrepreneurs obtain seed capital for their ventures. The few cases that have been retained have been updated. Two cases are presented at the end of each chapter. Comprehensive in nature, the cases have been selected to represent the principles examined within individual chapters and to provide readers with opportunities to think about how principles apply to situations particular companies are facing. The questions appearing at the end of each case can be used to stimulate classroom discussion or for quizzes or tests. MyLab Entrepreneurship offers additional discussion questions and practice questions to enhance your learning experience.

New and Updated "You Be the VC" Features Two features called "You Be the VC" appear toward the end of each chapter. Each of these unique features present readers with a "pitch" for funding an emerging entrepreneurial venture. The features are designed to stimulate classroom discussion by sparking a debate about whether a particular entrepreneurial venture should or should not be funded by a venture capitalist. In essence, students are asked to take on the role of a venture capitalist when evaluating the commercial viability of what are real-life entrepreneurial ventures. This updated edition includes eight brand-new "You Be the VC" features.

Updated References The amount of academic research being completed to add to our understanding of entrepreneurship and how entrepreneurs practice it continues to expand. Importantly, the quality of this research, in terms of its ability to inform entrepreneurial practices, is increasing. To provide our readers with the most recent insights from academic journals, we draw ideas and insights from recent research articles appearing in well-established and highly respected journals such as *Strategic Entrepreneurship Journal*, *Journal of Business Venturing*, *Entrepreneurship Theory and Practice*, *Academy of Management Journal*, *Strategic Management Journal*, and *Organization Science* among others. All of these journals are recognized for their contributions to entrepreneurship that are made by the articles they publish. Similarly, and as mentioned previously, we draw from podcasts, blogs, companies' websites, and publications such as *The Wall Street Journal* and *Entrepreneur* among others to find materials that describe how entrepreneurs rely on their hard-earned practical experience in order to achieve success when leading their entrepreneurial ventures. The references we drew from academic journals are very current as are the stories and experiences that are described in the podcasts, blogs, and established publications that we consulted while writing this edition of our book.

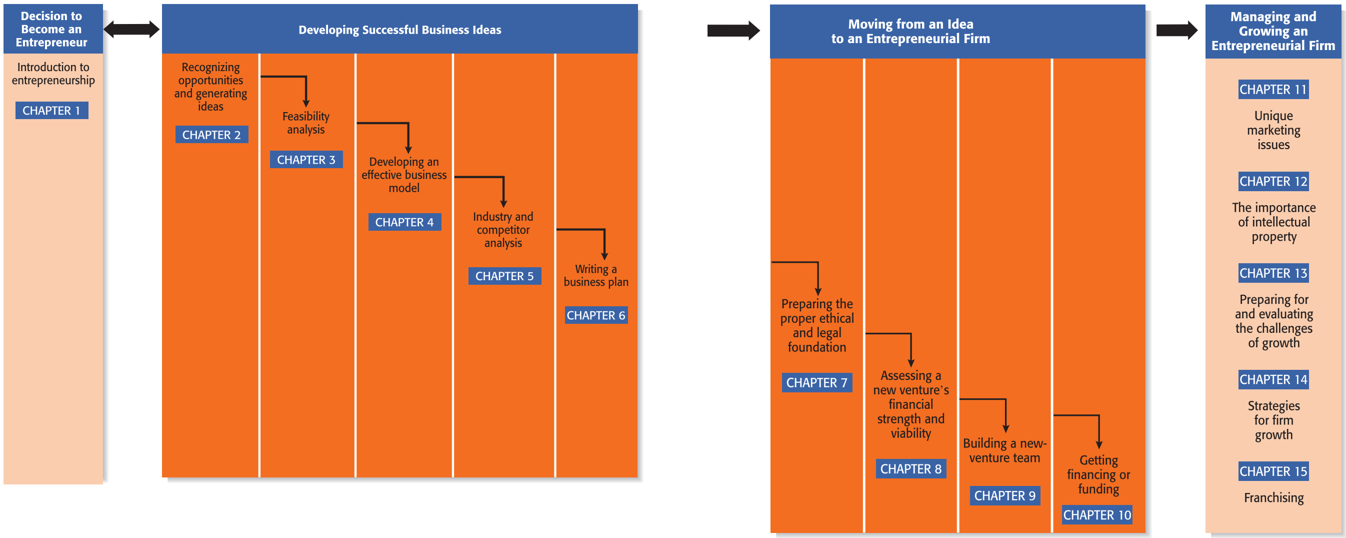
Solving Teaching and Learning Challenges

The lure of entrepreneurship for people who launch their own businesses is the ability to create a product or a service with the potential to enhance people's lives. While entrepreneurs want to earn profits from the money, time, and energy they invest in their firms, they typically also want to make a difference—to individuals who buy their product or service and to the local community in which they operate. To do this though, entrepreneurs need to follow a process to fulfill their dreams and to be successful.

As has always been the case with our book, we remain committed to the position that to be successful, entrepreneurs must follow a specific set of activities. We call this set of activities "The Entrepreneurial Process," around which this book is written. This process includes four interrelated steps: (1) deciding to become an entrepreneur, (2) developing successful business ideas, (3) moving from an idea to an entrepreneurial firm, and (4) managing and growing the entrepreneurial firm. While entrepreneurship is not easy, we strongly believe that following the entrepreneurial process presented in this book will increase the likelihood that entrepreneurs will be successful in their efforts to launch and operate a business that is based on their identification of an opportunity and the development of their unique idea, in the form of a product or a service, to pursue it.

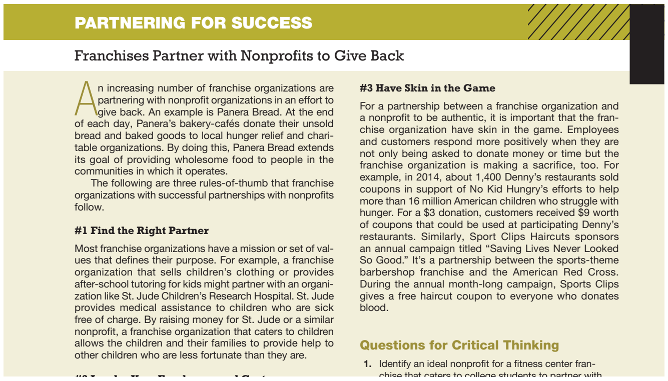
By following this unique process, aspiring entrepreneurs increase the likelihood that the investments they make will pay dividends and will bring them great satisfaction as they meet the needs of various groups including customers, those working for the entrepreneurial venture, and the local communities in which those ventures operate. We use the following features to clearly and concisely explain the entrepreneurial process and to bring that process to life for readers in the process of doing so.

The Entrepreneurial Process The process' 4 major steps are explained in a total of 15 chapters. Studying this process informs an understanding of entrepreneurship and how to practice it for the purpose of establishing and then successfully growing an entrepreneurial venture. Once a venture has been launched, entrepreneurs should continuously revisit and study the parts of the process to verify that the venture is taking actions with a high probability of leading to entrepreneurial success.



Opening Profiles Each of the book's 15 "Opening Profiles" describes the launching of an entrepreneurial venture by entrepreneurs when they were university or college students (or shortly after graduation). The individual profiles are related to individual chapters' core topic—a topic that is part of the entrepreneurial process. In addition to demonstrating how entrepreneurs apply a particular part of the entrepreneurial process, the "Opening Profiles" show that as university-level students, some individuals decide at that time to become entrepreneurs. Owlet Baby Care, for example, is the subject firm of Chapter 3's "Opening Profile." This firm's product, called the Owlet Baby Sock, is also pictured on the cover of this book. By placing the Owlet Baby Sock on a foot, parents are able to monitor a baby's heartbeat and oxygen level while she or he sleeps. Chapter 3's topic is Feasibility Analysis, meaning that the discussion about Owlet Baby Sock in the chapter's "Opening Profile" revolves around efforts the firm's cofounders took to see if their product was indeed commercially feasible. Overall, the "Opening Profiles" show students reading this book that they, too, may have the potential to establish an entrepreneurial venture while attending a university or college or shortly after graduating.

Partnering for Success Boxed Feature The ability for entrepreneurial ventures to partner with other firms is becoming an increasingly important attribute of successful entrepreneurial ventures. This boxed feature exposes students to a number of different ways entrepreneurial ventures partner with others for the purpose of increasing their success. Sometimes entrepreneurial firms partner with companies their own size while they partner with very large organizations in other instances. The purpose of this boxed feature, which appears in each of the 15 chapters, is to describe collaborative relationships that benefit entrepreneurial ventures. Questions about each feature's content appear at the end of the feature. These questions challenge students to think critically about the feature's content and can be used to stimulate classroom discussions.


PARTNERING FOR SUCCESS

Franchises Partner with Nonprofits to Give Back

An increasing number of franchise organizations are partnering with nonprofit organizations in an effort to give back. An example is Panera Bread. At the end of each day, Panera's bakery-cafés donate their unsold bread and baked goods to local hunger relief and charitable organizations. By doing this, Panera Bread extends its goal of providing wholesome food to people in the communities in which it operates.

The following are three rules-of-thumb that franchise organizations with successful partnerships with nonprofits follow.

#1 Find the Right Partner

Most franchise organizations have a mission or set of values that defines their purpose. For example, a franchise organization that sells children's clothing or provides after-school tutoring for kids might partner with an organization like St. Jude Children's Research Hospital. St. Jude provides medical assistance to children who are sick free of charge. By raising money for St. Jude or a similar nonprofit, a franchise organization that caters to children allows the children and their families to provide help to other children who are less fortunate than they are.

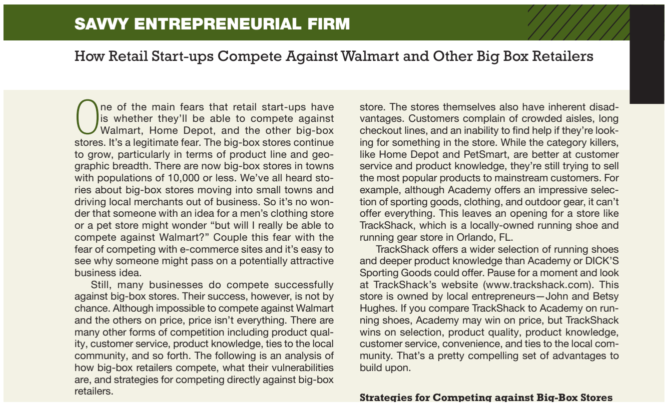
#3 Have Skin in the Game

For a partnership between a franchise organization and a nonprofit to be authentic, it is important that the franchise organization have skin in the game. Employees and customers respond more positively when they are not only being asked to donate money or time but the franchise organization is making a sacrifice, too. For example, in 2014, about 1,400 Denny's restaurants sold coupons in support of No Kid Hungry's efforts to help more than 16 million American children who struggle with hunger. For a $3 donation, customers received $9 worth of coupons that could be used at participating Denny's restaurants. Similarly, Sport Clips Haircuts sponsors an annual campaign titled "Saving Lives Never Looked So Good." It's a partnership between the sports-theme barbershop franchise and the American Red Cross. During the annual month-long campaign, Sports Clips gives a free haircut coupon to everyone who donates blood.

Questions for Critical Thinking

1. Identify an ideal nonprofit for a fitness center fran-

Savvy Entrepreneurial Firm Each chapter contains a feature called "Savvy Entrepreneurial Firm." These features, which explain practices entrepreneurs follow that help their ventures become successful, present students with tools and techniques entrepreneurs use when leading entrepreneurial ventures. Essentially, this feature describes entrepreneurship in action. After reading all 15 "Savvy Entrepreneurial Firm" features, students will have a set of practices entrepreneurs use for the purpose of increasing their firm's operational success. Questions that can be used to facilitate discussions among students or as quizzes or tests appear at the end of each feature.


SAVVY ENTREPRENEURIAL FIRM

How Retail Start-ups Compete Against Walmart and Other Big Box Retailers

One of the main fears that retail start-ups have is whether they'll be able to compete against Walmart, Home Depot, and the other big-box stores. It's a legitimate fear. The big-box stores continue to grow, particularly in terms of product line and geographic breadth. There are now big-box stores in towns with populations of 10,000 or less. We've all heard stories about big-box stores moving into small towns and driving local merchants out of business. So it's no wonder that someone with an idea for a men's clothing store or a pet store might wonder "but will I really be able to compete against Walmart?" Couple this fear with the fear of competing with e-commerce sites and it's easy to see why someone might pass on a potentially attractive business idea.

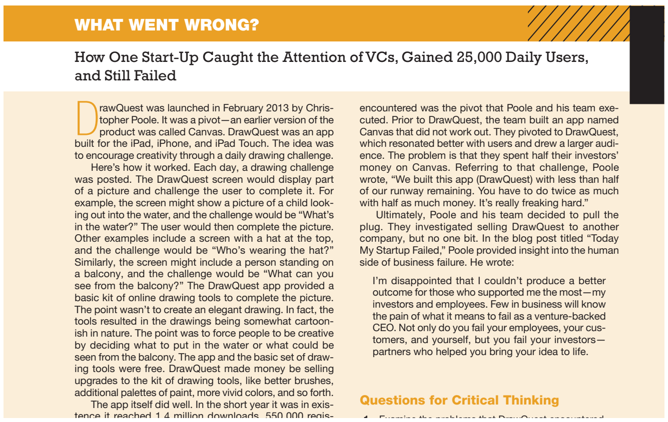
Still, many businesses do compete successfully against big-box stores. Their success, however, is not by chance. Although impossible to compete against Walmart and the others on price, price isn't everything. There are many other forms of competition including product quality, customer service, product knowledge, ties to the local community, and so forth. The following is an analysis of how big-box retailers compete, what their vulnerabilities are, and strategies for competing directly against big-box retailers.

store. The stores themselves also have inherent disadvantages. Customers complain of crowded aisles, long checkout lines, and an inability to find help if they're looking for something in the store. While the category killers, like Home Depot and PetSmart, are better at customer service and product knowledge, they're still trying to sell the most popular products to mainstream customers. For example, although Academy offers an impressive selection of sporting goods, clothing, and outdoor gear, it can't offer everything. This leaves an opening for a store like TrackShack, which is a locally-owned running shoe and running gear store in Orlando, FL.

TrackShack offers a wider selection of running shoes and deeper product knowledge than Academy or DICK'S Sporting Goods could offer. Pause for a moment and look at TrackShack's website (www.trackshack.com). This store is owned by local entrepreneurs—John and Betsy Hughes. If you compare TrackShack to Academy on running shoes, Academy may win on price, but TrackShack wins on selection, product quality, product knowledge, customer service, convenience, and ties to the local community. That's a pretty compelling set of advantages to build upon.

Strategies for Competing against Big-Box Stores

What Went Wrong? Mistakes are made in entrepreneurial firms. With this feature, with one appearing in each chapter, we describe for students "What Went Wrong?" for an entrepreneur and the venture she or he was leading. Reading these features explains actions to students that they want to avoid as entrepreneurs. The questions appearing at the end of each feature can be used as discussion starters, and as a foundation for asking students to describe actions that could have been taken to avoid the problem that is described in a particular "What Went Wrong?" feature.


WHAT WENT WRONG?

How One Start-Up Caught the Attention of VCs, Gained 25,000 Daily Users, and Still Failed

DrawQuest was launched in February 2013 by Christopher Poole. It was a pivot—an earlier version of the product was called Canvas. DrawQuest was an app built for the iPad, iPhone, and iPad Touch. The idea was to encourage creativity through a daily drawing challenge.

Here's how it worked. Each day, a drawing challenge was posted. The DrawQuest screen would display part of a picture and challenge the user to complete it. For example, the screen might show a picture of a child looking out into the water, and the challenge would be "What's in the water?" The user would then complete the picture. Other examples include a screen with a hat at the top, and the challenge would be "Who's wearing the hat?" Similarly, the screen might include a person standing on a balcony, and the challenge would be "What can you see from the balcony?" The DrawQuest app provided a basic kit of online drawing tools to complete the picture. The point wasn't to create an elegant drawing. In fact, the tools resulted in the drawings being somewhat cartoonish in nature. The point was to force people to be creative by deciding what to put in the water or what could be seen from the balcony. The app and the basic set of drawing tools were free. DrawQuest made money be selling upgrades to the kit of drawing tools, like better brushes, additional palettes of paint, more vivid colors, and so forth.

The app itself did well. In the short year it was in exis-

encountered was the pivot that Poole and his team executed. Prior to DrawQuest, the team built an app named Canvas that did not work out. They pivoted to DrawQuest, which resonated better with users and drew a larger audience. The problem is that they spent half their investors' money on Canvas. Referring to that challenge, Poole wrote, "We built this app (DrawQuest) with less than half of our runway remaining. You have to do twice as much with half as much money. It's really freaking hard."

Ultimately, Poole and his team decided to pull the plug. They investigated selling DrawQuest to another company, but no one bit. In the blog post titled "Today My Startup Failed," Poole provided insight into the human side of business failure. He wrote:

> I'm disappointed that I couldn't produce a better outcome for those who supported me the most—my investors and employees. Few in business will know the pain of what it means to fail as a venture-backed CEO. Not only do you fail your employees, your customers, and yourself, but you fail your investors—partners who helped you bring your idea to life.

Questions for Critical Thinking

Barringer/Ireland Business Model Template The Barringer/Ireland Business Model Template, developed by the authors specifically for this book, is a nicely designed tool that helps students think through and articulate the business model for a proposed venture or an existing firm. Each section of the template, which is presented as Appendix 1 on p. 182 in Chapter 4, is fully explained in the chapter. The template can be easily copied and used by those wishing to develop a business model for an entrepreneurial venture. Additionally, if students are required to develop an idea for an entrepreneurial venture as a course requirement, they can also be asked to complete the template as part of such an assignment. In Case 4.2, titled "TOMS' One-for-One Business Model: Is It Sustainable?" we use the Barringer/Ireland Business Model Template to present TOMS' business model (see p. 177). This allows students to study a "live" business model and increase their understanding of how to use the template.

Feasibility Analysis Students and entrepreneurs typically find it challenging and difficult to determine if their idea for a product or service is feasible as the foundation for an entrepreneurial venture. Chapter 3 provides a detailed explanation of the steps entrepreneurs should take to complete a feasibility analysis. These steps are shown in Table 3.1. Three additional tools are offered to students in Chapter 3 to enhance their understanding of how to conduct a feasibility analysis. In Appendix 3.1 on p. 139, tips for conducting interviews to assess a product or a service's feasibility, as well as examples of questions to ask and questions not to ask during an interview, are presented. In Appendix 3.2 (see p. 140), we present a tool called First Screen. Students and entrepreneurs can use this template to complete a feasibility analysis regarding an idea they have for an entrepreneurial venture. Finally, Appendix 3.3 on p. 142 contains an Internet Resource Table that provides resources that are helpful when completing the First Screen template. In all, students can use the tools and information featured in these three appendixes to assess the feasibility of an idea they have as the foundation for launching an entrepreneurial venture.

End-of-Chapter Review and Application Questions Two sets of questions appear at the end of each chapter. By answering the review questions, students have opportunities to see if they have understood the concepts, tools, and techniques that were presented within each chapter. More comprehensive in nature, the application questions can be used to stimulate classroom discussions or to assess students' ability to explain how chapter-specific concepts, tools, and techniques would be used by an entrepreneur or within an entrepreneurial firm.

Review Questions

1-1. What are the characteristics of firms with higher entrepreneurial intensity? How can they be achieved?
1-2. What key insights does the GEM study provide us about entrepreneurship?
1-3. What does evidence show us about the rate of failure associated with entrepreneurial ventures?
1-4. What is entrepreneurship?
1-5. In what ways is an entrepreneur who
1-11. What are the skills and abilities required to effectively execute a business idea?
1-12. What are the startup types available to someone looking to start their own business?
1-13. What are the five common myths of entrepreneurship?
1-14. To what extent are entrepreneurs motivated by money?
1-15. What are the four distinctive parts of the

Application Questions

13-21. Sean Damsey has been running a budget hotel for the past six months and has been doing quite well. He did a quick survey and found that his town still does not have enough hotels to accommodate the number of tourists that visit, especially during weekends and holidays. At the moment, there are only three hotels, including Sean's. Sean is planning to expand and start another hotel in the same area, but he is afraid that his business might

You Be the VC Two of these features, which asks students to assume the role of a venture capitalist, appear at the end of each chapter. In each "You Be the VC" feature, the idea behind a newly-launched entrepreneurial venture is described. Given the product or service and the firm, students are asked to decide what additional information they would require to decide if they would or would not fund the venture. Chapter 6's "You Be the VC 6.2" (see p. 250) discusses Go-Jek, a company that has built a smartphone app that helps customers navigate Indonesia's traffic woes by offering the motorcycle equivalent of Uber. With a total of 30 "You Be the VC" features included in the book, students have multiple opportunities to carefully evaluate the commercial potential of a variety of products and services being offered by newly-established entrepreneurial firms.

YOU BE THE VC 6.2 Company: Go-Jek

• Web: www.go-jek.co • Twitter: @gojekindonesia

Business Idea: A moped-based transport and delivery service operating in several cities across Indonesia.

Pitch: Go-Jek is a motorcycle ride-hailing phone service in Indonesia established in 2010. Since then, it has developed into an on-demand service using a mobile platform and app and has expanded its operations from the city of Jakarta to over 25 cities across Indonesia. It has also expanded its services to incorporate transportation and logistics, food delivery, and other delivery services.

Go-Jek prides itself on speed and innovation and is determined to make a lasting contribution to the lives of those who work for the business. Their drivers are referred to as partners, not employees, but they do have access to health and accident insurance and other benefits.

Indonesian cities are famous for their traffic congestion ... private taxis are unsafe, unregulated, and insanitary (thousands have worn that old crash helmet before you!) Go-Jek solves all these problems with real-time tracking and control as well as free head covers and face masks for customers.

Go-Jek has thus become the motorcycle equivalent of Uber. In cities like Jakarta, due to the heavy traffic, Go-Jek actually has a significant advantage over Uber. Users register when they open the app for the first time, and all they need to do is to fill out the pickup address, the delivery address, and when they need the service. The app will then show the price. Payment can be made in cash, Go-Jek credits, or corporate pin number. Go-Jek also features a referral promotion code system. When a new user keys in an existing customer's promo code, they receive $2 credit, as does the customer whose promo code they used. This way, there is a direct incentive for

YOU BE THE VC 12.2 COMPANY: Wakoopa

• Web: www.wakoopa.com • Facebook: wakoopa • Twitter: @wakoopa

Business Idea: To establish a social network for software users to make it easier to track, share, and find software.

Pitch: Buying software online or from a store is often a tricky task, and staying up-to-date with the latest releases can be confusing. There are thousands of new software releases every year and dozens of different operating systems. Although there are many online websites and magazines offering software reviews, there is no way of knowing how long the reviewer has used the program and what their own preference is. Wakoopa was founded by two Dutch bloggers, Robert Gaal and Wouter Broekhof, to solve these problems and create a social network for software users.

Wakoopa's sign-up process is very simple: Users provide a user name and password and are then sent to a page with the download links for the Wakoopa tracking software. They then install a small application on their PC or Mac that works by performing a check every 15 minutes to track what software is used. It tracks a range of applications such as music players, office software, and photo editing, and records how long they use it. The information gathered can then be shared with friends, and personal profiles are automatically updated with news, updates, and reviews on each specific application. Users can check out the usage statistics before they decide whether or not to spend money on a program. Wakoopa lets them check whether the program is a one-hit wonder or has proved its value to many users in the long term.

Wakoopa started in 2006 as a social network that acquired around 200,000 registered users who called themselves

End-of-Chapter Cases Two cases appear at the end of each chapter. Comprehensive in scope, both cases presented within individual chapters speak to those chapters' core topics. Dealing with real companies, these cases present students with opportunities to evaluate multiple applications of a particular chapter's concepts, tools, and techniques as they are applied within a firm. In some instances, a case asks students to evaluate firms that are not being as successful as those leading them want to be the case. This is true for Quiznos, which is the subject of Case 15.1 (see p. 590). This case describes the challenges a franchisor (Quiznos) has encountered over a number of years following a successful launch and after achieving initial successes. Questions appearing at the end of this case challenge students to decide if they believe that actions this firm is taking today will result in a positive turnaround for Quiznos as a foundation for returning to entrepreneurial success. In other instances, an end-of-chapter case describes an entrepreneurial venture's success and asks students to decide if the firm's positioning will yield additional success across time. This situation describes d.light, the focal firm of Case 6.2 on p. 254. As explained in this case, d.light's business plan was instrumental to its success and appears to have the potential to be the foundation for the firm's continuing success in the future. However, the firm faces challenges, some of which appear in the form of questions that students can answer as a means of fully considering d.light's future.

CASE 6.2

d.light: How Bringing Its Business Plan to Life Helped a Social Enterprise Get Off to a Strong Start

• *Web: dlightdesign.com* • *Facebook: D.lightDesign* • *Twitter: @dlightdesign*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Imagine the following. You are in the audience of a business plan competition. The next team up to present is d.light, a for-profit social enterprise that plans to bring light to people without access to reliable electricity. Two young men introduce themselves as the founders of d.light, and say they're going to start their presentation with a demonstration. The lights go out. In a few

kerosene fire, an event that deeply impacted Goldman. At one point during his time in the village, Goldman was given a battery-powered LED headlamp, and was struck by the dramatic difference that simply having light at night can make in a person's life. He could now cook, read, and do things at night that were unimaginable without the benefits reliable lighting provides.

Impacted by this experience, Goldman sought

CASE 15.1

Quiznos: Will It Regain a Leadership Position in the Sandwich and Sub Shop Franchise Industry?

• *Web: www.quiznos.com* • *Facebook: Quiznos* • *Twitter: @Quiznos*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

In the early 1980s, Jimmy Lambatos moved from New York City to Denver to attend college. Growing up in New York, he frequently ate sub sandwiches made with crusty Italian bread. It was artisan bread, the flavorful kind with spices, oils, and vinegars. Once in Denver, Lambatos kept eating sub sandwiches, but couldn't find a sandwich shop that used artisan bread. He caught

like their sandwiches warm, but that the heat brings out the flavor in artisan breads. After operating solely from Grant and 13th in Denver for two years, Quiznos started franchising in 1983. By 1987, 12 Quiznos restaurants were operating in the United States. That year, Richard Schaden, at the age of 23, and his father, who was an aviation attorney, opened a Quiznos franchise in Boulder, CO. They opened three additional Quiznos sub

MyLab Entrepreneurship

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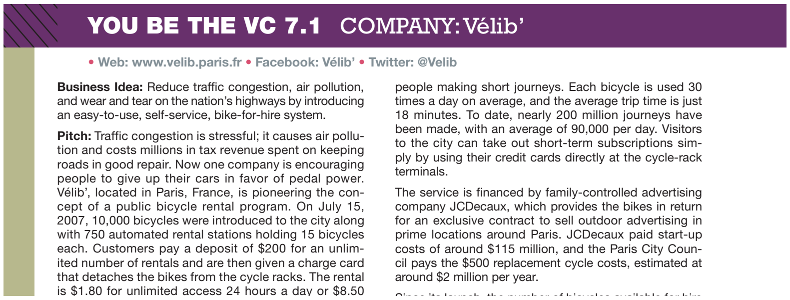
Developing Employability Skills

To succeed in today's rapidly changing job market, students should develop skills that will facilitate their efforts to achieve career success—whether they intend to be an entrepreneur or not. In this book, we focus on developing "employability skills" that will help students who seek to be entrepreneurs as well as those who seek to achieve business success by pursuing different options. We focus on developing these skills in the following ways:

Business Ethics and Social Responsibility Examples of firms engaging in socially responsible actions and seeking to solve some of society's challenges appear throughout the book. For instance, consider the story of Vélib', the initiative in the "You Be the VC 7.1" feature. This initiative is a bicycle-sharing system that reduces traffic congestion and pollution in the city of Paris. We discuss the need for firms to establish a strong ethical culture as a foundation for how they operate. Specific actions business people can take to "lead by example" when it comes to demonstrating ethical behaviors consistently appear on p. 264. We also describe on p. 265 what should be done to implement an ethics training program in entrepreneurial ventures and all other types of firms. Moreover, when considering each chapter's core topic, instructors can ask students to discuss the "ethical issues" associated with, for example, building effective work teams (Chapter 9) and deciding how to market a firm's product or service (Chapter 11).


YOU BE THE VC 7.1 COMPANY: Vélib'

• Web: www.velib.paris.fr • Facebook: Vélib' • Twitter: @Velib

Business Idea: Reduce traffic congestion, air pollution, and wear and tear on the nation's highways by introducing an easy-to-use, self-service, bike-for-hire system.

Pitch: Traffic congestion is stressful; it causes air pollution and costs millions in tax revenue spent on keeping roads in good repair. Now one company is encouraging people to give up their cars in favor of pedal power. Vélib', located in Paris, France, is pioneering the concept of a public bicycle rental program. On July 15, 2007, 10,000 bicycles were introduced to the city along with 750 automated rental stations holding 15 bicycles each. Customers pay a deposit of $200 for an unlimited number of rentals and are then given a charge card that detaches the bikes from the cycle racks. The rental is $1.80 for unlimited access 24 hours a day or $8.50 people making short journeys. Each bicycle is used 30 times a day on average, and the average trip time is just 18 minutes. To date, nearly 200 million journeys have been made, with an average of 90,000 per day. Visitors to the city can take out short-term subscriptions simply by using their credit cards directly at the cycle-rack terminals.

The service is financed by family-controlled advertising company JCDecaux, which provides the bikes in return for an exclusive contract to sell outdoor advertising in prime locations around Paris. JCDecaux paid start-up costs of around $115 million, and the Paris City Council pays the $500 replacement cycle costs, estimated at around $2 million per year.

Critical Thinking Learning how to think critically about issues is foundational to a person's ability to identify opportunities to develop a product or service that meets a certain customer group's needs. The 30 end-of-chapter cases in this edition expose students to an array of products and services that entrepreneurs developed to serve customers. In each instance, the entrepreneurs had to think critically as a foundation for deciding how to proceed to launch their ventures. In Case 1.1, for example (see p. 60), Julie Rice and Elizabeth Cutler decided that they wanted to create an alternative to fitness routines and experiences that felt like work. After thinking through various options, they developed a cardio-workout experience that is relational in nature for their customers. In their view, the exercise experience SoulCycle provides to customers is tribal, primal, and fun.

Collaboration Skills There is no doubt that being able to collaborate with others (both within and outside a firm) is critical to success for firms competing in today's business environment. In particular, the "Partnering for Success" features allow students to increase their understanding of how collaboration increases the likelihood of a firm improving its performance. In Chapter 8's feature (see p. 305), students learn how entrepreneurial firms participate in groups (often called cooperatives) that are organized and used for the purpose of helping individually small firms gain access to the benefits accrued through collective purchases of products rather than purchasing as individual firms.

Data Literacy Being able to interpret the business-related meaning of data is a critical skill for today's business people to develop. The Feasibility Analysis Templates appearing as appendixes at the end of Chapter 3 help students understand how to interpret data for the purpose of deciding if a business idea is feasible and as such, worth pursuing. The Barringer/Ireland Business Model Template generates data students can analyze for the purpose of forming a business model for an entrepreneurial venture. Interpreting the meaning of financial data is at the center of Chapter 10's discussion of how entrepreneurial firms obtain the funding required to launch and/or continue their operations. How entrepreneurs interpret financial data though parallels how all business people interpret such data.

Instructor Teaching Resources

This program comes with the following teaching resources:

Supplements available to instructors at www.pearsonglobaleditions.com	Features of the Supplement
Instructor's Manual authored by Ram Subramanian from Stetson University	■ Chapter-by-chapter summaries ■ Teaching outlines ■ Teaching tips ■ Solutions to all questions and problems in the book
Test Bank authored by Ram Subramanian from Stetson University	More than 1,500 multiple-choice, true/false, and short-answer questions with these annotations: ■ Difficulty level (1 for straight recall, 2 for some analysis, 3 for complex analysis) ■ Learning outcome ■ AACSB learning standard (Written and Oral Communication; Ethical Understanding and Reasoning; Analytical Thinking; Information Technology; Interpersonal Relations and Teamwork; Diverse and Multicultural Work; Reflective Thinking; Application of Knowledge)
Computerized TestGen	TestGen allows instructors to: ■ Customize, save, and generate classroom tests ■ Edit, add, or delete questions from the Test Item Files ■ Analyze test results ■ Organize a database of tests and student results
PowerPoints authored by Bruce Barringer from Oklahoma State University	Slides include many of the tables, illustrations, and figures in the textbook. PowerPoints meet accessibility standards for students with disabilities. Features include, but are not limited to: ■ Keyboard and Screen Reader access ■ Alternative text for images ■ High color contrast between background and foreground colors

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Student Entrepreneurs We want to extend a heartfelt "thank you" to the student entrepreneurs who contributed to the "Opening Profiles" appearing in this edition of our book. Our conversations with these individuals were both informative and inspiring. We enjoyed getting to know these bright young entrepreneurs, and we wish them nothing but total success as they continue to build their ventures.

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Frank Demmler, *Carnegie Mellon University*
David Desplaces, *University of Hartford/Barney*
Vern Disney, *University of South Carolina—Sumter*
Dale Eesley, *University of Toledo*
Alan Eisner, *Pace University*
Susan Everett, *Clark State Community College*
Henry Fernandez, *North Carolina Central University*
Charles Fishel, *San Jose State University*
Dana Fladhammer, *Phoenix College*
Brenda Flannery, *Minnesota State University*
John Friar, *Northeastern University*
Barbara Fuller, *Winthrop University*
Barry Gilmore, *University of Memphis*
Caroline Glackin, *Delaware State University*
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Frederick Greene, *Manhattan College*
Lee Grubb, *East Carolina University*
Brad Handy, *Springfield Technical Community College*
Carnella Hardin, *Glendale College*
Ashley Harmon, *Southeastern Technical College*
Steve Harper, *University of North Carolina at Wilmington*
Alan Hauff, *University of Missouri—St. Louis*
Gordon Haym, *Lyndon State College*
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Jo Hinton, *Copiah Lincoln Community College*
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Jeffrey Jackson, *Manhattanville College*
Grant Jacobsen, *Northern Virginia Community College–Woodbridge*
Susan Jensen, *University of Nebraska—Kearney*
Alec Johnson, *University of St. Thomas*
James M. Jones, *University of the Incarnate Word, ERAU, Del Mar College*
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Dara Szyliowicz, *University of Denver*

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Barry Van Hook, *Arizona State University*

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We wish each of you—our readers—all the best in your study of the entrepreneurial process. We do indeed hope that each of you will be highly successful entrepreneurs as you pursue the ideas you will develop at different points in your careers.

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About the Authors

Bruce R. Barringer Bruce R Barringer is a professor and department head for the School of Entrepreneurship at Oklahoma State University. He also holds the N. Malone Mitchell Jr. and the Student Ventures chairs. Bruce received his PhD from the University of Missouri and his MBA from Iowa State University. His research interests include feasibility analysis, firm growth, corporate entrepreneurship, and the impact of interorganizational relationships on business organizations. Over the years, he has worked with a number of technology-based incubators and student-led entrepreneurship activities and clubs.

Bruce's work has been published in *Strategic Management Journal, Journal of Management, Journal of Business Venturing, Journal of Small Business Management, Journal of Developmental Entrepreneurship* and several other outlets. He is the author or coauthor of five books, including *Entrepreneurship Successfully Launching New Ventures* (Pearson, 2019), *Preparing Effective Business Plans* (Pearson, 2015), *Launching a Business: The First 100 Days* (Business Expert Press, 2013), *The Truth About Starting a Business* (FT Press, 2009), and *What's Stopping You? Shatter the 9 Most Common Myths Keeping You from Starting Your Own Business* (FT Press, 2008).

Bruce's outside interests including running, trail biking, and swimming.

R. Duane Ireland R. Duane Ireland is a University Distinguished Professor and holds the Benton Cocanougher Chair in Business in the Mays Business School, Texas A&M University. He also serves as the Executive Associate Dean for the Mays School. Previously, he served as a member of the faculties at the University of Richmond, Baylor University, and Oklahoma State University. His research interests include strategic entrepreneurship, entrepreneurship in informal economies, corporate entrepreneurship, and the effective management of organizational resources.

Duane's research has been published in journals such as *Academy of Management Journal*, *Academy of Management Review*, *Academy of Management Executive*, *Academy of Management Perspectives*, *Academy of Management Annals*, *Administrative Science Quarterly*, *Strategic Management Journal*, *Journal of Management*, *Strategic Entrepreneurship Journal*, *Journal of Business Venturing*, and *Entrepreneurship Theory and Practice*, among others. He is a co-author of both scholarly books and textbooks in the areas of entrepreneurship and strategic management.

Duane has served as a member of editorial review boards for many journals including *Academy of Management Journal*, *Academy of Management Review*, *Journal of Management*, and *Journal of Business Venturing*. He completed a three-year term as editor of the *Academy of Management Journal* and was the 69^{th} president of the Academy of Management. He is a fellow of the Academy of Management and a fellow of the Strategic Management Society. He has received a number of awards such as a Lifetime Achievement Award for Scholarship and Research from Mays Business School, a Distinguished Service Award from the Academy of Management, and a Distinguished Service Award from the Strategic Management Division of the Academy of Management. Duane's outside interests include running, reading, and spending time with his family.

PART 1 Decision to Become an Entrepreneur

Owlet Baby Care, Inc.

CHAPTER 1 **Introduction to *Entrepreneurship*** **29**

Getting Personal with SUPERJAM

Founder

FRASER DOHERTY

Photo Credit: Fraser Doherty

Dialogue *with* Fraser Doherty

BEST ADVICE I'VE RECEIVED
Go with your passion. Makes it so much easier! I love bikes, and it makes my job infinitely easier.

MY BIGGEST WORRY AS AN ENTREPRENEUR
That we're not innovating fast enough to keep ahead of the competition

WHAT I DO WHEN I'M NOT WORKING
Drive my 40-year-old VW camper van round the countryside!

MY FAVORITE SMARTPHONE APP
SuperJam's Recipe App

MY FIRST ENTREPRENEURIAL EXPERIENCE
Hatching chickens on top of the TV, age 10, and selling their eggs

FAVORITE BAND ON MY SMARTPHONE LIST
The Smiths

FAVORITE PERSON I FOLLOW ON TWITTER
Has to be Stephen Fry.

CHAPTER 1

Introduction to *Entrepreneurship*

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OPENING PROFILE

SUPERJAM

The Classic Entrepreneurial Story

• Web: http://www.superjam.co.uk • Facebook: SuperJam 100% Fruit Spread • SuperJam's Recipe App

Growing up in Scotland, Fraser Doherty spent his childhood coming up with ideas for new products. Not all his money-making ideas were a success—indeed, his fledgling egg-selling enterprise ended abruptly when a fox ate all his chickens—but he had a hunger to set up a business.

At the age of 14, Doherty gave jam-making a try. He had always enjoyed the jam his grandmother made and thought there might be an opportunity here. After making a batch and selling it door-to-door, he discovered people really liked it, and Doherty's jam enterprise gradually spread into local shops and farmers' markets. A feature in the *Edinburgh Evening News* brought in even more orders from further afield.

After resolving to expand the business, Doherty did some research and found that sales of jam had been in decline for the past few decades. Jam had acquired an old-fashioned image and people preferred healthier alternatives on their toast.

The solution the young Scottish entrepreneur came up with was a jam for the modern world. Doherty's SuperJam would be made using traditional recipes, completely from fruit juice. The jars would contain no sugar and no artificial flavoring. He also boldly resolved to target supermarkets to sell his products.

Fraser faced a number of challenges. At this point, he was making hundreds of jars of jam every week in his parents' kitchen. Apart from the fact his parents were struggling to get in there to cook their dinner, the business clearly couldn't grow any further.

At the age of 17, he was in no position to start a factory and did not have any money to pay a design agency to create a brand. He did not have a clue about how to approach supermarkets either. All he had was a passion about his product and a great recipe.

The first supermarket Fraser approached was Waitrose on a "meet the buyer" day. Fraser pitched his idea to the senior jam buyer—he liked it but said it had a long way to go. He advised Fraser to set up a production facility and create a brand before coming back with a well-priced product.

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Describe entrepreneurship, corporate entrepreneurship, and the characteristics of entrepreneurial firms.
2. Discuss three main reasons people decide to become entrepreneurs.
3. Identify four main characteristics of successful entrepreneurs.
4. Explain five common myths regarding entrepreneurship.
5. Describe the three types of start-up firms.
6. Discuss the changing demographics of entrepreneurs in the United States.
7. Discuss the positive effects of entrepreneurship and entrepreneurial firms on economies and societies.
8. Explain the entrepreneurial process.
9. Learn how understanding entrepreneurship and the entrepreneurial process can facilitate your career success.

Fraser set off around the United Kingdom trying to convince food manufacturers to believe in his 100 percent fruit jam. He told them that he didn't have any money to invest, but if they took the long-term view, then they too would reap the benefit. He did the same with a string of advertising agencies to persuade them to help him create a brand. Eventually, after two years of persistence, Doherty finally convinced a factory and an advertising agency to work with him.

SuperJam is exhibited in the National Museum of Scotland as an "Iconic Scottish Brand" alongside Irn-Bru and Tunnock's and Baxters, two other brands synonymous with Scotland. In 2010, Fraser shared his jam-making secrets with the world in the SuperJam Cook; this was followed in 2011 by his autobiography and jam story, *SuperBusiness*. Since 2010, Fraser has been the entrepreneur-in-residence at the London Metropolitan University, where he delivers presentations and lectures on aspects of entrepreneurship.

Doherty has kept close to his customers throughout SuperJam's meteoric rise and is conscious of the part technology and, in particular, social networks play in his business and in maintaining a meaningful conversation with his customers.

Against a backdrop of digital social networking, SuperJam Tea Parties are about as far removed from the virtual world as you could imagine. The company runs these events for elderly people who live alone, primarily in care homes or sheltered accommodation. To date, they have run over 350 events across the United Kingdom. The mix of live music, dancing, a heavy dose of scones, and SuperJam attract up to 600 people to each event.

From humble beginnings working at his kitchen table to growing his entrepreneurial venture, Fraser now supplies over 2,000 supermarkets around the world with SuperJam and has won a variety of awards for the range. Fraser has now scooped up over 20 prestigious awards, including Bighearted Scotland Business Person of The Year (2009), Smarta 100 Award (2010), and *Inc*. magazine's 30 under 30 Award (2010). He also made the finals for "Times Young Power List" (2011), NatWest Enterprise Awards Finalist (2012), and Ben & Jerry's "Join Our Core" Finalist (2012).[1]

In this first chapter of your book about the successful launching of an entrepreneurial venture or firm, we define entrepreneurship and discuss why some people decide to become entrepreneurs. We then consider successful entrepreneurs' characteristics, the common myths surrounding entrepreneurship, the different types of start-up firms, and the changing demographics of entrepreneurs in the United States and other nations as well. We then describe entrepreneurship's importance, including the economic and social impact of new firms as well as the importance of entrepreneurial firms to larger businesses. To close the chapter, we introduce you to the entrepreneurial process. This process, which we believe is the foundation for successfully launching and operating a start-up firm, is the framework we use to present the book's materials to you.

Introduction to Entrepreneurship

There is tremendous interest in entrepreneurship around the world. Although this statement may seem bold, there is evidence supporting it, some of which is provided by the Global Entrepreneurship Monitor (GEM). GEM, which is a joint research effort among several international universities and the International Council for Small Business, tracks entrepreneurship in 115 countries, including the United States. Of particular interest to GEM is total early stage entrepreneurial activity (TEA), which consists of businesses that are just being started and businesses that have been in existence for less than three and a half years. A sample of the rate of total early-stage entrepreneurial activity in countries included in the GEM study is shown in Table 1.1. Although the highest rates of entrepreneurial start-up activities occur in low-income countries, where good jobs are not plentiful, the rates are also impressive in high-income countries such as Germany (7.6 percent), Japan (5.4 percent), the Kingdom of Saudi Arabia (14 percent), South Africa (10.8 percent), Spain (6.2 percent), Switzerland (9.8 percent), the United Arab Emirates (16.4 percent), the United States (17.4 percent), and the United Kingdom (9.3 percent). What the 9.3 percent means for the United Kingdom is that almost one out of every eleven British adults is actively engaged in starting a business or is the owner or manager of a business that is less than three-and-a-half-years old.[2]

The GEM study also identifies whether its respondents are starting a new business to take advantage of an attractive opportunity or because of necessity to earn an income. However, the 2019 GEM Global Report went further and included more factors as primary motivations for entrepreneurial activity. The first is the goal of making a difference in the world. Commanding the highest share of TEA in 15 economies, mostly in the Asia-Pacific and the Middle East and Africa, this is an increasingly common motive for starting a business. The second goal, to earn a living because jobs are scarce, is a common motive too, cited by more than 50 percent of entrepreneurs in 35 countries, particularly Latin American and Caribbean economies. The third motive is to build great wealth or earn a very high income, but its prevalence varies, with only 10 percent citing this as their motive in some regions and as much as 70 percent in others, particularly South Africa, India, and Panama. The fourth is to continue a family tradition, and this too varies; only 10 percent of the startups in the

TABLE 1.1 Rates of Early-Stage Entrepreneurial Activity (Ages 18 to 64)

Country	Percent of Population Starting a New Business
Australia	10.5%
Brazil	23.3%
Chile	25.9%
China	8.7%
Germany	7.6%
India	15%
Japan	5.4%
Kingdom of Saudi Arabia	14%
South Africa	10.8%
Spain	6.2%
Switzerland	9.8%
United Arab Emirates	16.4%
United Kingdom	9.3%
United States	17.4%

Source: Niels Bosma, Stephen Hill, Aileen Ionescu-Somers, Donna Kelley, Jonathan Levie, and Anna Tarnawa, *GEM 2019/2020 Global Report* (London: Global Entrepreneurship Research Association, 2020).

Republic of Korea and the United Kingdom reported this motive, but 80 percent of those in Poland and India did.[3]

One criticism of entrepreneurship, which is often repeated in the press, is that the majority of new businesses fail.[4] It simply isn't true. The often used statistic that 9 out of 10 businesses fail in their first few years is an exaggeration. In the United Kingdom, the number of startups has been rising every year despite concerns over Brexit. According to Gov.uk, one company was formed every minute in 2019. Nearly 89 percent of startups survive their first year, although fewer than half the businesses started remain in existence five years later. While overall these figures are heartening, the percentage of firms that do fail shows that a motivation to start and run a business isn't enough; indeed, motivation must be coupled with a solid business idea, good financial management, and effective execution to maximize chances of success. In this book, we'll discuss many examples of entrepreneurial firms and the factors separating successful new ventures from unsuccessful ones.

Many people see entrepreneurship as an attractive career path. Think about your friends and others you know. In all probability, you are acquainted with at least one or two people who want to become an entrepreneur—either now or at some point in the future. The number of books dealing with starting one's own business is another indication that entrepreneurship is growing in popularity. Amazon.com, for example, currently lists over 58,510 books dealing with entrepreneurship and over 80,686 books concerned with small businesses. The number of books on entrepreneurship is up from 36,900 just three years ago.

What Is Entrepreneurship and Why Is It Important?

LEARNING OBJECTIVE

1. Describe entrepreneurship, corporate entrepreneurship, and the characteristics of entrepreneurial firms.

The word *entrepreneur* derives from the French words *entre*, meaning "between," and *prendre*, meaning "to take." The word was originally used to describe people who "take on the risk" between buyers and sellers or who "undertake" a task such as starting a new venture.[5] Inventors and entrepreneurs differ from each other. An inventor creates something new. An entrepreneur assembles and then integrates all the resources needed—the money, the people, the business model, the strategy, and the risk-bearing ability—to transform the invention into a viable business.[6]

Entrepreneurship is defined as the process by which individuals pursue opportunities without regard to resources they currently control for the purpose of exploiting future goods and services.[7] Others define it more simply, seeing entrepreneurship as the art of turning an idea into a business. In essence, an entrepreneur's behavior finds him or her trying to identify opportunities and putting useful ideas into practice.[8] The tasks called for by this behavior can be accomplished by either an individual or a group and typically require creativity, drive, and a willingness to take risks. Fraser Doherty, the subject entrepreneur in the chapter's "Opening Profile," exemplifies all these qualities. Fraser saw an *opportunity* to market a traditional fruit preserve for a modern world that had already moved on to "healthier" alternatives. He took a *risk* by passing up alternatives to work on SuperJam full time, and he's now *working hard* to put SuperJam in a position to deliver *creative* and *useful* products to its customers.[9]

In this book, we focus on entrepreneurship in the context of an entrepreneur or team of entrepreneurs launching a new business. However, ongoing firms can also behave entrepreneurially. Typically, established firms with an entrepreneurial emphasis are proactive, innovative, and risk-taking. For example, Google is widely recognized as a firm in which entrepreneurial behaviors are clearly evident. Larry Page, one of Google's cofounders, is at the heart of Google's entrepreneurial culture. With his ability to persuade and motivate others' imaginations, Page continues to inspire Google's employees as they develop innovative product after innovative product. To consider the penetration Google has with some of its innovations, think of how often you and people you know use the Google search engine, Gmail, Google Maps, Google Earth, or Google Home. Google is currently working on a bevy of far-reaching innovations, such as a virtual reality platform for Android and self-driving cars. Similarly, if you were to study Facebook's or Dropbox's actions you would quickly recognize their ability to grow and succeed. This growth and success reveals a history of entrepreneurial behavior at multiple levels within the two firms. In addition, many of the firms traded on the NASDAQ (the largest U.S. stock market with nearly 3,100 companies listed), such as Apple, Zynga, Facebook, and Amgen are commonly thought of as entrepreneurial firms.

As we mentioned, existing firms too can act entrepreneurially. In this sense, established firms with an orientation toward acting entrepreneurially practice **corporate entrepreneurship**.[10] All firms fall along a conceptual continuum that ranges from highly conservative to highly entrepreneurial. The position of a firm on this continuum is referred to as its **entrepreneurial intensity**.[11] As we noted, entrepreneurial firms are typically proactive innovators and are not averse to taking calculated risks. In contrast, conservative firms take more of a "wait and see" posture, are less innovative, and are risk averse.

One of the most persuasive indications of entrepreneurship's importance to an individual or a firm is the degree of effort undertaken to behave entrepreneurially. Firms with higher entrepreneurial intensity regularly look for ways to cut bureaucracy. For example, Virgin Group, the large British conglomerate, works hard to keep its units small and instill in them an entrepreneurial spirit. Virgin is one of the most recognized brands in Britain and is involved in businesses as diverse as airlines and music. In the following quote, Sir Richard Branson, the founder and CEO of Virgin, describes how his company operates in an entrepreneurial manner:

> Convention . . . dictates that "big is beautiful," but every time one of our ventures gets too big we divide it up into smaller units. I go to the deputy managing director, the deputy sales director, and the deputy marketing director and say, "Congratulations. You're now MD [managing director], sales director and marketing director—of a new company." Each time we've done this, the people involved haven't had much more work to do, but necessarily they have a greater incentive to perform and a greater zeal for their work. The results for us have been terrific. By the time we sold Virgin Music, we had as many as 50 subsidiary record companies, and not one of them had more than 60 employees.[12]

Why Do People Become Entrepreneurs?

LEARNING OBJECTIVE

2. Discuss three main reasons people decide to become entrepreneurs.

The three primary reasons that people become entrepreneurs and start their own firms are to be their own boss, pursue their own ideas, and pursue financial rewards.

Be Their Own Boss

The first of these reasons—being one's own boss—is given most commonly. This doesn't mean, however, that entrepreneurs are difficult to work with or that they have trouble accepting authority. Instead, many entrepreneurs want to be their own boss because either they have had a long-time ambition to own their own firm or because they have become frustrated working in traditional jobs. The type of frustration that some entrepreneurs feel working in conventional jobs is exemplified by Wendy DeFeudis, the founder of VeryWendy, a company

Pressmaster/Shutterstock

An entrepreneurial career is full of possibilities. These three young entrepreneurs are starting a graphic design business. They are passionate about website design, logo design, and business branding.

that makes customized social invitations. Commenting on how her experiences working for herself have been more satisfying than working for a large firm, DeFeudis remarked:

> I always wanted to be my own boss. I felt confined by the corporate structure. I found it frustrating and a complete waste of time—a waste to have to sell my ideas to multiple people and attend all kinds of internal meetings before moving forward with a concept.[13]

Some entrepreneurs transition from a traditional job to owning their own business more gradually, as shown by a decision to initially operate their firm on a part-time basis. While this approach isn't possible in all situations, by starting a business part time individuals can gain valuable experience, tuck away the money they earn, and find out if they really like the business before deciding to leave their job. In some businesses, such as catering or financial planning, it takes time to build a client list. Some entrepreneurs will time their departure from their job with the point in time at which their client list is large enough and profitable enough to support a full-time business.[14]

Pursue Their Own Ideas

The second reason people start their own firms is to pursue their own ideas.[15] Some people are naturally alert, and when they recognize ideas for new products or services, they have a desire to see those ideas realized. Corporate entrepreneurs who innovate within the context of an existing firm typically have a mechanism for their ideas to become known. Established firms, however, often resist innovation. When this happens, employees are left with good ideas that go unfulfilled.[16] Because of their passion and commitment, some employees choose to leave the firm employing them in order to start their own business as the means to develop their own ideas.

This chain of events can take place in noncorporate settings, too. For example, some people, through a hobby, leisure activity, or just everyday life, recognize the need for a product or service that is not available in the marketplace. If the idea is viable enough to support a business, they commit tremendous time and energy to converting the idea into a part-time or full-time firm. In Chapters 2 and 3, we focus on how entrepreneurs spot ideas and determine if their ideas represent viable business opportunities.

Many entrepreneurs experience tremendous satisfaction when their entrepreneurial idea catches on, and they see the positive results it creates. An example is Marco Zappacosta, the founder of Thumbtack. Thumbtack is an online platform that allows people to quickly locate local service providers, such as photographers, house painters, and piano teachers. Zappacosta's insight at the time Thumbtack was founded in 2009 was that all across America there were local service providers struggling to find new clients, and ordinary people looking for service providers they could trust. Commenting on how Thumbtack solves both a big problem but also makes a difference in ordinary people's lives, Zappacosta remarked:

> The macro of it (connecting people who need services with people who are willing to provide them) is a big problem and it's satisfying to work on big things that can have a huge impact. But then what (I) really like—you feel day to day is the stories of impacting individuals, it's the pest control guy in Brooklyn sending us flowers to say thank you for all the business that we're now sending him, or the busy mom who is sending pictures of her birthday party that she was able to throw with Thumbtack. That feels great and that's certainly a bigger part of the motivation that we feel.[17]

Since its inception, Thumbtack has helped millions of people connect with local service providers and over $1 billion is exchanged through its platform each year.[18]

Pursue Financial Rewards

Finally, people start their own firms to pursue financial rewards. This motivation, however, is typically secondary to the first two and often fails to live up to its hype. The average entrepreneur does not make more money than someone with a similar amount of responsibility in a traditional job. The financial lure of entrepreneurship is its upside potential. People such as Jeff Bezos of Amazon.com, Mark Zuckerberg of Facebook, and Larry Page and Sergey Brin of Google made billions of dollars building their firms. Money is also a unifier. Making a profit and increasing the value of a company is a solidifying goal that people can rally around. But money is rarely the primary motivation behind the launch of an entrepreneurial firm. Some entrepreneurs even report that the financial rewards associated with entrepreneurship can be bittersweet if they are accompanied by losing control of their firm. For example, Sir Richard Branson, after selling Virgin Records, wrote, "I remember walking down the street [after the sale was completed]. I was crying. Tears . . . [were] streaming down my face. And there I was holding a check for a billion dollars . . . . If you'd have seen me, you would have thought I was loony. A billion dollars."[19] For Branson, it wasn't just the money—it was the thrill of building the business and of seeing the success of his initial idea.

Characteristics of Successful Entrepreneurs

Although many behaviors have been ascribed to entrepreneurs, several are common to the successful ones. Those in new ventures and those who are already part of an entrepreneurial firm share these qualities, which are shown in Figure 1.1 and described in the following section.

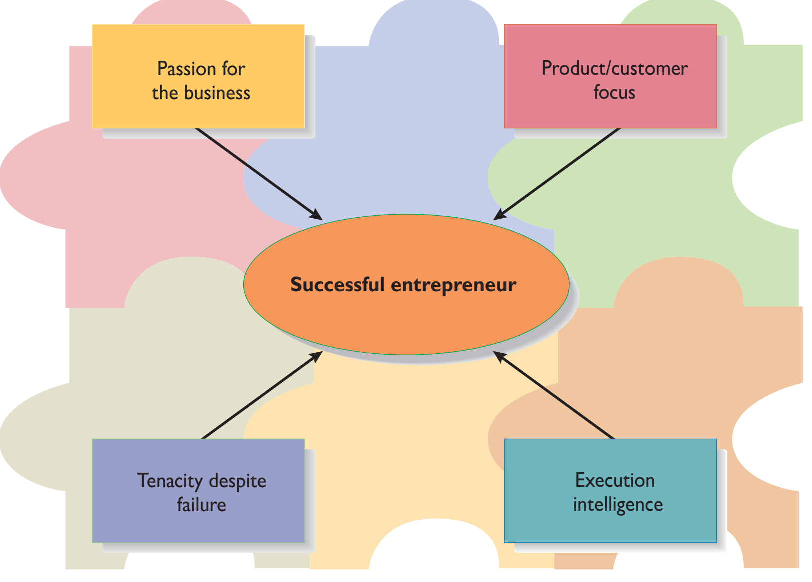
LEARNING OBJECTIVE

3. Identify four main characteristics of successful entrepreneurs.


Antonio Guillem/Shutterstock

One of the most satisfying things about an entrepreneurial career is bringing products to life that enhance people's lives. This young woman is enjoying watching a music video provided by an online streaming music service started by two entrepreneurs.

FIGURE 1.1
Four Primary Characteristics of Successful Entrepreneurs



Passion for the Business

The number one characteristic shared by successful entrepreneurs is a **passion for their business**, whether it is in the context of a new firm or an existing business. Frequently, it's the passion for an idea that gets a business going and keeps it going when times are tough. This sentiment was expressed by Patrick Whaley, the founder of Titin, a company that makes innovative weighted compression gear, which some athletes have found useful in training. "I'm passionate that there's a better way to train," Whaley said. "That's what inspired me to design and develop this product, and that's what keeps me going."[20] Recall that Kirsten Blowers, the owner of Riffraff and the subject company of the chapter's "Opening Profile" remains "passionate about her business" and that this passion influences her daily as she leads her businesses.

Making a difference in people's lives is the primary motivator behind many social enterprises, which are often started by people who set aside promising careers to pursue a social goal. This was the case with John Wood, who founded Room to Read and is the author of the book *Leaving Microsoft to Change the World*. Wood's deep passion to help children in the developing world caused him to start cashing in small amounts of Microsoft stock to buy books and build schools, even before he left the company. In excerpts from an interview published by *Forbes* magazine, Wood said:

> During my travels, I met so many children in the poorest parts of the world, lacking access to school, books, and libraries, that I began cashing in small amounts of stocks to help them. Two hundred shares of Microsoft stock was enough to build an entire school in rural Nepal.[21]

Wood eventually left Microsoft to work on Room to Read full time. Since its inception in 2000, Room to Read has served over 10.7 million children, published 1,295 books, and delivered over 18 million books to young readers, all in developing parts of the world.[22]

Passion is particularly important for both for-profit and not-for-profit entrepreneurial organizations because although rewarding, the process of starting a firm or building either a profit-making corporation or a social enterprise is demanding. There are five primary reasons passion is important, as reflected in Table 1.2. Each of these reasons reflects a personal attribute that passion engenders. Removing just one of these qualities would make it much more difficult to launch and sustain a successful entrepreneurial organization.

A note of caution is in order here: While entrepreneurs should have passion, they should not wear rose-colored glasses. It would be a mistake to believe that all one needs is passion and anything is possible. It is important to be enthusiastic about a business idea, but it is also important to understand its potential flaws and risks. In addition, entrepreneurs should understand

TABLE 1.2 Five Primary Reasons Passion Is Important for the Launch of a Successful Entrepreneurial Organization

Reason Passion Is Important	Explanation
1. The ability to learn and iterate	Founders don't have all the answers. It takes passion and drive to solicit feedback, make necessary changes, and move forward. Needed changes won't always be obvious. Passion makes the search for the right answers invigorating and fun.
2. A willingness to work hard for an extended period of time	Commonly, entrepreneurs work longer hours than people with traditional jobs. You can only do that on a sustained basis if you're passionate about what you're doing.
3. Ability to overcome setbacks and "no's"	It's rare that an entrepreneur doesn't experience setbacks and hear many "no's" from potential customers, investors, and others while building an entrepreneurial business or a social enterprise. The energy to continue comes from passion for an idea.
4. The ability to listen to feedback on the limitations of your organization and yourself	You'll meet plenty of people along the way—some with good intentions and some without—who will tell you how to improve your organization and how to improve yourself. You have to be willing to listen to the people with good intentions and make changes if it helps. But you also have to be able to brush aside feedback from people with bad intentions without letting them get you down.
5. Perseverance and persistence when the going gets tough	Perseverance and persistence come from passion. As an entrepreneur, you'll have down days. Building an entrepreneurial organization is fraught with challenges. Passion is what provides an entrepreneur the motivation to get through tough times.

Source: Based on A. Sack, "Why Is Passion So Important to a Startup?" A Sack of Seattle blog, https://asack.typepad.com/a_sack_of_seattle/2010/03/why-is-passion-so-important-to-a-startup.html (posted March 16, 2010, accessed May 22, 2011).

that the most effective business ideas take hold when their passion is consistent with their skills and is in an area that represents a legitimate business opportunity.

To illustrate the importance of passion, as well as other factors that are critical in determining a firm's success or failure, we include a boxed feature titled "What Went Wrong?" in each chapter. The feature for this chapter shows how Prim, a laundry and pick-up and delivery service, ultimately failed, in part because its founders were not able to remain passionate about their business idea.

Product/Customer Focus

A second defining characteristic of successful entrepreneurs is a **product/customer focus**. This quality is exemplified by Steven Jobs, the late cofounder of Apple Inc., who wrote, "The computer is the most remarkable tool we've ever built . . . but the most important thing is to get them in the hands of as many people as possible."[23] This sentiment underscores an understanding of the two most important elements in any business—products and customers. While it's important to think about management, marketing, finance, and the like, none of those functions makes any difference if a firm does not have good products with the capability to satisfy customers.

This philosophy is affirmed by Alex Algard, the founder of WhitePages.com. WhitePages.com started in 1997 to provide consumers a free, accurate, and fast online alternative to telephone directory assistance. It is one of the most trusted and comprehensive sources for consumers to quickly find relevant, accurate contact information in North America. When asked how he was able to grow WhitePages.com from a one-person operation in 1997 to the multimillion-dollar company it is today, Algard's reply reflected not only his feelings about the importance of providing value to both users and customers but also how a company measures if the value is being successfully delivered:

> The philosophy that we as a company have always stuck to is that everything we build has to provide real value to both our users and customers. The best measurement of whether or not we are successful at delivering something valuable is if our customers, advertisers in our case, are willing to pay.[24]

A product/customer focus also involves the diligence to spot product opportunities and to see them through to completion. The idea for the Apple Macintosh, for example, originated in the early 1980s when Steven Jobs and several other Apple employees took a tour of a Xerox research facility. They were astounded to see computers that displayed graphical icons and pull-down menus. The computers also allowed users to navigate desktops using a small, wheeled device called a mouse. Jobs decided to use these innovations to create the Macintosh, the first user-friendly computer. Throughout the two and a half years during which the Macintosh team developed this new product, it maintained an intense product/customer focus, creating a high-quality computer that is easy to learn, fun to use, and meets the needs of a wide audience of potential users.[25] Apple's early history, and in particular its commitment to building high-quality products, has been portrayed in several movies, including *Pirates of the Silicon Valley* (2005) and *JOBS* (2013).

Additional examples of product/market focus are provided in an excellent weekly podcast produced by National Public Radio (NPR) called "How I Built This." Each episode provides an in-depth interview with the founder of a well-known firm, and provides a complete overview of how the firm was built and won customers. Guests have included Joe Gebbie, the cofounder of Airbnb; Angie Hicks, the founder of Angie's List; Jane Wurwand, the founder of Dermalogica; and Yvon Chouinard, the founder of Patagonia.[26]

WHAT WENT WRONG?

Prim: How a Lack of Passion and Resolve Can Kill a Business

Prim's idea was to disrupt the laundry industry. A growing number of people in the United States are using laundry services to wash and fold their clothes. The problem with these services is that they are a hassle. In most instances customers have to bag their laundry, drop the bag or bags off at the laundry service, and then pick them up later. Many services have lines at the busiest times of the day, which result in drivers having to wait to drop off or pick up their laundry.

Prim launched in mid-2013, after passing through the prestigious Y Combinator business accelerator program earlier that year. Here's how Prim's laundry service worked. A customer bagged her/his laundry, and then went online to choose a pickup and delivery time. The price was $25 for the first bag and $15 for each additional bag. The bags would be picked up by a driver recruited by a third-party delivery service. (Rickshaw was the name of the delivery service in the city where Prim started.) Everything would be back, washed and folded, later that day or early the next day. No cash changed hands between the customer and the pickup or delivery drivers. Everything was paid for through Prim's website. Prim gained favorable press and early momentum. When it closed, it was handling 1,000 pounds of laundry a day from 40 clients and was growing. What went wrong?

Two things went wrong with Prim. First, once Prim got your clothes, it went from an innovative disruptor to an old-school company. It would take your clothes to a laundry service and utilize its wash and fold services. Prim negotiated volume discounts with several laundry services; but, the discounts were verbal, not written. What Prim didn't count on was the partnerships going sour. While the laundry services were initially receptive to working with Prim, they had their own delivery services and eventually saw Prim as siphoning off their customers and revenue. During its short history, Prim churned through three different laundry services.

The second thing that went wrong with Prim was a lack of passion and resolve on the part of its founders. Faced with the reality that working with local laundry services was a fragile business model, Prim's founders, Yin Yin Wu and Xuwen Cao, had a decision to make. Should they build or lease their own laundry service? This was a daunting prospect, given the hundreds of thousands of dollars necessary to build and staff a high-volume laundry wash and fold facility. Even more daunting was the prospect that this step would need to be repeated in each new market Prim entered. After two months of deliberation, Wu and Cao pulled the plug. While they estimated that by constructing their own laundry service they could build a profitable business in 5 to 10 years, with revenues of $10 million to $15 million, it was a direction they simply did not want to pursue. Both were computer science students in college and had no direct experience in the laundry business. In an article published by *CNNMoney*, Garry Tan, a partner with Y Combinator, reflecting on why Wu and Cao closed Prim, said, "They didn't want to actually have to wash the laundry—they wanted to be the connector."

Questions for Critical Thinking

1. Why is passion such a critical part of entrepreneurial success? Prim's founders were apparently passionate about building a company but not passionate about the laundry business specifically. In what ways is this combination problematic?
2. How could Prim's cofounders have better anticipated that laundry services would eventually see Prim as siphoning off their own business and be reluctant to work with them?
3. Rather than employ its own drivers to pick up and deliver laundry for its customers, Prim relied on the use of third-party delivery services. In what ways do you think this approach could have limited Prim's growth in other markets?
4. San Francisco, the city in which Prim launched, has several innovative laundry services. These services include LaundryLocker, where you drop your clothes in a public locker, Sfwash, a delivery service where you pay by the pound, and Sudzee, which requires special lockable bags. Spend some time studying LaundryLocker (https://laundrylocker.com), Sfwash (https://sfwash.com), and Sudzee (https://sudzee.com). Select the service that you think has the most potential and explain the rationale for your selection. Compare the service to Prim's approach.

Sources: J. P. Mangalindan, "Prim: Anatomy of a Folded Startup," *CNNMoney*, available at https://tech.fortune.com/2014/01/22-prim-anatomy-of-a-folded-startup (posted January 22, 2014, accessed March 14, 2014); J. Constine, "Prim Laundry Startup Throws in the Towel," TechCrunch, available at https://techcrunch.com/2014/01/06/prim-laundry-shuts-down (posted January 6, 2014, accessed March 14, 2014).

Tenacity Despite Failure

Because entrepreneurs are typically trying something new, the possibility of failure exists. In addition, the process of developing a new business is somewhat similar to what a scientist experiences in the laboratory. A chemist, for example, typically has to try multiple combinations of chemicals before finding an optimal combination that can accomplish a certain objective. In a similar fashion, developing a new business idea may require a certain degree of experimentation before success is attained. Setbacks and failures inevitably occur during this process. The litmus test for entrepreneurs is their ability to persevere through setbacks and failures.

An example of the degree of tenacity it sometimes takes to launch a successful firm is provided by Jerry Stoppelman and Russel Simmons, the cofounders of Yelp, the popular online review site. The original idea for Yelp, which was founded in 2004, is that when people are looking for a new restaurant, dentist, or plumber they normally ask their friends for recommendations. Yelp was launched to give people the ability to e-mail a list of their friends and ask for a recommendation. The message included a link that allowed the friend to easily respond. The business plan didn't work. People started complaining that they were getting too many e-mail messages from friends who often didn't have a recommendation to provide. Yelp could have died at this point. Instead, Stoppelman and Simmons demonstrated the tenacity it often takes to keep a business alive. Curiously, the one aspect of Yelp's business plan that did work was the ability to write your own review—a feature that had been included by Stoppelman and Simmons almost as an afterthought. Rather than responding to a friend's request for a recommendation, people seemed to enjoy sharing information about their favorite restaurant or hair salon without being asked. In 2005, Yelp pivoted and revised its business plan. The new plan dropped the "e-mail your friend idea" and focused on providing a platform for people to proactively write reviews of local businesses. Today, Yelp is one of the most popular review sites on the Internet.

It's also important that entrepreneurs have sufficient tenacity to overcome personal obstacles along with professional ones. An example is Rick and Melissa Hinnant, the founders of Grace & Lace, a company that makes lacey leg warmers for women. In 2010, the couple experienced a tragedy when they lost an unborn child. While Melissa was in the hospital, she had a vision of crocheting her unborn child a blanket, which kindled in her a desire to sew. In the fall of 2011, she made her first pair of lacy leg warmers, and everywhere she went, people would stop her and ask her where she got them. That experience led to Grace & Lace, which is now a full-blown women's apparel company.[27] In 2013, Grace & Lace appeared on Shark Tank, and received an offer from Barbara Corcoran. Reflecting on the episode, and the tenacity that Rick and Melissa Hinnant exhibited overcoming the loss of a child, Corcoran said:

> The best pitch I heard last season (Season 5), was from Grace & Lace, designers of lacy boot socks and leg warmers. When Melissa and Rick Hinnant burst onto the Shark Tank set, they exuded both the passion and street smarts that I know get all good entrepreneurs to the finish line. When they announced that they had $800,000 in sales in their first year in business, they got the attention of all the sharks. But what got my attention was Melissa and Rick's backstory—a story of extreme resilience in the face of personal failure. The story they told proved that they were great entrepreneurs who knew how to take a hit and keep on ticking.[28]

Execution Intelligence

The ability to fashion a solid idea into a viable business is a key characteristic of successful entrepreneurs. Commonly, this ability is thought of as **execution intelligence**.[29] In many cases, execution intelligence is the factor that determines whether a start-up is successful or fails. An ancient Chinese saying warns, "To open a business is very easy; to keep it open is very difficult."

The ability to effectively execute a business idea means developing a business model, putting together a new venture team, raising money, establishing partnerships, managing finances, leading and motivating employees, and so on. It also demands the ability to translate thought, creativity, and imagination into action and measurable results. As Jeff Bezos, the founder of Amazon.com, once said, "Ideas are easy. It's execution that's hard."[30] For many entrepreneurs, the hardest time is shortly after they launch their firm. This reality was expressed by Jodi Gallaer, the founder of a lingerie company, who said, "The most challenging part of my job is doing everything for the first time."[31]

To illustrate solid execution, let's look at The Bouqs Company, an online flower delivery service, which is the subject of Case 11.1 later in the book. The Bouqs was cofounded in 2012 by Jason Tabis and J. P. Montufar, largely out of their frustration with the state of the online cut-to-order flower delivery industry. At that time, about 90 percent of the flowers sold in the United States came from either Colombia or Ecuador, and passed through multiple layers of distributors and wholesalers before they reached the end consumer. In addition, most orders that were placed online were fulfilled by a local florist, who may or may not have the exact flowers the customer ordered. Tabis and Montufar took on the industry, primarily by creating an advantage via execution intelligence. Rather than utilizing conventional distribution channels, they established direct relationships with flower growers in Columbia, Ecuador, Chile, and across the United States and Canada. Flowers ordered via The Bouqs website were cut the day they were ordered and were shipped directly from the farm, allowing the flowers to reach the customer in 2–4 days rather than 10–14. This shortened timeframe resulted in providing customers flowers that were fresher and more attractive than competing offerings. Other aspects of ordering flowers online were improved. The selection available was carefully curated, so as to not overwhelm the customer, and only flowers that were available were displayed. Pricing was transparent, with all selections priced at $40 which included the product and shipping, with no hidden fees. In addition, The Bouqs only sourced flowers from farms that practiced sustainable, eco-friendly farming.[32] The result: The Bouqs is a thriving cut-to-order online flower delivery firm, with both consumer and corporate clients. It has raised over $19 million in funding since 2012.[33]

One way early-stage companies learn execution intelligence is by participating in start-up incubator and accelerator programs. In each chapter, we provide a "Savvy Entrepreneurial Firm" feature that presents you with an example of a tool or technique that well-managed entrepreneurial firms use to improve their performance. In the nearby "Savvy Entrepreneurial Firm" feature, we discuss the benefits of participating in a start-up incubator or accelerator program.

Common Myths About Entrepreneurs

LEARNING OBJECTIVE

4. Explain the five common myths regarding entrepreneurship.

There are many misconceptions about who entrepreneurs are and what motivates them to launch firms to develop their ideas. Some misconceptions develop because of the media covering atypical entrepreneurs, such as a couple of college students who obtain venture capital to fund a small business that they grow into a multimillion-dollar company. Such articles rarely state that these entrepreneurs are the exception rather than the norm and that their success is a result of carefully executing an appropriate plan to commercialize what inherently is a solid business idea. Indeed, the success of many of the entrepreneurs we study in each chapter's "Opening Profile" is a result of carefully executing the different aspects of the entrepreneurial process. Let's look at the most common myths and the realities about entrepreneurs.

SAVVY ENTREPRENEURIAL FIRM

Start-Up Incubators and Accelerators: A Smart Way of Gaining Access to Mentors, Partners, Investors, and Other Critical Start-up Resources

The number of start-up incubator and accelerator programs in the Unites States continues to grow. Incubators are organizations that provide start-ups with shared operating space. They are sponsored by universities, city or county governments, or nonprofit organizations. Incubators also provide start-up businesses access to networking opportunities, mentors, and shared equipment. Incubators typically do not ask for equity from their participants and do not provide seed funding. They were very popular in the 1980s and remain an important part of the entrepreneurial ecosystem in many areas.

Accelerators are a newer concept. They are mostly for-profit organizations that offer a small amount of seed funding in exchange for small equity positions in the companies that participate in their programs. Most accelerator programs admit start-ups in cohorts, and put the start-ups through a 10- to 15-week intensive program. The accelerator typically offers free office space, perks such as free WiFi and web hosting, weekly meetings with mentors, and coaching on how to put together an effective investor pitch. The programs normally cumulate with a "Demo Day" which provides the participants the opportunity to pitch their business ideas to a group of investors, mentors, and reporters. The better programs will have 200+ investors present at their Demo Days. The greatest advantage of getting into either an incubator or accelerator program is the mentorship opportunities they provide. They are also fertile places for entrepreneurs to meet potential cofounders, business partners, and investors.

The two most well-known accelerator programs are Y Combinator and TechStars. Y Combinator is located in the Silicon Valley. It provides $120,000 in funding for 7 percent equity in each start-up it admits. Its participants are admitted in two, three-month sessions per year. It doesn't offer office space. Instead, its program includes "office hours" where its start-up founders meet individually and in groups with Y Combinator partners for advice. Founders also participate in weekly dinners where top-flight guests from the Silicon Valley ecosystem speak to the founders. Y Combinator's motto is "Make Something People Want." TechStars is similar to Y Combinator in that it is a three month program. It provides $18,000 in funding for a 6 percent equity stake. Started in Boulder, CO, it has expanded and now has 26 programs that are organized around cities and themes. TechStars has offices in Atlanta, Chicago, Boulder, New York City, London, Seattle, and several other cities. Examples of the themes on which it focuses include Alexa (voice-powered technology), Internet of Things, music, and retail.

While admission to Y Combinator and TechStars is very competitive, there are a growing number of start-up incubators and accelerators in American cities. Most are accessible to hard-working start-up founders with promising business ideas. Many focus on a particular industry or sector, such as food, medical devices, software, mobile, or technology. To illustrate how prevalent start-up incubators and accelerators have become, the following is a list of start-up incubators and accelerators in five American cities. You can identify the start-up incubators or accelerators in your area by speaking to local entrepreneurs or investors or by conducting a simple Google search.

Capital Innovators is a start-up accelerator located in St. Louis. It provides tech start-ups $50,000 in seed funding, office space, access to weekly networking events, and follow-on funding opportunities.

Excelerator Labs is an intensive summer accelerator in Chicago. It selects 10 companies every spring to participate in a 13-week intensive summer program. The program is unique in that it attracts mentors from across the country who work with the participants on a one-on-one basis.

Capital Factory is an Austin, TX start-up incubator/accelerator and coworking space. It also hosts meet-ups and other events for aspiring entrepreneurs. Its accelerator program offers mentorship opportunities and connects its entrepreneurs with investors. In 2015, more than 50,000 entrepreneurs, programs, and designers were involved in Capital Factory programs and events.

EnterpriseWorks is part of the University of Illinois' Research Park. It's a start-up incubator that hosts early-stage tech firms that are commercializing research emerging from the university's labs. It is a hub of activities and its clients include start-ups focused on fields such as chemical sciences, biotechnology, software development, and material sciences.

Food-X is a New York City-based business accelerator that is focused on launching food-related businesses. Its three-month program provides up to $50,000 in seed funding, coworking space with other food entrepreneurs, and access to a world-class network of food companies, investors, and press. Each week, participants meet with 3–5 expert mentors to test, validate, and accelerate their food ventures.

Questions for Critical Thinking

1. If you were starting a new venture, do you think you would benefit from participating in a business incubator or accelerator program? If so, what do you think the primary benefits would be?
2. Find an example of a start-up incubator or accelerator program at the college or university you are attending, in the town in which you live, or in a nearby city. Describe the program. Which one of the programs mentioned in this feature does it resemble the most?
3. If you have a promising business idea, what can you do while you're in college to improve your chances of being admitted to a prestigious start-up incubator or accelerator program when you graduate?
4. Make a list of the types of mentors that a participant in a start-up incubator or accelerator program might encounter.

Myth 1: Entrepreneurs Are Born, Not Made

This myth is based on the mistaken belief that some people are genetically predisposed to be entrepreneurs. The consensus of many hundreds of studies on the psychological and sociological makeup of entrepreneurs is that entrepreneurs are not genetically different from other people. This evidence can be interpreted as meaning that no one is "born" to be an entrepreneur and that everyone has the potential to become one. Whether someone does or doesn't is a function of environment, life experiences, and personal choices.[34] However, there are personality traits and characteristics that are commonly associated with entrepreneurs; we list these in Table 1.3. These traits are developed over time and evolve from an individual's social context. For example, studies show that people with self-employed parents are more likely to become entrepreneurs.[35] After witnessing a father's or mother's independence in the workplace, an individual is more likely to find independence appealing.[36] Similarly, people who personally know an entrepreneur are more than twice as likely to be involved in starting a new firm as those with no entrepreneur acquaintances or role models.[37] The positive impact of knowing an entrepreneur is explained by the fact that direct observation of other entrepreneurs reduces the ambiguity and uncertainty associated with the entrepreneurial process.

Myth 2: Entrepreneurs Are Gamblers

A second myth about entrepreneurs is that they are gamblers and take big risks. The truth is, entrepreneurs are usually **moderate risk takers**, as are most people.[38] This finding is affirmed by The Hartford's 2015 Small Business Success Study in which a total of 79 percent of the participants rated themselves as conservative rather than risky.[39] The idea that entrepreneurs are gamblers originates from two sources. First, entrepreneurs typically have jobs that are less structured, and so they face a more uncertain set of possibilities than managers or rank-and-file employees.[40] For example, an entrepreneur who starts a social network consulting service has a less stable job than one working for a state governmental agency. Second, many entrepreneurs have a strong need to achieve and often set challenging goals, a behavior that is sometimes equated with risk taking.

TABLE 1.3 Common Traits and Characteristics of Entrepreneurs

A moderate risk taker	Optimistic disposition
Persuasive	A networker
Promoter	Achievement motivated
Resource assembler/leverager	Alert to opportunities
Creative	Self-confident
Self-starter	Decisive
Tenacious	Energetic
Tolerant of ambiguity	A strong work ethic
Visionary	Lengthy attention span

Myth 3: Entrepreneurs Are Motivated Primarily by Money

It is naïve to think that entrepreneurs don't seek financial rewards. As discussed previously, however, money is rarely the primary reason entrepreneurs start new firms and persevere. The importance and role of money in a start-up is put in perspective by Colin Angle, the founder and CEO of iRobot, the maker of the popular Roomba robotic vacuum cleaner. Commenting on his company's mission statement, Angle said:

> Our, "Build Cool Stuff, Deliver Great Products, Have Fun, Make Money, Change the World" (mission statement) kept us (in the early days of the Company) unified with a common purpose while gut-wrenching change surrounded us. It reminded us that our goal was to have fun and make money. Most importantly, it reminded us that our mission was not only to make money, but to change the world in the process.[41]

Some entrepreneurs warn that the pursuit of money can be distracting. Media mogul Ted Turner said, "If you think money is a real big deal . . . you'll be too scared of losing it to get it."[42] Similarly, Sam Walton, commenting on all the media attention that surrounded him after he was named the richest man in America by *Forbes* magazine in 1985, said:

> Here's the thing: money never has meant that much to me, not even in the sense of keeping score . . . . We're not ashamed of having money, but I just don't believe a big showy lifestyle is appropriate for anywhere, least of all here in Bentonville where folks work hard for their money. We all know that everyone puts on their trousers one leg at a time . . . . I still can't believe it was news that I get my hair cut at the barbershop. Where else would I get it cut? Why do I drive a pickup truck? What am I supposed to haul my dogs around in, a Rolls-Royce?[43]

Myth 4: Entrepreneurs Should Be Young and Energetic

Entrepreneurial activity is fairly evenly spread out over age ranges. The recent age distribution of business owners, as reported in the Kauffman Index of Startup Activity, is shown in Table 1.4. As you see, the percentage of owners is quite evenly distributed across 4 major age categories. Not suprisingly, given this age distribution, the majoity of business owners have work experience prior to launching a new venture. Although it is important to be energetic, investors often cite the strength of the entrepreneur (or team of entrepreneurs) as their most important criterion in the decision to fund new ventures.[44] In fact, a

TABLE 1.4 Age Distribution of Business Owners

Age	Percentage of Business Owners
20–34	24.7
35–44	22.9
45–54	26.6
55–64	25.8

Source: R. W. Fairlie, A. Morelix, E. J. Reedy, and J. Russell, *2015 The Kauffman Index of Startup Activity: National Trends*, available at Kauffman_index-startup_activity_national_trends_2015-1.pdf.

sentiment that venture capitalists often express is that they would rather fund a strong entrepreneur with a mediocre business idea than fund a strong business idea and a mediocre entrepreneur. What makes an entrepreneur "strong" in the eyes of an investor is experience in the area of the proposed business, skills and abilities that will help the business, a solid reputation, a track record of success, and passion about the business idea. The first four of these five qualities favor older rather than younger entrepreneurs.

Myth 5: Entrepreneurs Love the Spotlight

Indeed, some entrepreneurs are flamboyant; however, the vast majority of them do not attract public attention. In fact, many entrepreneurs, because they are working on proprietary products or services, avoid public notice. Consider that entrepreneurs are the source of the launch of many of the 3,100 companies listed on the NASDAQ, and many of these entrepreneurs are still actively involved with their firms. But how many of these entrepreneurs can you name? Perhaps three or four? Most of us could come up with Jeff Bezos of Amazon.com, Mark Zuckerberg of Facebook, and maybe Larry Page and Sergey Brin of Google or Elon Musk of Tesla and SpaceX. Whether or not they sought attention, these are the entrepreneurs who are often in the news. But few of us could name the founders of Netflix, YouTube, or DIRECTV, even though we frequently use these firms' services. These entrepreneurs, like most, have either avoided attention or been passed over by the popular press. They defy the myth that entrepreneurs, more so than other groups in our society, love the spotlight.

Types of Start-Up Firms

LEARNING OBJECTIVE

5. Describe the three types of start-up firms.

As shown in Figure 1.2, there are three types of start-up firms: salary-substitute firms, lifestyle firms, and entrepreneurial firms.

Salary-substitute firms are small firms that yield a level of income for their owner or owners that is similar to what they would earn when working for an employer. Dry cleaners, convenience stores, restaurants, accounting firms, retail stores, and hairstyling salons are examples of salary-substitute firms. The vast majority of small businesses fit into this category. Salary-substitute firms offer common, easily available and not particularly innovative products or services to customers.

Lifestyle firms provide their owner or owners the opportunity to pursue a particular lifestyle and earn a living while doing so. Lifestyle firms include personal trainers, golf and tennis pros, owners of bed & breakfasts, and tour guides. These firms are not innovative, nor do they grow quickly. Commonly, lifestyle companies promote a particular sport, hobby, or pastime and may employ only the owner or just a handful of people.

Entrepreneurial firms bring new products and services to market. As we noted earlier, the essence of entrepreneurship is creating value and then disseminating that value to customers. In this context, **value** refers to worth, importance,

FIGURE 1.2
Types of Start-Up Firms

PARTNERING FOR SUCCESS

Partnering with College Students via Campus Ambassador and Campus Rep Programs

A novel way that start-ups spread the word about their businesses is to create "campus ambassador" or "campus rep" programs. Most campus ambassador and campus rep programs fall somewhere between an internship and a job. The programs vary. Some recruit students to promote their brand on campus through an assortment of events, programs, and social media. Others ask students to create content, such as YouTube videos, articles for a company's main website, and Instagram photos of the company's products being used on their campus. Students often find these programs to be a great way to build their résumés, get work experience, earn a little extra money, and get their foot in the door of an exciting company. Companies that run campus ambassador or campus rep programs are typically looking for students who (1) have upbeat personalities, (2) are effective communicators, (3) have in-depth knowledge and a love for the product, (4) have effective marketing skills, and (5) have the ability to provide insightful feedback and advice. Here are examples of three campus ambassador or campus rep programs and how they work.

Apple. Apple Campus Reps work directly with the company's campus reps' team to tailor an approach for evangelizing Apple products on their local campus. Activities include planning and conducting workshops on Apple products, creating and distributing flyers and other promotional materials, and running competitions and events that highlight creative uses of Apple software and hardware. Apple Campus Reps make roughly \$10 to \$11 an hour, and work up to 15 hours per week. You can apply for the Apple Campus Reps program online at www.apple.com/education/campusreps.

Flex Watches: Flex Watches are colorful and flexible sport watches. The watches come in a variety of colors, and each color represents a different social or charitable cause. Ten percent of the purchase price of each watch is donated to its corresponding cause. The company's campus rep program looks for energetic and socially minded students who want to represent Flex Watches on their campus. Campus reps are charged with promoting the company's products and charity partnerships to students, and earn cash and Flex Watches products for their efforts. Campus reps must be active users of both Facebook and Instagram. Applications are available at https://flexwatches.com/campusreps.

Her Campus Media: Her Campus Media is the number one online community for college women. College females are recruited to setup Her Campus Chapters on their local campus. The local chapters sign up campus correspondents, who create, edit, and upload content to their chapter's website. The content focuses on six categories of interest to college females: style, beauty, health, love, life, and career. Local correspondents work with the company's national team to organize Her Campus events on their campus. Her Campus targets college females who are interested in journalism, public relations, marketing, or entrepreneurship. Information about starting a Her Campus Chapter is available at www.hercampus.com/start-your-own-my-campus-chapter.

Other companies that run well-regarded campus ambassador or campus rep programs include Chipotle, Victoria's Secret, CBS Sports, Adobe, Amazon, Rent the Runway, Prezi, and Monster Energy Drink.

Questions for Critical Thinking

1. As part of your college experience, do you think you would benefit from participating in a campus ambassador or campus rep program? Why or why not?
2. In what ways would participating in a campus ambassador or campus rep program help you prepare to own your own business someday?
3. Why do you think companies such as Apple, Flex Watches, and Her Campus Media sponsor campus ambassador or campus rep programs? How do the companies benefit?
4. What types of start-ups would benefit the most from starting campus ambassador programs?

or utility. Entrepreneurial firms bring new products and services to market by creating and then seizing opportunities. Dropbox, Facebook, and Uber are well-known, highly successful examples of entrepreneurial firms. Having recognized an opportunity, the entrepreneurs leading companies of this type create products and services that have worth, are important to their customers, and provide a measure of usefulness to their customers that they wouldn't have otherwise.

One characteristic of entrepreneurial firms, which we explore throughout this book, is that they partner with other firms and organizations, often to obtain the boost they need to realize their full potential. In each chapter, look for the boxed feature titled "Partnering for Success," which illustrates how entrepreneurial firms use partnerships to increase their chances for success. The feature in the first chapter of your book discusses how some firms partner with college students via campus ambassador and campus rep programs to spread the word about their business.

Next, we describe the newly emerging characteristics of today's entrepreneurs. You may be surprised to learn about the types of individuals who are choosing to become entrepreneurs! While studying these characteristics, think about people you know who are accurately described by these characteristics. Do you think any of these people will choose to become entrepreneurs?

Changing Demographics of Entrepreneurs

LEARNING OBJECTIVE

6. Discuss the changing demographics of entrepreneurs in the United States.

Over the past 10 years, the demographic makeup of entrepreneurial firms has changed around the world. According to the European Commission's *Annual Report on European SMEs 2018/2019*, there were more than 25 million small and medium-sized enterprises (SMEs) in the European Union. Between 2018 and 2019, there were 200,000 startups in the United Kingdom, adding to a total of 5.9 million businesses in 2019. Around 38 percent of UK SME owners are under the age of 35. A study of 1,500 small businesses in the United Kingdom found that, compared to Generation X, who generally set up their business at the age of 35, millennials have started their business at the age of 22 on average.[45] However, there are many factors that influence the average start-up age of entrepreneurs in the United Kingdom and around the world.

Women Entrepreneurs

While men are still more likely to start businesses than women, the number of women-owned businesses is increasing globally. Based on data from All Raise, there were 4,399 female-founded startups in 2019 around the world, which is an unprecedented number.[46] A study by Mastercard in 2019 titled *Mastercard Index of Women Entrepreneurs* showed positive trends in women's business ownership. The top-performing countries in the study, which focused on 58 markets, were the United States, New Zealand, and Canada, with a large number of women-owned businesses encouraged by conducive and enabling entrepreneurial environments. The United States showed an increase from 64.1 percent in 2018 to 76.8 percent in 2019 in what the study called "women entrepreneurial activity rate (F/M)."

The Mastercard study confirmed that women's entrepreneurial activity is higher in an opportunity-driven environment where higher income, developed economies, and active markets encourage the setting up of businesses. In such markets, which also include Australia, Ireland, Switzerland, and Singapore,

Gino Santa Maria/Shutterstock

These are the faces of the entrepreneurs of the future. Collectively they will include more women and will be more ethnically diverse than at any time in the past.

women can enter business markets with greater ease, as resources like capital, financial services, training, education, and support programs are more accessible. However, based on other findings, the report suggests that it is not always necessary that higher wealth and the advancement of an economy increases women's entrepreneurial activity. Countries like Uganda, Ghana, and Botswana, which have less conducive business environments, rank in the top three economies for women business ownership rates compared to the more developed ones. The women from such economies are "necessity-driven" entrepreneurs, with a need for survival without access to enabling resources.[47]

In Europe, women constitute 34.4 percent of the European Union's self-employed population and nearly 30 percent of the startups in the region.[48] In countries like Poland, Slovakia, and Hungary, almost a quarter of new businesses are founded by women.[49] According to a study by Startup Genome, the Chinese city of Shanghai had one of the world's largest numbers of female founders in 2019, pushing it to the top five of the global ecosystem for gender diversity.[50] An IE study found a higher representation of women as entrepreneurs in China (25 percent) compared to Europe (18 percent).[51]

While the number of men involved in entrepreneurial activity is higher than women in most countries, the GEM 2019 found higher levels of female entrepreneurial activity in Saudi Arabia, Qatar, and Madagascar. One in every three startups in Arab countries is by a woman, which is a higher percentage than in Silicon Valley. The Middle East is fast becoming a promising place with conducive policies for women-led start-ups.[52]

Minority Entrepreneurs

There has been a substantial increase in minority entrepreneurs around the world. In the United States, the number of businesses in the minority community is growing, with more than 4 million minority-owned companies and sales of nearly $700 billion annually in 2020.[53] Similarly, the number of ethnic minority businesses (EMBs) is growing in the United Kingdom, with a contribution of nearly $33 billion to its economy.[54] However, just like women-owned businesses, there is still a huge gap to be filled by minority businesses in the United Kingdom.

The UK's Diversity and Inclusion Business Council has recommended seven strategies to support women- and minority-owned businesses: encouraging more diversity (women and minorities) in the high value-added sectors, providing local level target support, establishing government-sponsored resource centers for ethnic minority and women-owned businesses, government involvement to ensure satisfactory inclusion in these groups at the central and local levels, involvement of minority groups in decision making and in business networks, prioritizing the needs of the local minority businesses, and involving women and ethnic minorities in the overseas missions of the UK Trade & Investment department of the government.[55]

Senior Entrepreneurs

The number of seniors starting businesses is substantial and growing. According to the European Commission, more and more seniors are becoming entrepreneurs, and they can also be a source of guidance, knowledge, and skills for young aspiring entrepreneurs.[56] Facing an aging population in Europe, the EU and the Organization for Economic Co-operation and Development (OECD) have started several initiatives to encourage senior entrepreneurship by developing a conducive environment and favorable frameworks.[57] Such efforts are also welcomed by seniors, who understand the challenge of starting a new business as a foundation for a new career.

The increase in senior entrepreneurs is attributed to several factors, including corporate downsizing, an increasing desire among older workers for more personal fulfillment in their lives, and growing worries among seniors that they need to earn additional income to pay for future health care services and other expenses. Many people in the 60-and-older age range have substantial business experience, financial resources that they can draw upon, and excellent vigor and health, which make them ideal candidates to start businesses in many industries. In advanced industrialized countries like the United Kingdom, Australia, Japan, and the United States, the steady increase in life expectancy means that people are not only living longer but also healthier and are likely to remain engaged in either a job or an entrepreneurial venture longer in their lives than earlier generations.

Millennial Entrepreneurs

A desire to pursue an entrepreneurial career is high among millennials. The *2016 Global Entrepreneur Survey* by GoDaddy reported that 62 percent of millennials around the world intended to start a business before 2026.[58] According to the *BNP Paribas Global Entrepreneur Report 2016*, which covered 18 countries in Asia, Europe, and the United States, a new generation of entrepreneurs under 35, the “Millennipreneurs,” has emerged. These millennials started their own business at a younger age and on average have launched 8 more companies than the average of 3.5 of their predecessors in both emerging and traditional business sectors.[59] Women millennials have been more successful than men and are most active in Poland, Spain, and China in the sectors of fashion, trade, and professional services. The regions with the most attractive millennial business activity are the United States, China, and Germany.

The GEM 2017–18 report noted that 41 percent of Gen Z want to become entrepreneurs. Growing in times of global financial crunch and widespread debt, this generation is looking at career options that don’t come with huge loans.[60]

According to the 2019 GEM report, in Asia Pacific, small businesses with younger owners have a higher likelihood of growth as compared to the ones with older business owners. These young entrepreneurs are more innovative, create more job opportunities, export more, use social media, and undergo training. Nearly 30 percent of young entrepreneurs aim to launch a new and innovative product or service, and 50 percent intend to achieve growth through e-commerce. The entrepreneurial activity among the 18–34 group shows huge variation, from 2.8 percent in Malaysia to 18.9 percent in Indonesia.

There are many forces at work encouraging millennials in particular to consider entrepreneurship as a career. An increasing number of colleges and universities around the world offer courses, diplomas, and degrees in entrepreneurship. Although the bulk of entrepreneurship education takes place within business schools, many other colleges and departments are offering entrepreneurship courses as well, including engineering, agriculture, law, hospitality management, and nursing. Additionally, programs offered by a number of organizations are encouraging college students to consider becoming entrepreneurs. For example, The Prince’s Trust Enterprise Program offers free business courses, mentoring, and grants to aspiring entrepreneurs in the United Kingdom.[61] In the UAE, the government sponsors The Mohammed bin Rashid Awards for Young Business Leaders, which rewards young Arab entrepreneurs and SMEs for business ideas that contribute to the region’s development.[62]

The Positive Effects of Entrepreneurship and Entrepreneurial Firms

LEARNING OBJECTIVE

7. Discuss the positive effects of entrepreneurship and entrepreneurial firms on economies and societies.

Entrepreneurship’s importance to an economy and the society in which it resides was expertly articulated in 1934 by Joseph Schumpeter, an Austrian economist who did the majority of his work at Harvard University. In his book *The Theory of Economic Development*, Schumpeter argued that entrepreneurs develop new products and technologies that over time make current products and technologies

TABLE 1.5 Organizations that Help College Students Learn More about Entrepreneurship and/or Advance Their Business Ideas

Organization	Description	Website Address
3-Day Startup	Offers a 3-day program that helps students kick-start companies and build entrepreneurial capabilities	http://3daystartup.org
CEO (Collegiate Entrepreneurs' Organization)	Premier entrepreneurship network with chapters on more than 240 college campuses	www.c-e-o.org
CollabFinder	This is a web platform that students across the country are using to team up on start-ups and other projects. A business student, for example, can use the platform to find an engineering student to collaborate on a business idea.	www.collabFinder.com
College Startup	An independent start-up news site dedicated to covering entrepreneurial people, companies, and events emerging from college campuses	www.collegestartup.org
Dorm Room Fund	This is a student-run venture fund that invests in student-initiated start-ups. It is backed by First Round Capital.	http://dormroomfund.com
Entrepreneurs' Organization	A global business network of 9,500+ business owners; runs the annual Global Student Entrepreneur Award program	www.gsea.org
Startup Weekend	Startup weekends are 54-hour events during which developers, marketers, product managers, and start-up enthusiasts come together to share ideas, form teams, build products, and launch start-ups.	http://startupweekend.org
VentureWell	A nonprofit organization that funds and trains faculty and student innovators to create new businesses	www.venturewell.org

obsolete. Schumpeter called this process **creative destruction**. Because new products and technologies are typically better than those they replace and the availability of improved products and technologies increases consumer demand, creative destruction stimulates economic activity. The new products and technologies may also increase the productivity of all elements of a society.[63]

The creative destruction process is initiated most effectively by start-up ventures that improve on what is currently available. Small firms that practice this art are often called "innovators" or "agents of change." The process of creative destruction is not limited to new products and technologies; it can include new pricing strategies (e.g., Warby Parker in eyewear), new distribution channels (such as e-books for books), or new retail formats (such as IKEA in furniture and Whole Foods Market in groceries).

Now let's look more closely at entrepreneurship's importance.

Economic Impact of Entrepreneurial Firms

For two reasons, entrepreneurial behavior has a strong impact on an economy's strength and stability.

Innovation. **Innovation** is the process of creating something new, which is central to the entrepreneurial process.[64] According to the SBA Office of Advocacy, small innovative firms are 16 times more productive than large innovative firms in terms of patents per employee. Small firms tend to be particularly innovative in certain industries, as measured by patent activity. For example, small firms account for more than 32 percent of patents in both smart grids and solar energy and 15 percent of patents in batteries and fuel cells.[65]

Job Creation. According to the European Commission, the backbone of Europe's economy is built on the small and medium-sized enterprise (SME) sector. These firms account for 99 percent of all of the businesses in the European Union. Since 2015, they have created 85 percent of all new jobs and more than 65 percent of the total private sector employment. The European Commission believes that SMEs and entrepreneurship are the main factors that contribute to economic growth, innovation, job creation, and social integration in the region.

A recent Kauffman Foundation study (focusing largely on the United States) affirmed these numbers and provided additional insight. According to the study, it is not the size of a business that matters as much as its age. Companies less than one year old have created an average of 1.5 million jobs per year over the past 30 years. New and young companies also contribute to economic dynamism by injecting competition into markets and spurring innovation.[66]

Entrepreneurial Firms' Impact on Society

Entrepreneurial firms' innovations have a dramatic impact on a society. Think of all the new products and services that make our lives easier, enhance our productivity at work, improve our health, and entertain us. For example, Amgen, an entrepreneurial firm that helped pioneer the biotechnology industry, has produced a number of drugs that have dramatically improved people's lives. An example is NEUPOGEN®, a drug, which decreases the incidence of infection in cancer patients who are undergoing chemotherapy treatment. In addition to improved health care, consider smartphones, social networks, Internet shopping, overnight package delivery, and digital photography. All these products are new to this generation, yet it's hard to imagine our world without them.

However, innovations do create moral and ethical issues with which societies are forced to grapple. For example, bar-code scanner technology and the Internet have made it easier for companies to track the purchasing behavior of their customers, a fact, which raises privacy concerns. Similarly, bioengineering has made it easier to extend the shelf life of many food products, but some researchers and consumers question the long-term health implications of bioengineered foods.

Entrepreneurial Firms' Impact on Larger Firms

In addition to the impact that entrepreneurial firms have on economies and societies, they also positively impact the effectiveness of larger firms. For example, some entrepreneurial firms are original equipment manufacturers, producing parts that go into products that larger firms manufacture and sell. Thus, many exciting new products, such as smartphones, digital cameras, and improved prescription drugs, are not solely the result of the efforts of larger companies with strong brand names, such as Samsung, Apple, and Johnson & Johnson. They were produced with the cutting-edge component parts or research-and-development efforts provided by entrepreneurial firms.

The evidence shows that many entrepreneurial firms have built their entire business models around producing products and services that increase the efficiency and/or effectiveness of larger firms. For example, an increasing number of U.S. firms are competing in foreign markets. These initiatives often require firms to employ translators to help them communicate with their foreign counterparts. Entrepreneurial firms are sometimes founded to respond to larger firms' needs. This is the case with start-up firm SpeakLike, a company that created an online service, which provides real-time translation services for two or more people who speak different languages. The cost of this service is considerably below what it costs to employ human translators. A large percentage of SpeakLike's customers are large firms. Similarly, Box is an entreprenurial startup that allows clients to store data files in the cloud. The majority of *Fortune* 500 companies are now Box subscribers.

The Entrepreneurial Process

LEARNING OBJECTIVE

8. Explain the entrepreneurial process.

The entrepreneurial process we discuss in this book consists of four steps:

Step 1 Decision to become an entrepreneur

Step 2 Developing successful business ideas

Step 3 Moving from an idea to an entrepreneurial firm

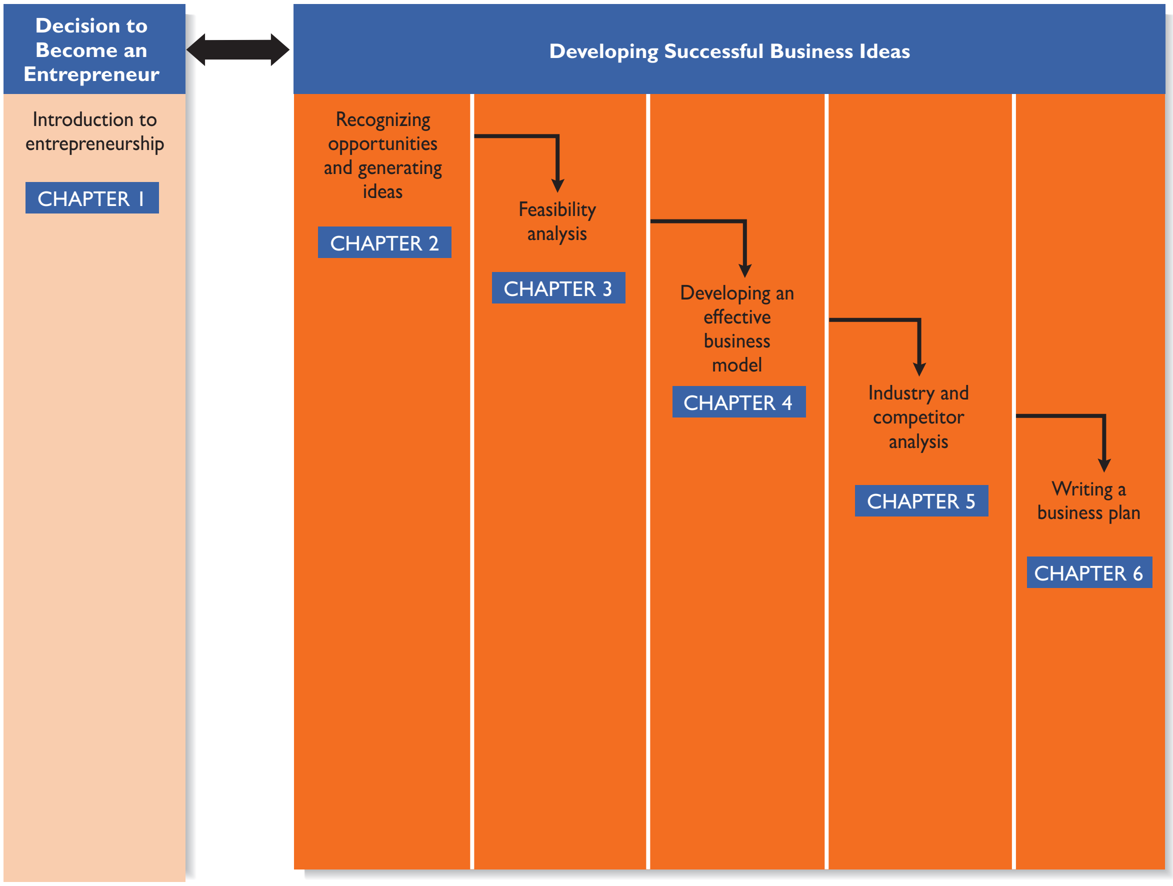
Step 4 Managing and growing an entrepreneurial firm

Figure 1.3 models the entrepreneurial process you'll study while reading this text. This process is the guide or framework around which we develop this book's contents. The double-headed arrow between the decision to become an entrepreneur and the development of successful business ideas indicates that sometimes the opportunity to develop an idea prompts a person to become an entrepreneur. The four major stages of the entrepreneurial process and each stage's component parts (see Figure 1.3) are explained in the following sections.

Decision to Become an Entrepreneur (Chapter 1)

As discussed earlier, people become entrepreneurs to be their own bosses, to pursue their own ideas, and to pursue financial rewards. Usually, a **triggering event** prompts an individual to become an entrepreneur.[67] For example, an individual may lose her job and decide that the time is right to start her own business or a person might receive an inheritance and for the first time in his life have the money to start his own company. Lifestyle issues may also trigger

FIGURE 1.3
Basic Model of the Entrepreneurial Process

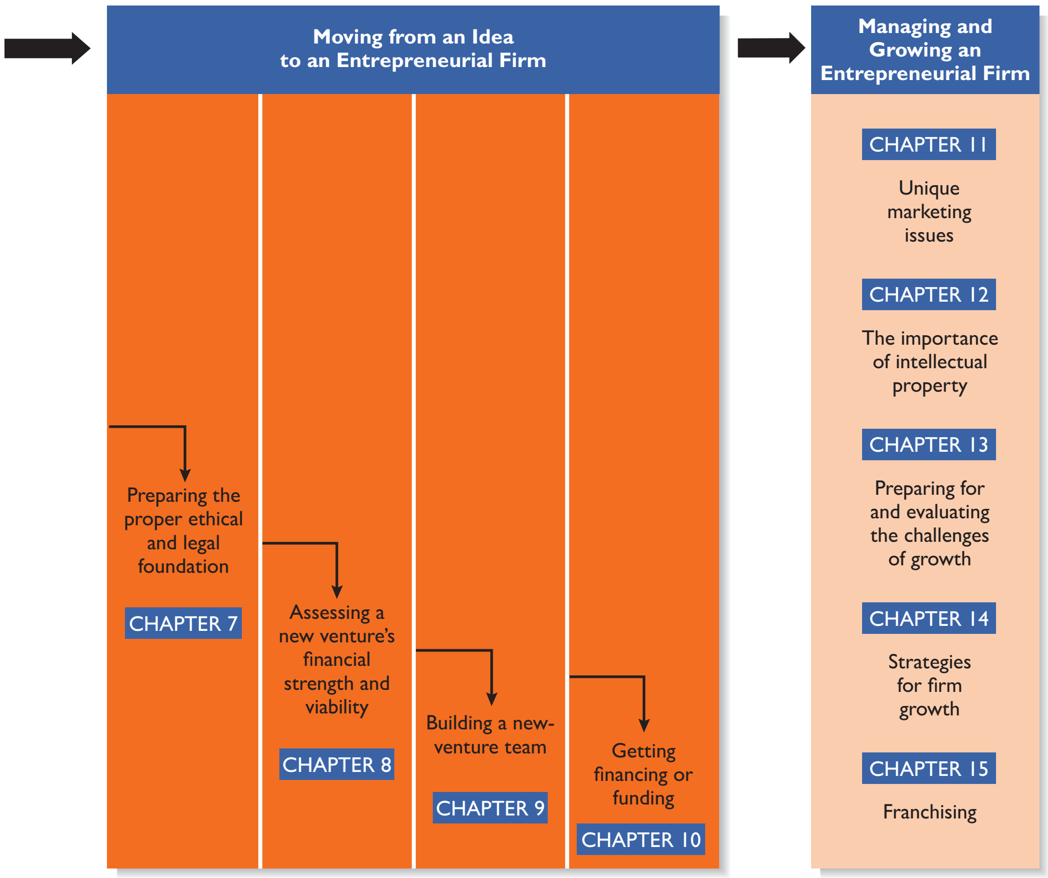


entrepreneurial careers. For example, a woman may wait until her youngest child is in school before she decides to launch her own entrepreneurial venture.

Developing Successful Business Ideas (Chapters 2–6)

Many new businesses fail not because the entrepreneur didn't work hard but because there was no real opportunity to begin with. Developing a successful business idea includes opportunity recognition, feasibility analysis, the development of an effective business model, industry analysis, and writing a business plan.Chapter 2 takes a scientific look at how entrepreneurs recognize opportunities and describes how the opportunity recognition process typically unfolds. Chapter 3 focuses on the feasibility analysis: the way to determine whether an idea represents a viable business opportunity. Chapter 4 focuses on the important topic of developing an effective business model. A firm's **business model** is its plan or recipe for how it creates, delivers, and captures value for its stakeholders. Entrepreneurial firms need to have a crystal clear understanding of the issues concerned with creating, delivering, and capturing value if they are to be successful. Industry and competitor analysis is our concern in Chapter 5. Knowing the industry in which a firm will choose to compete is crucial to an entrepreneur's success. In Chapter 6, we describe how to write a business plan. A **business plan** is a written document that describes all the aspects of a business venture in a concise manner. It is usually necessary to have a written business plan to raise money and attract high-quality business partners. Some entrepreneurs are impatient and don't want to spend the time it takes to write a business plan.[68] This approach is usually a mistake. Writing a business plan

FIGURE 1.3
Continued



forces an entrepreneur to think carefully through all the aspects of a business venture. It also helps a new venture establish a set of milestones that can be used to guide the early phases of the business rollout.

Moving from an Idea to an Entrepreneurial Firm (Chapters 7–10)

The first step in turning an idea into reality is to prepare a proper ethical and legal foundation for a firm, including selecting an appropriate form of business ownership. These issues are discussed in Chapter 7. Chapter 8 deals with the important topic of assessing a new venture's financial strength and viability. Important information is contained in this chapter about completing and analyzing both historical and pro forma financial statements. Chapter 9 focuses on building a new-venture team. Chapter 10 highlights the important task of getting financing or funding and identifies the options a firm has for raising money.

Managing and Growing an Entrepreneurial Firm (Chapters 11–15)

Given today's competitive environment, all firms must be managed and grown properly to ensure their ongoing success. This is the final stage of the entrepreneurial process.

Chapter 11 focuses on the unique marketing issues facing entrepreneurial firms, including selecting an appropriate target market, building a brand, and the four Ps—product, price, promotion, and place (or distribution). Chapter 12 examines the important role of intellectual property in the growth of entrepreneurial firms. More and more, the value of "know-how" exceeds the value of a company's physical assets. In addition, we will talk about protecting business ideas through intellectual property statutes, such as patents, trademarks, copyrights, and trade secrets.

Preparing for and evaluting the challenges of growth is the topic of Chapter 13. We'll look at the characteristics and behaviors of successful growth firms. In Chapter 14, we'll study strategies for growth, ranging from new product development to mergers and acquisitions. We conclude with Chapter 15, which focuses on franchising. Not all franchise organizations are entrepreneurial firms, but franchising is a growing component of the entrepreneurial landscape. When you finish studying these 15 chapters, you will have been exposed to all components of the entrepreneurial process—a process that is vital to entrepreneurial success.

Developing Skills for Your Career

LEARNING OBJECTIVE

9. Learn how understanding entrepreneurship and the entrepreneurial process can facilitate your career success.

In this chapter, we introduced you to the phenomenon known as entrepreneurship and described the entrepreneurial process as a path entrepreneurs can follow to be successful. As readers, some of you may not imagine that you would ever become an entrepreneur, others of you think you may develop an entrepreneurial venture at some time in the future while some of you may find the stories of the entrepreneurs discussed in the 15 chapters' "Opening Profile" features inspirational to the point that you are now contemplating launching an entrepreneurial venture as soon possible. For all three types of readers, this book's contents address some of the "employability skills" that are critical to personal success within organizational settings. Let's see how this is so.

Business Ethics and Social Responsibility. From various sources, including the United Nations and corporate boards of directors, the need for and commitment to ethical business practices continues to strengthen. The same situation exists with respect to social responsibility in that increasingly, societies across the globe want organizations to be responsible for the effects of their actions on stakeholders. The importance of a strong ethical culture to an entrepreneurial firm's performance is fully discussed in Chapter 7. The materials you'll read in this chapter explain how to go about establishing a culture that is ethical and that generates ethical behaviors from employees on both a short- and long-term basis. These are insights that you can apply in any for-profit or not-for-profit organization in which you might choose to work as well as to entrepreneurial ventures.

Critical Thinking. As explained in Chapter 2, being able to think critically is linked to studying potential opportunities to determine if any of the identified opportunities are the foundation for a viable business venture. Identifying opportunities is inherently a goal-directed process through which opportunities are specified that have the potential to help a person or an organization reach a valued outcome. Sometimes, however, that valued outcome is not reached. To address this matter, we include a feature in each chapter called "What Went Wrong?" This feature is used to describe ineffective actions entrepreneurs took in the pursuit of entrepreneurial success. At the close of each feature is a set of questions that will challenge you to think critically about what the entrepreneur could have done to avoid the mistakes that were made.

Collaboration. A feature titled "Partnering for Success" appears in each chapter as well. In this feature, we describe how entrepreneurs collaborate with other people and organizations to reach some of their objectives. In each instance, you'll see that through partnerships, people sometimes are able to accomplish more by working together than they are by working independently.

Data Literacy. Learning how to access and interpret data is considered throughout your book particularly in Chapter 5. By studying this chapter, you will learn how firms gather data about competitors and then how they use those data to identify actions to take to outperform them.

Chapter Summary

LO1. Entrepreneurship is the process by which individuals pursue opportunities without regard to resources they currently control. A specific application of entrepreneurship, called corporate entrepreneurship, is the conceptualization of entrepreneurship at the organizational level. Entrepreneurial firms are proactive, innovative, and risk taking. In contrast, conservative firms take a more "wait and see" posture, are less innovative, and are risk averse.

LO2. The three primary reasons people decide to become entrepreneurs and start their own firms are as follows: to be their own boss, to pursue their own ideas, and to pursue financial rewards. Of these, the desire to be one's own boss or manager is the driving force of most individuals' decision to become an entrepreneur. While important, the desire to reap financial rewards from one's entrepreneurial endeavors is secondary to the other two reasons people decide to launch their own firm.

LO3. Passion for the business, product/customer focus, tenacity despite failure, and execution intelligence are the four primary characteristics of successful entrepreneurs. Of these four, being passionate about the firm the entrepreneur intends to launch is the most common characteristic shared among successful entrepreneurs. Commonly, the entrepreneur's passion is demonstrated by a belief that her/his firm will make a difference in people's lives. Always concentrating on the product or service as a means of satisfying a customer need, being tenancious in pursuing an entrepreneurial opportunity, and the ability to craft a business idea into a viable business operation are the other key characteristics associated with successful entrepreneurs.

LO4. The five most common myths regarding entrepreneurship are that entrepreneurs are born, not made; that entrepreneurs are gamblers; that entrepreneurs are motivated primarily by money; that entrepreneurs should be young and energetic; and that entrepreneurs love the spotlight. The issue with myths is that, if unchecked, they can affect an individual's orientation toward and subsequent behaviors as an entrepreneur. The challenge for entrepreneurs is to carefully examine myths and prevent each of them from negatively affecting their approach to entrepreneurship.

LO5. There are three types of start-up firms. Entrepreneurial firms bring new products and services to market by recognizing and seizing opportunities regardless of the resources they currently control. Entrepreneurial firms stress innovation, which is not the case for salary-substitute and lifestyle firms. In the case of a salary-substitue firm, the entrepreneur seeks to earn an amount of income that is similar or identical to what she or he can earn by working as an employee for another company. Lifestyle firms are ones through which an entrepreneur can pursue a desire to experience a certain lifestyle (e.g., as a hunting trip guide) and earn a sufficient amount of income while doing so.

LO6. The demographic makeup of those launching entrepreneurial firms is changing in the United States and around the world. There is growing evidence that an increasing number of women, minorities, seniors, and millennials are becoming actively involved in the entrepreneurial process. Evidence suggests that these groups are capable of appropriately using the entrepreneurial process as a foundation for developing a successful entrepreneurial venture.

LO7. There is strong evidence that entrepreneurship and the entrepreneurial behavior associated with it have significantly positive impacts on the stability and strength of economies throughout the world. The areas in which entrepreneurial firms contribute the most are innovation and job creation. Entrepreneurial behavior also has a dramatic impact on society. It's easy to think of new products and services that have helped make our lives easier, that have made us more productive at work, that have improved our health, and that have entertained us in new ways. In addition, entrepreneurial firms have a positive impact on the effectiveness of larger firms. There are many entrepreneurial firms that have built their entire business models around producing products and services that help larger firms increase their efficiency and effectiveness.

LO8. The four distinct elements of the entrepreneurial process, shown in Figure 1.3, are deciding to become an entrepreneur, developing successful business ideas, moving from an idea to establishing an entrepreneurial firm, and managing and growing an entrepreneurial firm. Each of these elements plays a critical role in entrepreneurial success. As a result, we carefully examine these elements in the book's remaining chapters.

LO9. After studying this book, some readers will decide they do not want to become entrepreneurs, others will conclude that becoming an entrepreneur at some point is desirable, while still others will decide to launch an entrepreneurial venture as quickly as possible. For all readers though, the tools, techniques, and concepts discussed in this book will further develop some of your "employability skills." In particular, by studying entrepreneurship, you will learn about the importance of using ethical business practices in entrepreneurial firms while simultaneously making certain that those firms commit to being socially responsible in all of their actions. Making these outcomes possible is a strong organizational culture, which you will better understand after reading this book. By contemplating how to use the entrepreneurial tools, techniques, and concepts featured in this book, you will enhance your critical thinking skills and the importance of collaborating with other firms in the pursuit of an entrepreneurial firm's desired objectives such as serving customers and societies and earning positive returns on your investments while doing so.

Key Terms

business model, **53**
business plan, **53**
corporate entrepreneurship, **33**
creative destruction, **50**
entrepreneurial firms, **45**
entrepreneurial intensity, **33**
entrepreneurship, **32**
execution intelligence, **40**
innovation, **50**
lifestyle firms, **45**
moderate risk takers, **43**
passion for their business, **36**
product/customer focus, **38**
salary-substitute firms, **45**
triggering event, **52**
value, **45**

MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

1-1. What are the characteristics of firms with higher entrepreneurial intensity? How can they be achieved?

1-2. What key insights does the GEM study provide us about entrepreneurship?

1-3. What does evidence show us about the rate of failure associated with entrepreneurial ventures?

1-4. What is entrepreneurship?

1-5. In what ways is an entrepreneur who just launched a restaurant different from someone who just took a job as the general manager of a restaurant owned by a major restaurant chain?

1-6. What are the three main attributes of firms that pursue high levels of corporate entrepreneurship?

1-7. How are the reasons for becoming an entrepreneur usually ranked?

1-8. How might an entrepreneur transition from a traditional job to owning their own business over time?

1-9. Why is passion such an important characteristic of successful entrepreneurs?

1-10. What is it about passion that makes it particularly compatible with the entrepreneurial process?

1-11. What are the skills and abilities required to effectively execute a business idea?

1-12. What are the startup types available to someone looking to start their own business?

1-13. What are the five common myths of entrepreneurship?

1-14. To what extent are entrepreneurs motivated by money?

1-15. What are the four distinctive parts of the entrepreneurial process and what is the relationship among the parts?

✪ 1-16. Do you agree with the notion that entrepreneurs are born and not made?

1-17. How do entrepreneurial firms have a positive impact on larger firms?

✪ 1-18. What did Joseph Schumpeter mean by the term *creative destruction*?

1-19. In general, what effects does entrepreneurship have on economies and societies throughout the world?

1-20. What are the changes to the demographic makeup of entrepreneurs in the United States that are described in this chapter?

Application Questions

1-21. After rereading the opening case, identify all of the effective and smart moves made by Fraser Doherty in the early days of SuperJam.

1-22. Assume that you are the dean of a business school and that you are interested in more entrepreneurship courses being offered in your school. Surprisingly to you, some professors are resisting the idea of offering these courses on the basis of their view that entrepreneurship is a skill that can only be learned through experience. Using materials in this chapter, make an argument that entrepreneurship can be taught.

1-23. As a business lecturer, Peter asked students in his class to form groups and present a few business ideas that they plan to pursue after their graduation. One particular group caught his attention with their idea of developing an ecotourism center in their neighborhood, which seems realistic and achievable. There might be a good opportunity for them to take this to the next level. However, when Peter spoke to them, it became clear that they had many misconceptions about entrepreneurship and were afraid to pursue it as a career. How can Peter ease their fears and convince them to fulfil their potential?

1-24. One question that is often asked by people thinking about launching an entrepreneurial venture is "what should first-time entrepreneurs know before they launch?" Based on information featured in this chapter, what should entrepreneurs know before they commit to launching their firm?

1-25. A friend has come up to you for advice. She has been contemplating starting a new venture for some time now, and after 15 years of being employed in the corporate sector, she has finally decided to pursue her dream of starting a wellness center with a focus on healthy living. However, she is still a little hesitant and is hoping to learn more about the positive effects of entrepreneurship. Help her decide why she should undertake this process.

1-26. A group of new students in your entrepreneurship class was heard arguing that being an entrepreneur positively affects the entrepreneur in question only. They do not believe that an entrepreneur somehow benefits the society and the nation as well. They do not believe that creative destruction stimulates economic activity and increases the productivity of all elements of a society. Explain to them the positive effects of entrepreneurship and entrepreneurial firms on economies and societies.

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Business Idea: Create a shipping service that picks up, packages, and ships items for individuals and businesses via the most affordable option available.

Pitch: Who likes shipping? You must rustle up a box, pack the item you'd like to ship, drive to the post office or UPS, wait in line, and pay whatever price they ring up. If you're a business that ships products to customers, it's even worse. For many online sellers, shipping is one of their largest cost categories and biggest headaches. Given the continuing increases in online sales, shipping problems for businesses will no doubt become even more serious.

No more. Shyp has developed a shipping service that takes all the hassle out of shipping. Here's how it works. A customer accesses a mobile app, where he or she enters a package's pick-up and destination addresses, and uploads a photo of the package to be shipped. In 20 minutes or less—that's the goal—a courier arrives and whisks the item away. True to the company's tagline—"We'll take it from here"—Shyp then places the item in a box, prepares a label, and ships it in the most affordable manner, which could be USPS, UPS, FedEx, or a local carrier. Shyp does all this for $5 plus the price of shipping. Unlike Uber and Lyft, all of Shyp's employees are just that—employees, rather than independent contractors, and receive benefits such as health insurance. By bypassing the independent contractor option, Shyp has built a healthy culture and has kept out of the contentious debate over contractors vs. employees.

Shyp makes money in two ways with the first being the $5 pickup fee. The second way the firm makes money is that because of the volume it ships, it is able to negotiate deep discounts with shippers. It captures the difference between the retail price of shipping (which is what it charges its customers) and what it actually pays.

Shyp services both individuals and business clients. It noticed early on that customers were using its service to return items to online retailers. As a result, it launched a service called Shyp Returns, to handle returns for online sellers, and forged partnerships with e-commerce companies such as Amazon, Target, and Bonobos. Now, the customers of those companies, in the communities in which Shyp operates, can use Shyp to return items rather than doing it themselves. Shyp has a similar arrangement with eBay. Shyp also caters to small businesses. It has, in effect, become the shipping department for many online retailers in the communities in which it operates, relieving those businesses of the hassles involved with shipping. The beauty of Shyp's business model is that it benefits its customers in two ways that are meaningful for virtually everyone. Specifically, using Shyp saves customers' time and money.

Currently, Shyp is available in Los Angeles, New York, San Francisco, and Chicago. It plans to add new cities soon.

1-27. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

1-28. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 1.2 COMPANY: Vital Vio

• Web: www.vitalvio.com • Facebook: Vital Vio • Twitter: @vitalvio

Business Idea: Design, manufacture, and sell LED lights that kill bacteria and other organisms in high-risk environments, such as health-care settings, airplanes, gyms, restaurants, office buildings, and public restrooms.

Pitch: On a daily basis, people spend time in environments that are high-risk for contracting infections. According to the Centers for Disease Control in Atlanta, one in 25 patients in a hospital or health-care setting like a nursing home will contract a health care–associated infection. This is a serious concern. MRSA (methicillin-resistant *Staphylococcus aureus*), which is a common infection contracted in hospitals, is resistant to antibiotics. In the United States alone, 99,000 deaths per year are associated with hospital-acquired infections.

There are other high-risk environments that most of us enter frequently such as airplanes, classroom buildings, restaurants, gyms, and public restrooms. For example, MRSA survives in the seat pocket material on airplanes for as long as 168 hours and *E. coli* lives for up to 96 hours on a rubber armrest. Similarly, studies have shown that the grips on machines in fitness centers and gyms often have high counts of bacteria. Airplane cleaning crews and others are aware of the risks, and do what they can to periodically disinfect the most vulnerable surfaces. Still, people contract infections in these settings, which can lead to serious health complications.

Vital Vio has designed, manufactured, and is selling lighting systems that tackle these problems in a new way. Its lights emit a precise spectrum of white light, created with patent pending LED technology, which kills harmful bacteria, with no adverse effects on humans or animals. Hospitals and others already use ultraviolet lights to disinfect surfaces, but UV light is not safe for people to absorb. Vital Vio sells overhead lights that can be retrofitted into existing lighting systems and under cabinet lights. Once installed, Vital Vio's technology is disinfecting every area of a room at all times, just at different rates based on distance. Vital Vio's system works by manipulating light in a manner to achieve passive decontamination of specific bacteria, such as MRSA, *E. coli,* and *Salmonella*. Traditional methods of decontamination, such as manually wiping down a counter with a cleaning product and paper towel, can be effective but are intermittent in their use. The advantage of Vital Vio's passive approach is that as long as the lights are left on, decontamination occurs on a continuous basis.

Vital Vio manufactures proprietary LED lights to compete in specific markets and licenses its technology to manufacturers that are competing in other areas.

1-29. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

1-30. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 1.1

SoulCycle: A Classic Entrepreneurial Tale

• *Web: www.soulcycle.com* • *Facebook: SoulCycle* • *Twitter: @soulcycle*

Bruce R. Barringer, *Oklahoma State University*

R. Duane Ireland, *Texas A&M University*

Introduction

Imagine the following. You're in the midst of a stressful day. You have a great deal on your mind and there is a problem at work you're trying to sort out. Your phone hums to remind you of your 4:00 pm SoulCycle workout. You make the short drive to the SoulCycle studio. You walk in, and the young woman at the desk greets you by name. She hands you a bottle of water (she remembers you like Dasani). You slip your iPhone into your bag because phones are not allowed at SoulCycle. You enter the studio and pick out a stationary bike. The room, which is lit by scented candles, is dim. The spinning class begins, and you and 30 other riders pick up the

SoulCycle studio in Los Angeles, CA.

Araya Diaz/Stringer/Getty Images

pace. The music settles you in. You picked the 4:00 pm class because you like the instructor—Jessica. She knows just when to push and when to back off. You start thinking about your problem at work, and for a while forget you're exercising. A solution occurs to you that you hadn't thought of before. Jessica brings you back with one last surge before the 45-minute session comes to a close. You leave the studio thinking that you just did something that was not only good for your body, but was good for you. Instead of feeling tired, you feel refreshed.

This is the SoulCycle experience, created in 2006 by Julie Rice and Elizabeth Cutler. This is how they did it.

The Blind Date

In the 1990s, Julie Rice was a talent agent in Los Angeles. She became acquainted with indoor cycling, which was a stress reliever for her. It was also her social outlet in that in the Los Angeles area, people socialized around exercise. The fitness centers, and boutique studios, also tried to make exercise an experience. In the early 2000s, Rice moved to New York City. She tried to find a fitness center, but couldn't find one that met her needs. In New York City, fitness centers were just that—fitness centers. People socialized and sought out experiences in other ways.

Rice eventually found an indoor cycling center, and in 2006, an instructor introduced her to Elizabeth Cutler. Cutler was also a New York City transplant, and shared Rice's frustration with the city's fitness centers. They met for what they called a "blind date" and found that they were both looking for the same thing—a fitness center that not only provided a good workout but provided a way to meet people and find a little bit of community. The two hit it off and started talking about opening a fitness center of their own. Rice recalls that after their first meeting, before her taxi door closed, she had a text from Cutler. The text said, "I'm going to look for real estate, you research towels."

The First SoulCycle Studio

Just a few days later, Cutler found a possibility on Craigslist. It was an old dance studio on the Upper West Side of Manhattan. It was properly zoned and had a five year sublet, so Rice and Cutler figured if their idea didn't work out they could lease the space to someone else. They took it, and decided to open a spinning studio. Spinning is high intensity indoor cycling. They didn't have much money, so the front desk was built from IKEA cabinetry. The studio was in the rear lobby of the building, so their customers had to walk a long hallway to find the studio. They made one big mistake. It wasn't until after they signed the lease that they found out they couldn't put up a sign on the front of the building. They decided to call their studio SoulCycle.

Rice and Cutler talked a lot about price. They decided to charge $28 for a 45-minute spinning session (it's now $34). They also decided to charge per class—no monthly membership required. They reasoned that people value what they pay for, and if someone pays $28 in advance for a spinning class, chances are they will show up for the class. They also knew the type of experience they wanted to deliver and it would take $28 per class to pay for it.

To get their first customers, Rice and Cutler went door to door in the neighborhood and worked their personal networks. They also delivered swag bags to as many of the health and beauty editors in New York City they could get in to see. They were also determined that their secret sauce—the thing that would get people talking about SoulCycle—would be the experience they delivered. At that time, there were no fitness boutiques in New York City, other than Yoga and Pilates studios. They were just mainstream fitness centers, some of which offered spinning as one of many classes. SoulCycle would be the first spinning boutique in the city—and Rice and Cutler were determined to nail it.

The SoulCycle Experience

The instructor. The SoulCycle experience starts with the instructors. A spinning class is led by an instructor, who rides a bike that faces the participants. The instructor is the pacesetter, the coach, and the motivator. At the time SoulCycle opened, spinning instructors either did it part time or picked up jobs at several fitness centers to cobble together an income. Rice and Cutler decided to change that, and hired instructors on a full-time basis. As a result, they got the best instructors and their clients got consistency. Providing instructors full-time jobs—which included health insurance—also gave the best instructors a chance to make spinning instruction a career. That greatly enhanced SoulCycle's chances to retain the best instructors.

The music. A big part of the SoulCycle experience is the music. Each instructor curates a playlist for each session. Music plays during the entire 45 minute experience. The music is chosen to match the ebbs and flows of the levels of intensity of the session. No two sessions are the same, and different instructors favor different styles of music. Each month, SoulCycle releases a "best of" list of songs played in its studios that month. But the individual playlists aren't released—you have to be present to hear the music.

The atmosphere. The atmosphere is unique. The studios are softly lit, with most of the light coming from scented candles. Smartphones are not allowed during the spinning sessions. The idea is to offer an experience that is at the same time loud and group-oriented and quiet and private. The SoulCycle experience is also conducive to making new friends. Many people have similar schedules or like the same instructor, so they see each other frequently at SoulCycle sessions. This leads to friendships outside of SoulCycle. This aspect of SoulCycle started with the first studio. Remember the long hallway? An unexpected benefit of the long hallway is that it created interactions—people would say hello to one another coming and going from sessions, or walk the hallway together and get acquainted. SoulCycle has repeated that design element—this time deliberately—in many of its other studios.

(*continued*)

SoulCycle is also both technologically advanced and primitive. Both are intentional. Its stationary bikes and sound systems are state of the art. At the same time there are no clocks in the studios, there are no rankings (some spinning studios rank the riders based on who is riding the hardest), and there is no gamification. People can wear Fitbits or other devices to monitor themselves. But as far as SoulCycle is concerned, the purer the experience, the better.

Everything about SoulCycle's atmosphere is intended to reinforce the experience the company wants to deliver. It wants people to have a good workout but to also find joy and contentment in the music, the soft light, the lyrics of the songs, the familiarity of the instructor, the friendships that are made, and so forth. That's the secret sauce on which the company is built.

Training. Rice and Cutler knew that for SoulCycle to be scalable, they had to perfect the SoulCycle experience and make it repeatable and teachable. So they focused heavily on training from day one. New instructors go through an eight-week training program. They're in school from 9:00 am to 5:00 pm every day, and ride an additional 5–6 times per week. The employees who work the front desk, and have the most direct interaction with customers, go through the SoulCycle hospitality school. The hospitality school focuses on topics such as the history of the brand, what is customer service, how to effectively communicate with colleagues, and so forth. One staple of SoulCycle's philosophy on training is that each new hire, regardless of rank, spends time working the front desk of a SoulCycle studio. The front desk is the best place, in Rice and Cutler's view, for a new employee to experience and learn SoulCycle's culture.

The Growth Years

The first SoulCycle studio was a success. Within six months of opening, it was profitable and had waiting lists for its classes. Rice and Cutler thought in the early months they would service about 75 people a day—it turned out to be between two and three hundred. Via the strength of the SoulCycle experience, the company had literally created a marketplace for its product.

The second SoulCycle studio opened in the Tribeca area of New York City. In the early days, people had to show up for SoulCycle classes early and put their name on a waiting list. To make things easier, SoulCycle developed the first online reservation system for a fitness boutique in New York City. It instantly became popular. Many classes would fill up within a few minutes of when their time-slots became available online. SoulCycle started selling branded apparel when its first studio opened in 2006. It added e-commerce in 2010. SoulCycle currently releases 12 private label collections per year. Pieces generally sell for about $40 for a top to $85 and higher for pants and sweatshirts. Many SoulCycle enthusiasts have multiple combinations of SoulCycle outfits.

SoulCycle's early growth took place primarily in the New York City area, where it steadily added studios. In 2011, the company decided to expand to California. At that time, Rice and Cutler sold SoulCycle to Equinox Fitness. The cofounders felt they needed experienced hands involved to manage what was anticipated to be rapid growth. Rice and Cutler stayed on and have managed SoulCycle as one of Equinox's brands.

Current Status and Challenges

SoulCycle now has 85 locations in the United States with approximately 20,000 riders each week. It has had riders as old as 85 and as young as 12. The company employs 1,500 people and reported sales of over $112 million in 2014.

Along with its continued success, SoulCycle faces a number of challenges. Companies like Peleton (www.peleton.com) now make high-quality stationary bikes that allow people to experience spinning classes at home through rich multimedia connections. The classes are available on-demand, which means that the classes are archived and you can take a class from your favorite instructor anytime you want—you don't have to show up at a studio at a particular time. A number of SoulCycle imitators have also sprung up, and offer classes at a lower rate than SoulCycle's current rate of $34 for a 45-minute class.

Discussion Questions

1-31. Which of the characteristics of successful entrepreneurs, discussed in the chapter, do you see in Julie Rice and Elizabeth Cutler? To what degree do you think these characteristics have contributed to SoulCycle's success?

1-32. How does SoulCycle's basic offering, its 45 minute spinning classes, "add value" to the lives of its customers?

1-33. On a scale of 1 to 10 (10 is high), rate SoulCycle on execution intelligence. Make a list of at least five things that you think SoulCycle did particularly well in this area. Justify your numerical ranking.

1-34. Talk about the challenge that Peleton poses to SoulCycle. If you were asked to advise SoulCycle on how to respond to the Peleton threat, what would you tell the company to do?

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CASE 1.2

PatientsLikeMe: Allowing People with Serious Diseases to Connect with One Another and Exchange Support and Advice

• Web: www.patientslikeme.com • Facebook: PatientsLikeMe • Twitter: @patientslikeme

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

It is a sad yet heartwarming story. In 1998, Stephen Heywood, a strong 29-year-old carpenter who was building his dream house in California, got the worst possible news. He was diagnosed with amyotrophic lateral sclerosis (ALS), or Lou Gehrig's disease. His brothers, Jamie and Ben, stood by his side as he doggedly fought his disease and pursued a cure. Stephen eventually succumbed to ALS, but his courageous journey will always be remembered through an autobiographical movie, *So Much So Fast*, and a book, *His Brother's Keeper,* by Pulitzer Prize–winning author Jonathan Weiner.

Helping Stephen deal with the day-to-day challenges of his disease and experiencing firsthand the decisions that have to be made and the lack of information that's often available profoundly changed the direction of Jamie and Ben Heywood's lives. In 1999, Jamie Heywood launched an organization called the ALS Therapy Development Institute, to help Stephen and others fight ALS. Today, it remains well funded and staffed and supports a number of research efforts. In 2005, Jamie and his brother Ben took an additional step and launched PatientsLikeMe, a web-based company, which allows people with life-changing diseases to converse with one another, share their experiences, and learn techniques from each other that help them better cope with their diseases.

Since its launch, PatientsLikeMe has achieved remarkable success. Any patient with any medical condition can join the site. As a result, the company now has nearly 500,000 members sharing their experiences with respect to over 2,700 conditions. Of particular note are the 9,000 ALS members, making PatientsLikeMe the largest online population of ALS patients in the world. At the heart of PatientsLikeMe's success is a truly unique value proposition—a platform that encourages patients

Tyler Olson/Shutterstock

PatientsLikeMe provides a means for patients to connect with others who have the same medical condition. The patients in the community share information and support one another. In the process, they generate data about the nature of the condition.

(*continued*)

to interact in ways that are very meaningful for them. PatientsLikeMe is also a bold company, in that one of its goals is to change the way that the medical industry thinks about patients and patient care. To facilitate that goal, PatientsLikeMe is working with, rather than against, the medical industry. In fact, its primary revenue driver is to sell aggregated data that it collects from its online patient communities to medical companies to enable them to factor the "voice of the patient" into all aspects of their product decisions.

Value Proposition

PatientsLikeMe's value proposition is the opposite of what you might expect, in that conventional thinking is that a person's medical information is private and should be kept confined to a tight circle of family and health-care providers. PatientsLikeMe advocates that people openly share their experiences to help others. It is inspirational in that most of its members have illnesses that consume a great deal of their own time and energy, yet they are willing to expend time and effort to share information to improve the lives of others.

Here's how it works. Say someone you care about has been diagnosed with Parkinson's disease, a neurological disorder. On PatientsLikeMe, that person will be able to interact with people who have been living with Parkinson's disease for 3 years, 5 years, 10 years, or more. Your friend or loved one will be able to ask, "What's it like after 3 years? What will I be able to do and not do? What's the scariest part of the disease?" Your friend or loved one will also be able to ask the number-one question that people with diseases have, which is: "Given my status, what's the best outcome I can hope for and how can I get there?" This question will be answered by someone who has the disease and who truly understands all the emotions and fears rather than being answered by a medical professional.

PatientsLikeMe's service is unique in that it not only facilitates these types of interactions but also collects detailed information from its members about the symptoms they're experiencing, medications they're on, and how their diseases are affecting their lives. It then displays this data in aggregate form for its members and others to see. It also drills deeper. It allows patients to share the experiences they're having with a particular drug, for example, including how long they've been on the drug, what the side effects have been, whether they feel the drug has been effective, and so forth. This is information that people who have just been prescribed a drug are anxious to see. Members can also interact directly with each other regarding their experiences. For example, Carbidopa-Levodopa is a drug commonly prescribed for Parkinson's disease patients. Someone named "Mary O." may have reported on her profile that "When I first started taking Carbidopa-Levodopa it made me sleepy, but over time my body adjusted and I no longer have that side effect." If you've just been prescribed Carbidopa-Levodopa, you can send a message to Mary O. and ask her, "How sleepy did you get? Was it so bad you couldn't go to work? How long did it take before your body adjusted? Did you try caffeine? Did it help?" Mary O. would then respond and answer the questions. In addition, as a result of this exchange, you and Mary O. may start to regularly correspond, and Mary O. may become, for you, an important source of information and support.

What's remarkable about PatientsLikeMe's value proposition is that the information its members exchange and the manner in which it aggregates and displays data aren't available anywhere else. The degree to which its members are willing to be transparent about very personal health-related issues is also compelling. Along with maintaining its website and member communities, PatientsLikeMe has also become an authoritative voice in the medical community. It has published over 80 peer-reviewed research studies. Recently, PatientsLikeMe's vice president for advocacy, Sally Okun, made a highly visible presentation at TEDMED about the idea of building a "patient lexicon" to make it as easy for patients to talk about their conditions and compare notes as it is for doctors. The eight-minute talk titled "Does Anyone in Healthcare Want to Be Understood?" is available at www.tedmed.com. Simply type "Sally Okun" into the search bar.

Revenue Driver

Although its services are free to users, PatientsLikeMe is a for-profit entrepreneurial venture. The company makes money by aggregating the information its members share and selling it to its partners. Its partners include members of the medical community such as drug companies, medical-device companies, insurance companies, and health-care providers. For example, the aggregate data of how patients with Parkinson's disease are reacting to a particular medication would be of interest to the company that makes that medication. The sharing of this information then circles back and helps patients. For example, if the maker of the Parkinson's drug finds that a large percentage of people who take the drug experience fatigue, the drug can potentially be tweaked to remedy that issue. For patients, not experiencing fatigue as a side effect of the drug may not only translate into feeling better, but may mean fewer days missed from work or even the ability to maintain a job rather than having to quit. Because of these types of outcomes, most patients are eager to have their personal data included in larger databases and passed along to companies in the medical industry. Finally, their experiences and their voices become part of the data that medical companies study when making decisions about patients and their care. PatientsLikeMe is very transparent about the fact that it sells its patients' data, and it sees the sharing of data as integral to its mission. It does not share or sell personally identifiable information without the explicit consent of the member.

There are no ads or sponsorships on PatientsLikeMe's website. The company's sole intention is to align the interests of its members with the medical community.

Challenges Ahead

PatientsLikeMe is expanding its reach. Although its site originally focused exclusively on life-threatening diseases, it has opened its doors to any patient with any condition. This expansion has resulted in communities that focus on issues such as infertility (for both men and women), mood conditions (including depression), and hearing loss. Rapid growth is a challenge for all firms, and PatientsLikeMe is in a rapid-growth phase. In fact, at the time this case was written, PatientsLikeMe was supporting communities for more than 2,700 conditions. Several recent developments bode positively for PatientsLikeMe's future. The effectiveness of the company's platform in improving patient outcomes has been affirmed in at least three studies. In early 2017, PatientsLikeMe entered into a broad-ranging partnership with digital life company iCarbonX to gain a better understanding of human health and disease. The partnership was accompanied by a $100 million investment made by iCarbonX and other investors.

There are also several worries that surround a service such as PatientsLikeMe. The company openly acknowledges these worries but believes the benefits outweigh the risks. One worry is that some employers may not want to employ people with a high-cost or high-risk disease. Again, it's possible that some people may reveal the existence of a disease on their PatientsLikeMe profiles that may jeopardize current or future employment opportunities. Another worry is the unknowns about changes to health-care policies and the overall health-care system in the United States as a result of the passage of the Affordable Care Act (ACA) and as of early 2017, the effects of potential changes to the ACA.

For now, PatientsLikeMe is aggressively moving forward. The company's overarching goal, along with providing the value it currently provides, is to shift the thinking of companies in the medical industry by providing them access to data they never had before. By better knowing the journey that patients are taking, the hope is that the medical community will increasingly go beyond treating patients' core diseases and create products that will impact all aspects—physical, social, and mental—of patients' lives.

Discussion Questions

1-35. Of the three reasons articulated in Chapter 1 that motivate people to start businesses, which of the three reasons was the primary motivation behind Jamie and Ben Heywood's decision to launch PatientsLikeMe?

1-36. How do those who are leading PatientsLikeMe practice "product/customer focus"? How do they practice "execution intelligence"?

1-37. What type of start-up firm is PatientsLikeMe?

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ESSAY QUESTIONS

1. What are the four primary traits and characteristics of successful entrepreneurs? Of the four traits, which ones are the most descriptive of Fraser Doherty, the entrepreneur whose experiences and successes are described in this chapter's Opening Profile?

2. What is execution intelligence? Use your understanding of this concept to think about the execution intelligence displayed by Prim, the focus of the "What Went Wrong?" feature" in the chapter. On a scale of 1 to 10 with 10 representing "outstanding execution intelligence," what rating do you ascribe to Prim in terms of execution intelligence and why?

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PART 2 Developing Successful Business Ideas

Owlet Baby Care, Inc.

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Getting Personal with Wiivv

Wiivv Wearables, Inc./Photo Credit: Shamil Hargovan

Cofounders

SHAMIL HARGOVAN

BA, Philosophy, Politics, and Economics, Claremont McKenna College, 2010

LOUIS-VICTOR (LV) JADAVJI

BA, International Relations and Leadership Studies, Claremont McKenna College, 2015

Dialogue *with* Shamil Hargovan

FAVORITE BAND ON MY SMART-PHONE APP
Daft Punk

BEST ADVICE I'VE RECEIVED
Everything in life should have a reason

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
How difficult having a personal life would be

MY ADVICE FOR NEW ENTREPRENEURS
You're not a true entrepreneur until you figure out how to make everyone around you an entrepreneur for your vision

FIRST ENTREPRENEURIAL EXPERIENCE
Turned college internship into start-up idea (Kicklight.com) at Stanford Research Institute

MY FAVORITE SMARTPHONE APP
Wunderlist

MY BIGGEST WORRY AS AN ENTREPRENEUR
Staying true to the vision in spite of short-term tactical ups and downs

BEST PART OF BEING A STUDENT
The freedom and time to figure out who you are and what you stand for

WHAT I DO WHEN I'M NOT WORKING
Enjoy the outdoors with my wife Jillian and our dog Xena

CHAPTER 2

Recognizing *Opportunities* and Generating Ideas

OPENING PROFILE

WIIVV

Solving Foot Pain and Fatigue via Custom Fitted 3D Printed Insoles

• *Web: https://wiivv.com* • *Facebook: wiivvit* • *Twitter: @wiivvit*

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Shamil Hargovan and Louis-Victor (LV) Jadavji met at a 3D printing conference in 2013. They quickly discovered that they had two things in common: first, they were both affiliated with Claremont McKenna College in California—Hargovan as an alumni and Jadavji as a student—and second, they both had an active interest in 3D printing.

After the conference, Hargovan and Jadavji kept in touch. At the time, Hargovan worked for Hewlett-Packard as a Group Product Manager and 3D Printing Lead. Jadavji remained in school and worked for a software company in the San Francisco Bay area. The two continued to share their interest in 3D printing. Hargovan was kicking around several ideas, outside his job at HP, including using 3D printing to create products for athletes, such as helmets. In early 2014, Jadavji had a bad experience with a pair of orthotics, and the thought occurred to him to utilize 3D printing to create customized, affordable insoles that would provide users maximum support.

In April of that year, Hargovan and Jadavji decided to work together on the 3D printed insoles idea. The idea made sense on several levels. First, many people have trouble with their feet and struggle to find a solution. Individuals who spend hours a day standing or walking, such as nurses and security guards, are the most susceptible. Second, there was a gap in the marketplace for products to help people with foot fatigue and other issues. On one end of the market were custom orthotics, which cost $400 or more. Along with the cost, being fitted for orthotics usually requires a visit to a podiatrist and is a time-consuming process. On the other end of the market were inexpensive insoles, which are basically small cushions you put in your shoes. Because the insoles aren't custom fitted, they often don't fit right or provide adequate support. What was missing was a product in the middle—a quality, custom fitted insole that could be obtained quickly at an affordable price. That was the sweet spot that Hargovan and Jadavji felt 3D printing was ideally suited to accommodate.

Wiivv, the company the two started, took shape in 2014 and 2015. It took time for the idea to be fleshed out and for the manufacturing process to be developed and the product to be tested. To test the process and product, Wiivv assembled a group of people called the Wiivv 100. These were people who spent a lot of time on their feet, and who beta tested the custom printed insoles Wiivv was 3D printing. The group was utilized for

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain the difference between opportunities and ideas.
2. Describe the three general approaches entrepreneurs use to identify opportunities.
3. Discuss the personal characteristics of entrepreneurs that contribute to their ability to recognize business opportunities.
4. Identify and describe techniques entrepreneurs use to generate ideas.

six months and saw the product through 72 iterations. Some of the testers were surveyed and others were brought into Wiivv's offices to be interviewed and for their insoles to be examined (after various lengths and types of use). The Wiivv 100 ultimately became strong advocates for the product and spread the word about Wiivv via social media.

Wiivv launched in early 2016 via a Kickstarter campaign. The campaign raised $235,054 and had 2,765 backers. The idea for the campaign wasn't so much to raise money, but to validate that there was a market for high-quality, 3D-printed custom insoles at a modest price. If you'd like to look at Wiivv's Kickstarter campaign, which includes a video, go to www.kickstarter.com and type in Wiivv. The campaign was successful and was the largest Kickstarter campaign at the time for a 3D printed product. The market validation that the campaign provided also helped Wiivv raise money from investors down the road and generated substantial positive publicity.

The way Wiivv works is really cool. To purchase a Wiivv custom insole, you start by going to Wiivv's website to buy a purchase code. The code costs $69 or $89, depending on the insole you buy. You then download the Wiivv app, watch a short tutorial, and tailor the insole to your liking. You can pick from various colors (for the bottom) and patterns (for the top). You then take five photos of your feet using your smartphone. The app guides you through the process, which doesn't take more than a few minutes. You finish up via a standard checkout process. In 7–14 days, your custom insoles arrive in the mail. Using the insoles is easy. You just place them in your shoes. You can slip the insoles in and out of all the shoes you own. Most people immediately notice a difference in terms of less foot fatigue. If you are not completely satisfied, Wiivv provides a 30-day satisfaction guarantee.

Behind the scenes, Wiivv's operations are complex. To manufacture the insoles, the firm uses a process called adaptive manufacturing. The part of the insole that provides a custom fit is 3D printed, and the rest is built via traditional manufacturing processes. A lot of thought regarding the user experience went into how the insoles are ordered and the photos are taken. Once the photos reach Wiivv, they are turned into data that Wiivv's commercial-grade 3D printers can understand. All of Wiivv's products are manufactured in San Diego, CA.

To grow its business, Wiivv has raised $7.88 million through two seed rounds and a Series A round. Wiivv's ultimate vision is to add active mental years to people's lives by producing custom fit footwear, orthopedics, and wearable products that encourage them to lead a more active lifestyle. A second line of products, in addition to insoles, is in the works but has yet to be announced publicly.

In this chapter, we discuss the importance of understanding the difference between ideas and opportunities. While ideas are interesting and can intrigue us as possibilities, not every idea is in fact the source of an opportunity for an entrepreneur to pursue. In addition to describing the differences between ideas and opportunities, this chapter also discusses approaches entrepreneurs use to spot opportunities, as well as factors or conditions in the external environment that may result in opportunities. As you will see, too, certain characteristics seem to be associated with individuals who are adept at spotting viable business opportunities.

The Differences Between Opportunities and Ideas

LEARNING OBJECTIVE

1. Explain the difference between opportunities and ideas.

Essentially, entrepreneurs recognize an opportunity and turn it into a successful business.[1] An **opportunity** is a favorable set of circumstances that creates a need for a new product, service, or business. Most entrepreneurial ventures are started in one of two ways. Some ventures are externally stimulated. In this instance, an entrepreneur decides to launch a firm, searches for and recognizes an opportunity, and then starts a business, as Jeff Bezos did when he created Amazon.com. In 1994, Bezos quit his lucrative job at a New York City investment firm and headed for Seattle with a plan to find an attractive opportunity and launch an e-commerce company. Other firms, such as Wiivv, are internally stimulated. In this instance, an entrepreneur recognizes a problem or an **opportunity gap** and creates a business to address the problem or fill the identified gap. In this instance, Wiivv's founders' seek to build " . . . a better foundation for every step you take with made-to-fit-you insoles and footwear."[2] A bionics company, Wiivv uses 3D-mapping technology to solve a problem of shoes not fitting customers as well as they want to be the case.

Regardless of which of these two ways an entrepreneur starts a new business, fresh opportunities are tough to spot. Identifying a product, service, or business opportunity that isn't merely a different version of something already available is difficult. A common mistake entrepreneurs make in the opportunity recognition process is picking a currently available product or service that they like or are passionate about and then trying to build a business around a slightly better version of it. Although this approach seems sensible, such is usually not the case. The key to opportunity recognition is to identify a product or service that people need and are willing to buy, not one that an entrepreneur wants to make and sell.

As shown in Figure 2.1, an opportunity has four essential qualities: It is (1) attractive, (2) timely, (3) durable, and (4) anchored in a product, service, or business that creates or adds value for its buyer or end-user. For an entrepreneur to capitalize on an opportunity, its **window of opportunity** must be open. The term *window of opportunity* is a metaphor describing the time period in which a firm can realistically enter a new market. Once the market for a new product is established, its window of opportunity opens. As the market grows, firms enter and try to establish a profitable position. At some point, the market matures, and the window of opportunity closes. This is the case with Internet search engines. Yahoo, the first search engine, appeared in 1995, and the market grew quickly, with the addition of Lycos, Excite, and several others. Google entered the market in 1998, sporting advanced search technology. Since then, the search engine market has matured, and the window of opportunity is less prominent. Today, it would be very difficult for a new start-up search engine firm to be successful unless it offered compelling advantages over already established competitors or targeted a niche market in an exemplary manner. Bing, Microsoft's search engine, is gaining ground with approximately 20.9 percent market share (compared to 63.9 percent for Google), but only after Microsoft has exerted an enormous amount of effort in head-to-head competition with Google.[3]

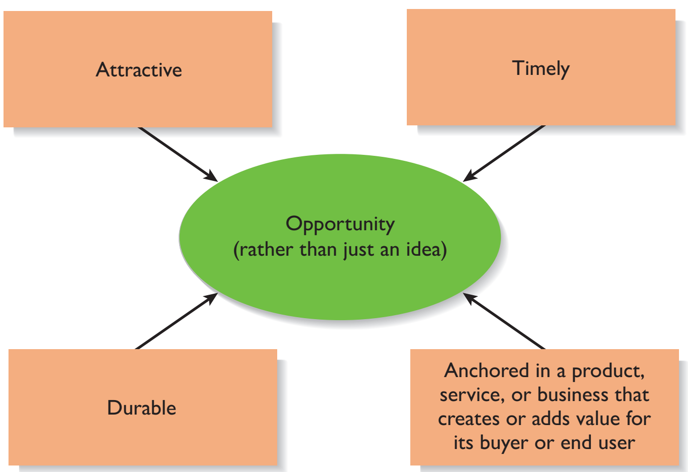


FIGURE 2.1
Four Essential Qualities of an Opportunity

It is important to understand that there is a difference between an opportunity and an idea. An **idea** is a thought, an impression, or a notion. An idea may or may not meet the criteria of an opportunity. This is a critical point because many entrepreneurial ventures fail not because the entrepreneurs that launched them didn't work hard, but rather because there was no real opportunity to begin with. Before getting excited about a business idea, it is crucial to understand if the idea fills a need and satisfies the criteria for an opportunity.

Three Ways to Identify Opportunities

LEARNING OBJECTIVE

2. Describe the three general approaches entrepreneurs use to identify opportunities.

There are three approaches entrepreneurs use to identify an opportunity their new venture can choose to pursue (see Figure 2.2). Once an entrepreneur understands the importance of each approach, she or he will be much more likely to look for opportunities and ideas that fit each profile. We discuss the three approaches in the next three sections.

Observing Trends

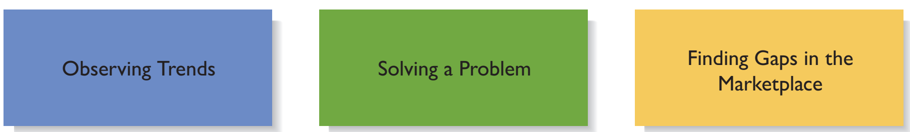
The first approach to identifying opportunities is to observe trends and study how they create opportunities for entrepreneurs to pursue. The most important trends to follow are economic trends, social trends, technological advances, and political action and regulatory changes. As an entrepreneur or potential entrepreneur, it is important to remain aware of changes in these areas. This sentiment is affirmed by Michael Yang, the founder of Become.com, a comparison shopping site, who believes that keen observation skills and a willingness to stay on top of changing environmental trends are key attributes of successful entrepreneurs:

> One of the most important attributes of a good entrepreneur is having a keen observation ability. Basically seeing what's needed in people's everyday lives and coming up with innovative new ideas and services that meet those needs . . . I always believe the entrepreneurs that anticipate trends and maintain observations of what's needed . . . to solve those needs will have a higher chance of succeeding in the marketplace.[4]

When looking at environmental trends to discern new business ideas, there are two caveats to keep in mind. First, it's important to distinguish between trends and fads. New businesses typically do not have the resources to ramp up fast enough to take advantage of a fad. Second, even though we discuss each trend individually, they are interconnected and should be considered simultaneously when brainstorming new business ideas. For example, one reason that smartphones are so popular is because they benefit from several trends converging at the same time, including an increasingly mobile population (social trend), the continual miniaturization of electronics (technological trend), and their ability to help users better manage their money via online banking and comparison shopping (economic trend). If any of these trends weren't present, smartphones wouldn't be as successful as they are and wouldn't hold as much continuing promise to be even more successful in the future.

Figure 2.3 provides a summary of the relationship between the environmental factors just mentioned and identifying opportunity gaps. Next, let's look at how entrepreneurs can study each of these factors to help them spot business, product, and service opportunity gaps.

FIGURE 2.2
Three Ways to Identify an Opportunity



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As baby boomers age, opportunities will grow for firms that provide unique services to the age group. Look for the resulting expansion in organic foods, travel, and technologies that enable older people to easily connect with their families and friends.

Economic Forces. There are a number of economic forces that help determine areas that are ripe for new business ideas, as well as areas to avoid. These forces include topics such as whether consumer spending is rising or falling, whether housing starts are up or down, whether international trade is strong or weak, and whether interest rates are stable, falling, or increasing. At the time this chapter was written (spring, 2017), personal income was rising, housing starts were up, international trade was flat, and interest rates were inching up.

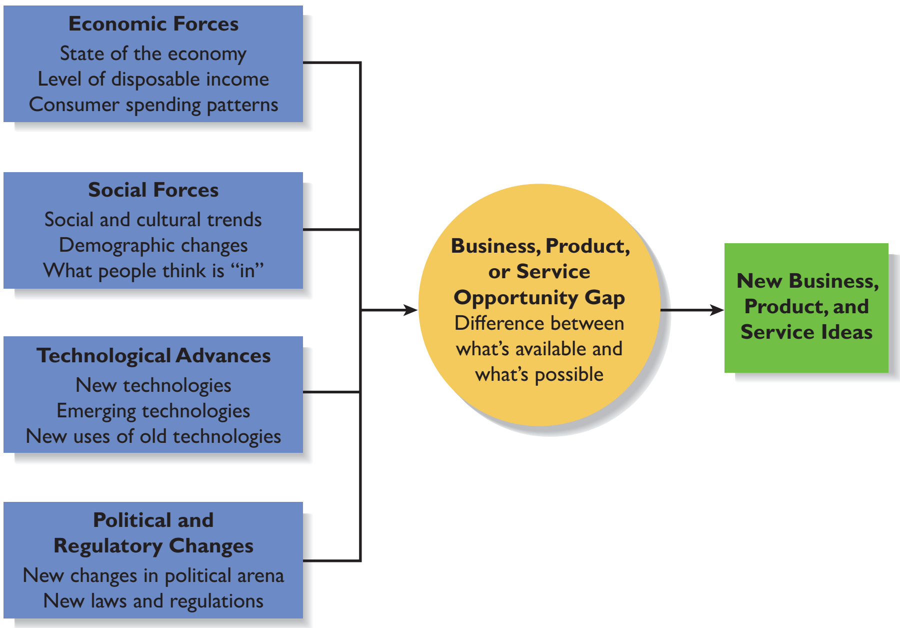


FIGURE 2.3
Environmental Trends Suggesting Business, Product, or Service Opportunity Gaps

When personal income is rising, consumers have more money to spend and are willing to buy discretionary products and services that enhance their lives. That bodes well for start-ups that provide discretionary products or services. For example, SoulCycle, the subject of Case 1.1, offers spinning classes in hip urban studios. The classes cost $34 per session. At that price, SoulCycle is more likely to gain new members when personal income is rising and the economy is strong. In contrast, when personal income is falling, not only do people have less money to spend, they are less willing to spend it, opting instead to accumulate cash. This environment provides business opportunities for start-ups that help consumers and businesses save money. An example is GasBuddy, a company started to help consumers and businesses save money on gas. Pause reading for a moment and go to GasBuddy's website, at www.gasbuddy.com, to see how the site works. A similar example of a service that helps people save money is YouNeedaBudget, which is an app that helps users reduce debt and manage their spending. Both GasBuddy and YouNeedaBudget would likely gain more users when personal incomes are falling rather than rising.

Another important economic force to evaluate is who has money to spend and what they spend it on. For example, an increase in the number of women in the workforce and their related increase in disposable income is largely responsible for the number of online retailers and boutique clothing stores targeting professional women that have opened the past several years. Similarly, the increased buying power of minority populations has resulted in an upswing of ethnic restaurants and ethnic supermarkets in the United States. Baby boomers are another group to examine. These individuals, who were born between 1946 and 1964, are retiring in large numbers and will be retiring in even larger numbers over the next five years or so. Approximately 76 million people are classified as baby boomers in the United States; currently, roughly 10,000 of them are retiring every day. The expectation is that these people will redirect a sizeable portion of their assets to products and services that facilitate their retirement. This trend will invariably spawn new businesses in many areas, largely because baby boomers have greater disposable income relative to previous generations. Areas that baby boomers spend heavily on include health care, travel, and consumer packaged goods. PillPack, the subject of "You Be the VC 2.1" in this chapter, makes a product with the ability to help baby boomers encountering difficulty when it comes to effectively dealing with their prescribed medications. The high cost of energy, coupled with a desire to be socially responsible, has also spawned a growing number of start-ups that are developing products and services that help business and consumers become more energy efficient. An example is Nest (www.nest.com), a 2010 start-up. Nest—which was acquired by Google in 2014—makes the world's first learning thermostat. The thermostat, which can be used in homes or businesses, learns from your temperature adjustments and programs itself to optimize a building's comfort and energy efficiency.[5]

An understanding of economic trends also helps identify areas to avoid. For example, a decision to launch a company that sells products or services to public schools is not always wise when economies are not growing or perhaps are declining. When tax revenues decline because economies (national, state, and/or local) are not growing, schools' budgets are cut. In turn, budget cuts reduce the ability of schools to purchase new products and services.

Social Trends. An understanding of the impact of social forces on trends and how they affect new product, service, and business ideas is a fundamental piece of the opportunity recognition puzzle. Often, the reason that a product or service exists has more to do with satisfying a social need than the more transparent need the product fills. The proliferation of fast-food restaurants, for example, isn't primarily because of people's love of fast food, but rather because people are busy and often don't have time to cook their own meals. Similarly, social networking sites like Facebook, Snapchat, and Instagram aren't popular because they can be used to post information and photos on a website. They're popular because they allow people to connect and communicate with each other, which is a natural human tendency.

Changes in social trends alter how people and businesses behave and how they set their priorities. These changes affect how products and services are built and sold. Here is a sample of the social trends that are currently affecting how individuals behave and set their priorities.

- Aging of the population
- The increasing diversity of the population
- Millennials entering the workforce
- Growth in the use of mobile devices
- An increasing focus on health and wellness
- Emphasis on clean forms of energy, including wind, solar, biofuels, and others
- Continual migration of people from small towns and rural areas to cities
- Desire for personalization (which creates a need for products and services that people can tailor to their own tastes and needs)

Each of these trends is providing the impetus for new business ideas. The continual migration of people from small towns and rural areas to cities, for example, is creating more congestion in cities. Businesses like Zipcar, a car-sharing service, and Zagster, a bicycle-sharing service, were started in part to address this problem. Similarly, the aging of the population is creating business opportunities from vision care to home health care to senior dating sites. An example is Glaukos, a company that's developing a new approach for treating glaucoma, which is an age-related eye disorder.

The proliferation of mobile devices is a social trend that's opening business opportunities for entrepreneurs across the globe. More than 2.1 billion people worldwide owned mobile phones in 2016, and that number is expected to grow to 2.87 billion by 2020. An increasing percentage of the mobile phones are smartphones, like the Apple iPhone and Android-equipped devices.[6] The proliferation of smartphones will spawn new businesses both in the United States and throughout the world. Sometimes social trends converge to create a particularly compelling business idea. For example, CareZone, a start-up in the health-care space, was launched by Jonathan Schwartz, who was looking for ways to better manage the care of five aging parents and in-laws. CareZone is an app for smartphones, tablets, or computers that allows those involved in a person's care to share and save information in a secure, online setting. CareZone's potential is bolstered by two societal trends: the aging of the population and the growth in the use of smartphone apps and other connected devices.

The increasing interest in social networking sites such as Facebook, Twitter, and LinkedIn is a highly visible social trend. In 2016, 78 percent of U.S. residents had a social media profile, a five percent increase from the year before. According to estimates, the number of worldwide social media users reached 1.96 billion in 2016 and is expected to grow to 2.5 billion by 2018.[7] In addition to providing people new ways to communicate and interact with each other, social networks also act as platforms for other businesses to build on. Zynga, for example, the maker of popular online games FarmVille and Scramble, became popular by making browser-based games that worked as application widgets on Facebook. Similarly, entrepreneurs have launched businesses for the purpose of starting social networks that cater to specific niches. An example is PatientsLikeMe, the subject of Case 1.2, which is a social networking site for people with serious diseases.

Technological Advances. Advances in technology frequently dovetail with economic and social changes to create opportunities. For example, there are many overlaps between an increased focus on health and wellness and technology. Wearable devices, like the Fitbit Charge 2 and the Jawbone Up, help people maintain a healthy lifestyle by monitoring their movements and sleep. In fact, according to Statista, the global market for wearable devices is expected to reach 19 billion dollars in 2018, more than 10 times its value in 2013.[8] The projected 19 billion dollar market includes wearable devices that have a variety of applications. For example, the Valedo Back Therapy is a wearable device that uses sensors to detect the nature of a user's lower back pain. Based on the data the sensors collect, the device suggests exercises the user can complete in a game format to relieve the pain.[9]

Technological advances also provide opportunities to help people perform everyday tasks in better or more convenient ways. For example, OpenTable.com is a website that allows users to make restaurant reservations online and now covers most of the United States. If you're planning a trip to San Francisco, for example, you can access OpenTable.com, select the area of the city you'll be visiting, and view descriptions, reviews, customer ratings, and, in most cases, the menus of the restaurants in the area. You can then make a reservation at the restaurant and print a map and the directions to it. The basic tasks that OpenTable.com helps people perform have always been done: looking for a restaurant, comparing prices and menus, soliciting advice from people who are familiar with competing restaurants, and getting directions. What OpenTable.com does is help people perform these tasks in a more convenient and expedient manner.

Another aspect of technological advances is that once a technology is created, products often emerge to advance it. For example, the creation of the Apple iPhone, iPad, and similar devices has in turned spawned entire industries that produce compatible devices. For example, Rokit Boost is a high-end mobile accessories company that makes smartphone cases, headphones, portable USB device chargers, and Bluetooth speakers. Rokit Boost wouldn't exist if it weren't for the advent of the smartphone industry. Similarly, there are a growing number of start-ups working on smartphone apps. An example is Lumbo Body Tech, the subject of the "You Be the VC 10.2" feature. Lumbo Body Tech has made a smartphone app that analyzes a user's running form and offers personalized coaching to help the user exceed his or her running goals.

Political Action and Regulatory Changes. Political and regulatory changes also provide the basis for business ideas. For example, new laws often spur start-ups that are launched to take advantage of their specifications. This happened with the initial passage of the Affordable Care Act (ACA) in the United States in 2010. The combination of new regulations, incentives for doctors and hospitals to shift to electronic records, and the release of mountains of data held by the Department of Health and Human Services (on topics such as hospital quality and nursing home patient satisfaction), yielded opportunities for entrepreneurs to launch electronic medical records' start-ups, apps to help patients monitor their medications, and similar companies.[10] Changes proposed for the ACA by the new administration that entered the White House on January 20, 2017 also yield opportunities for entrepreneurs to pursue.

On some occasions, entire industries hinge on whether certain government regulations evolve in a manner that is favorable to the industry. For example, there are several start-ups poised to commercialize the use of drones, or Aerial UAV's. Drones can potentially be used for a number of domestic purposes, such as helping farmers determine the optimal level of fertilizer to place on crops, delivering medicine to remote locations, and helping filmmakers shoot overhead shoots. As of June, 2016, the FAA permitted drones to be used only under certain conditions, such as within eyesight of the operator, maximum weight of 55 pounds, daylight-only operations, and a maximum altitude of 400 feet above ground. Several companies, including CyPhyWorks are working on more advanced applications, such as drones delivering packages in residential neighborhoods. Drone start-ups are waiting for the FAA to develop more liberal rules and standards that will allow drones to be used for expanded purposes. Drone technology will also need to advance before farsighted applications like package delivery are possible and economically attractive.

Political change also engenders new business and product opportunities. For example, global political instability and the threat of terrorism have resulted in many firms becoming more security-conscious. These companies need new products and services to protect their physical assets and intellectual property, as well as to protect their customers and employees. An example of a start-up in this area is Evolv, a Waltham, MA-based startup funded in part by Bill Gates. Launched in 2013, Evolv assembled a multidisciplinary team of experts to identify, invent, and apply new technologies to meet current terrorism-related threats. Combining sensors, artificial intelligence, and human IQ, the company developed Evolv Mosaiq, a security platform which is currently one of the world's most advanced threat detection systems.[11]

Table 2.1 offers additional examples of changes in environmental trends that provided fertile soil for opportunities and subsequent concepts to take advantage of them.

TABLE 2.1 Examples of How Changes in Environmental Trends Provided Openings for New Business and Product Opportunities

Changing Environmental Trend	Resulting New Business, Product, and Service Opportunities	Companies That Resulted
Economic Trends		
Rising personal incomes	Technology products, travel services, organic food	Jawbone, Hipmunk, Whole Food Markets
Baby boomers entering retirement with disposable income	In-home care, health and wellness apps, financial services for older people, travel-related services for older people	Honor, Guardian Medical Monitoring, Betterment, Senior Travel Services
Social Trends		
Increased interest in different, tastier, and healthier food	Healthy-fare restaurants, ethnic packaged foods, craft beer, functional beverages	Froozer, Beyond Meat, Hint (bottled water), Popchips
Increased interest in fitness as the result of new medical information warning of the hazards of being overweight	Fitness centers, pilates and yoga studios, exercise apps, weight-loss programs and apps	SoulCycle, 24 Hour Fitness, Yogaview (Chicago), Peloton, Noom
Technological Advances		
Smartphones	Smartphone operating systems, smartphone apps, smartphone accessories	Android, Instagram, Snapchat, Rokit Boost, iSkin
Wearable technology	Wearable fitness devices, wearable lifesytle devices (like Google Glasses), and wearable tech gadgets	Apple Watch, Spectacles, Oculus Rift, Recon Jet
Political and Regulatory Changes		
Increased EPA and OSHA standards	Consulting companies, software to monitor compliance	MobileEpiphany, SWAC, ESS Group, Air Quality Consultants
Affordable Care Act	Electronic health records, new models of primary care, apps and technologies to deliver care more efficiently	CareCloud, VillageMD, Aledade, Ginger.io, Dispatch

Solving a Problem

The second approach to identifying opportunities is to recognize problems and find ways to solve them. Problems can be recognized by observing the challenges that people encounter in their daily lives and through more simple means, such as intuition, serendipity, or chance. There are many problems that have yet to be solved. Commenting on this issue and how noticing problems can lead to recognizing business ideas, Philip Kotler, a marketing expert, said:

> Look for problems. People complain about it being hard to sleep through the night, get rid of clutter in their homes, find an affordable vacation, trace their family origins, get rid of garden weeds, and so on. As the late John Gardner, founder of Common Cause, observed: "Every problem is a brilliantly disguised opportunity."[12]

Consistent with this observation, many companies have been started by people who have experienced a problem in their own lives, and then realized that the solution to the problem represented a business opportunity. For example, in 1991, while leaving a local coffee drive-thru as he was taking his daughter to school, Jay Sorensen dropped a cup of coffee in his lap because the paper cup was too hot. This experience led Sorensen to invent an insulating cup sleeve and to start a company to sell it. Since launching his venture, the company, Java Jacket, has sold over four billion cup sleeves. Similarly, after watching countless women walk home barefoot after a long night in heels, New York University finance students Katie Shea and Susie Levitt started a company named CitySlips to make easily portable, comfortable shoes. They created a pair of flats that fold up to fit into a pocket-size zip pouch, which easily fits into most women's purses. When a woman pops on the shoes, the pouch unfurls into a tote bag to carry the high heels. The two began selling CitySlips in 2009; today, their product is carried in over 500 stores.[13]

Advances in technology often result in problems for people who can't use the technology in the way it is sold to the masses. For example, some older people find traditional cell phones hard to use: the buttons are small, the text is hard to read, and it's often difficult to hear someone on a cell phone in a noisy room. To solve these problems, GreatCall, Inc. is producing a line of mobile phones targeted to sell to older users. The Jitterbug Flip, for example, is a simple and easy-to-use cell phone while the Jitterbug Smart was the largest smartphone the firm produced in 2017. Both phones feature large keypads that make dialing easy, powerful speakers that deliver clear sound, easy-to-read text, and simple text-messaging capability. Another company that was founded in Australia, Kisa, has created a cell phone designed specifically for kids. The phone has a simple design and allows children to call up to 10 pre-set phone numbers. The back of the phone features an SOS button and can include medical or contact information. The large, bright display can be customized in a number of ways, including to display the names and photos of the people the child is allowed to call. For example, the screen might display boxes that say Mom, Dad, Grandma, Grandpa, Aunt Sarah, Uncle Jason, and so forth. All the child has to do is press the box to make a call. The phone is light enough that it isn't a burden for a child to carry, but durable enough to withstand a fall or two on the playground.[14]

Some business ideas are gleaned by recognizing problems that are associated with emerging trends. For example, sales of traditional low-cal sodas, like Diet Pepsi and Diet Coke, are down, largely due to growing concerns that people have with consuming artificial sweeteners. This trend has left an opening for start-ups such as Sparkling Ice and Spindrift Soda, which make carbonated beverages that are tasty but are made from natural ingredients. Similarly, the proliferation of smartphones enables people to stay better connected, but results in problems when people aren't able to access electricity to recharge their phones for a period of time. A number of companies have solved this problem in innovative ways. An example is the $70 Eton BoostTurbin 2000, which is a device that weighs less than four ounces. It combines a 2000-mAh battery with a hand crank that provides enough power to fully charge a typical smartphone. The device itself can be recharged via a USB port or the hand crank. The $155 HiNation HiLight is a little bulkier but packs more power and has multiple functions. It has a battery that can recharge an iPhone at least three times. The device itself can be recharged via solar power in about 10 hours.

On some occasions, individuals see problems that are rather obvious, but for some reason, no one has addressed them in a meaningful way. With a little ingenuity, a business can be created. For example, Jeannine Fradelizio liked to entertain. Because she lives close to Northern California's wine country, her parties always include good wine. One thing Ms. Fradelizio noticed is that when people put down their wine glass, they often forgot which one was theirs, so they would abandon the drink or reach for somebody else's. To solve this problem, she initially grabbed a marker from her drawer and scribbled people's names on the wine glasses. People liked the idea and Ms. Fradelizio realized she was on to a business idea. She needed a marker that was nontoxic, odorless, and wouldn't interfere with the bouquet of the wine. In addition, it needed to dry quickly without smudging but also needed to wash off easily. She enlisted the help of a chemist, and about a year later, the Wine Glass Writer was born. That was 2011. Today, Wine Glass Writers are sold at wineries, cooking stores, and other retailers in the United States and several foreign countries. Sales for 2015 topped $1.5 million.[15]

Additional examples of people who launched businesses to solve problems are included in Table 2.2.

Social ventures, a new type of entrepreneurial venture, are launched for the purpose of solving a range of social problems including poverty, hunger, and a lack of access to services such as water and electricity. These ventures can be for-profit firms or not-for-profit agencies. Many businesses are created when an attempt to solve a problem results in an opportunity being identified.

TABLE 2.2 Businesses Created to Solve a Problem

Entrepreneur(s)	Year	Problem	Solution	Name of Business That Resulted
Annie Halsall and Sara Maskopf	2015	In an unfamiliar area, there is no easy way for parents to know the retail locations and restaurants that are stroller friendly.	Create an online "Yelp"-like platform that allows parents to rate locations on "child-friendly" attributes	Winnie (www.winnie.com)
David Zhang and Clement Perrot	2014	No way to instantly have a physical photo to share with friends from a picture taken on a smartphone	Create an instant camera case for smartphones that can print a beautiful photo within seconds	Prynt (www.pryntcases.com)
Parking Panda	2011	There is no easy way to find a parking place in a city, particularly for a concert or a major sporting event	Create a web-based platform that allows users to find and reserve guaranteed parking in a city	Parking Panda (www.parkingpanda.com)
Sherwin Sheik	2011	It's not easy to find reliable caregivers for elderly people who would like to stay in their homes, and most professional caregiver services are expensive	Build an online platform that empowers families to easily find and hire caregivers who match their specific needs and budgets	CareLinx (www.carelinx.com)
Perry Chen, Yancey Strickler, and Charles Adler	2009	No easy-to-access platform for funding creative projects, like indie films, record albums, or food-related projects	Create a web-based "crowdfunding" platform that helps artists, musicians, and people involved in other creative projects raise money from the public	Kickstarter

SAVVY ENTREPRENEURIAL FIRM

Careem: Mobilizing a Solution to a Problem

Careem, the Middle East's first and leading taxi-booking app-based service, was created as a result of two entrepreneurs' attempts to a solve a region-wide problem. Mudassir Sheikha, a 39-year-old Stanford-educated Pakistani, and his Swedish colleague Magnus Olsson travelled extensively in their capacity as consultants for McKinsey & Company. During their travels to the Middle East and North Africa (MENA) region, they struggled to find an easy, quick, efficient, and reliable means of transportation. It also quickly became apparent that although Uber had provided a great solution to commuters' needs in many markets around the world, it had not yet entered the MENA region, and this presented an attractive opportunity. Inspired by the global transformation of taxi-booking services and recognizing an underserved market, the two tech-savvy consultants launched Careem in the city of Dubai, the United Arab Emirates, in 2012. Although Careem was initially launched for business customers, the company soon found that its users were booking rides for personal use, like airport trips, schools drops, and pick-ups.

Expanding Regionally

Careem is touted as one of the UAE's most successful start-ups, with growth of 30 percent month on month. Within five years of its launch, it has expanded to 60 cities across 11 countries, claims over 10 million registered users, and has over 250,000 contract drivers. Careem has ambitious plans to become leading transporter of people and things in the Middle East. With car ownerships as low as 2 to 5 percent in some countries and a large population of 700 million people in the region, there is a potential of between 150 million and 200 million trips a day—a huge opportunity for Careem.

Taking the Home Advantage

As a homegrown player, Careem has unmatched insight into the region's consumers, topography, infrastructure, neighborhoods, roads, and local commuting needs, allowing it to quickly act on the opportunity to develop better maps than and have a competitive advantage over Uber. Many cities and their neighborhoods in the region were inadequately covered by Google Maps and Nokia Maps, so Careem sent its own team to build a location database. The brand name, which means "generous" in Arabic, also worked very well with the local consumers.

Playing the Local Favorite

Close familiarity with the cultural and traditional values helped Careem to serve the regional markets well. In Saudi Arabia, where women were banned from driving until October 2017, Careem had a massive female following, making up nearly 80 percent of its customers. It even introduced a pre-booking facility for women so they could conveniently plan their trips. In Dubai, Careem launched its Ameera services, a ladies-only ride with a woman chauffer. In September 2016, in Saudia Arabia, Careem offered a special service during Eid-al Adha, a popular Muslim festival during which an animal, usually a sheep or a goat, has to be to sacrificed and distributed to family, friends, and the poor. This requires trips to farms, where they are sacrificed and then brought home. Careem offered to provide this service: its drivers got the animal, sacrificed it for the customers, and brought it to customers' homes according to the tradition. In situations where customers wanted the live animal to be transported to their homes, Careem arranged for pick-up vehicles for that too.

Dealing with the Rivalry

Uber entered the Middle East market in 2013 as a global brand with international appeal, changing the competitive dynamics in a growing market that presented an attractive opportunity. Both Uber and Careem adopted competitive strategies to capitalize on that opportunity. Careem already had a strong hold on the market due to its first-mover's advantage and local orientation. Due its global dominance, Uber was able to a raise $15 billion in venture capital compared to $425 million that Careem had raised. Faced with a changing competitive scenario and an aggressive opponent, Careem focused on providing more localized solutions to the region, including better maps, pre-booking services, dedicated call centers, and a varied fleet. Careem claims that other services operate only as a limo service, but it offers a different ride experience for everyone. For example, in Dubai, Careem offered different types of rides: Economy, Business, Careem Kids, MAX, First Class, and Ameera. While Uber seeks global dominance, Careem is concentrating on being a leading regional player with a strong focus on local needs and wants.

Questions for Critical Thinking

1. Identify the market gaps that Shiekha and Olson filled by launching Careem in the Middle East. What role did their personal commuting experience in the region play in identify the opportunity?
2. Comment on how being a local player helped Careem to cater to the needs of users in the region. What factors have contributed to its regional popularity?
3. As the taxi-booking segment matures in the Middle East, how relevant will factors like innovativeness and first-mover's advantage be to sustainability and continued success?
4. Considering the strong competition from global leader Uber, do you think Careem will be able to maintain its hold in the region?

Sources: Frank Kane, "Gentlemen, Start Your Engines: It's Uber vs Careem," *The National*, November 24, 2015, available at https://www.thenational.ae/business/gentlemen-start-your-engines-it-s-uber-vs-careem-1.13430 (Accessed November 7, 2017); Parmy Olson, "Meet the Unicorn That's Beating Uber in The Middle East," Forbes, June 15, 2017, available at https://www.forbes.com/sites/parmyolson/2017/06/15/dial-a-caravan/ (Accessed November 7, 2017).

"The Savvy Entrepreneurial Firm" presents the case of Careem, a car-booking app in the Middle East, which was launched by two ex-McKinsey employees who faced problems finding efficient means of transport in the region.

Finding Gaps in the Marketplace

Gaps in the marketplace are the third source of business opportunities. There are many examples of products that consumers need or want that aren't available in a particular location or aren't available at all. Part of the problem is created by large retailers, such as Walmart and Costco, which compete primarily on price and offer the most popular items targeted toward mainstream consumers. While this approach allows the large retailers to achieve economies of scale, it leaves gaps in the marketplace. This is the reason that clothing boutiques, specialty shops, and e-commerce websites exist. These businesses are willing to carry merchandise that doesn't sell in large enough quantities for Walmart and Costco to carry.

Product gaps in the marketplace represent potentially viable business opportunities. For example, Tish Cirovolo realized that there were no guitars on the market made specifically for women. To fill this gap, she started Daisy Rock guitars, a company, which makes guitars just for women. Daisy Rock guitars are stylish, come in feminine colors, and incorporate design features that accommodate a woman's smaller hand and build. In a related manner, Southpaw Guitars located in Houston, Texas, carries only guitars that are designed and produced for left-handed players. A start-up in a completely different industry is TopTal. TopTal fills a gap in the online recruiting industry by supporting a platform that enables companies to find top-notch software engineering developers and designers who are rigorously screened and are willing to work on a contract basis.

Additional examples of companies that started to fill gaps in the marketplace are provided in Table 2.3.

Gaps in the marketplace are commonly recognized when people become frustrated because they can't find a product or service they need and recognize that other people feel the same way. This scenario played out for Lorna Ketler and Barb Wilkins, who became frustrated when they couldn't find stylish

stockbroker/123rf.com

There are many gaps in the marketplace to be filled. This entrepreneur launched a start-up that runs after-school programs for students interested in STEM (Science, Technology, Engineering, and Mathematics) projects. These children recently competed in a national robotics competition for students in their age group.

TABLE 2.3 Businesses Created to Fill a Gap in the Marketplace

Gap in the Marketplace	Resulting New Business Opportunity	Name of Businesses That Resulted
No fitness centers that are open 24 hours a day	24-hour fitness centers to accommodate people who work odd hours	Anytime Fitness, 24 Hour Fitness, Snap Fitness
Lack of toys and toy stores that focus on a child's intellectual development	Toy stores, toy manufacturers, websites that sell educational toys, and toy and smartphone app combinations	Wonder Workshop, Little Bits, Osmos Genius Kit, Ubolly
Too few women pursuing careers in engineering	For-profit and non-profit organizations that teach older girls to code, after-school programs that engage school-age girls in engineering-related projects, interactive books and games that interest young girls in engineering	Girls Who Code, Engineering for Kids, GoldieBlox, Roominate
Shortage of clothing stores that sell fashionable clothing for hard-to-fit people	Boutiques and retail stores that sell fashionable clothing for hard-to-fit people, including plus-sized clothing, maternity clothes, or clothing for tall or short people	Casual Male XL, Fashions to Figure, Motherhood Maternity

"plus-sized" clothing that fit. In response to their frustration, they started Bodacious, a store that sells fun and stylish "plus-size" clothing that fits. Ketler's and Wilkins' experience illustrates how compelling a business idea can be when it strikes just the right chord by filling a gap that deeply resonates with a specific clientele. Reflecting on the success of Bodacious, Wilkins said:

> It's so rewarding when you take a risk and it pays off for you and people are telling you every single day, "I am so glad you are here." We've had people cry in our store. It happens a lot. They're crying because they're so happy (that they're finding clothes that fit). One woman put on a pair of jeans that fit her, and she called me an hour later and said, "They still look good, even at home!" Sometimes people have a body change that happens, whether they have been ill or had a baby, and there's lots of emotion involved in it. If you can go and buy clothes that fit, that helps people feel good about themselves.[16]

Sometimes gaps in the marketplace are noticed via serendipity or chance, similar to the way that problems that need to be solved are spotted. An example is the creation of Simple Gum Natural Chewing Gum. In 2012, Caron Proschan had just finished lunch of green juice and salad with a friend when she reached into her pocket for a stick of gum. When she looked at the gum, she realized it was a stark contrast to the healthy meal she had just eaten. She started looking for a healthy gum, but couldn't find one. Not to be deterred, she decided to create one. She tried to find an appropriate recipe and someone to manufacture a "healthy gum" for her, but struck out on both counts. She struck out on her own and eventually developed a gum that satisfied her. A year later, Simply Gum was born. It is now in approximately 1,200 stores across the country and is consistently a top seller in the chewing-gum category on Amazon.com.[17]

One thing entrepreneurs must remain mindful of in pursuing business opportunities, regardless of whether the opportunity results from changing environmental trends, solving a problem, or finding gaps in the marketplace, is that the opportunity must ultimately be fashioned into a successful business. The nearby "What Went Wrong?" feature focuses on Everpix, a company that resulted from its founders' frustration regarding the lack of a good service to store and organize photos. Regrettably, the founders spent too much time focused on the opportunity at the expense of the business, as you'll see in the feature.

WHAT WENT WRONG?

Why a Company That Solved a Problem with a Great Product Went Out of Business

In 2009, Pierre-Olivier Latour spent some time traveling through Asia with a friend. He became frustrated with how difficult it was to store and organize all the photos he was taking. When he returned to the United States, he discussed his frustration with Kevin Quennesson, a fellow French engineer. Quennesson had a different frustration with photos, noting that the more photos he took, the less likely he was to go back and look at them. Quennesson saw this likelihood as a paradox. The more he documented his life, the less likely he was to enjoy what he had created.

Latour and Quennesson saw the combination of their frustrations as a problem. There wasn't a good solution on the market to store and organize photos in a manner that would encourage people to go back and look at them. The two decided to start a business and build a prototype of a photo storing and organizing service that potentially solved the problem. In June 2011, they met Wayne Fan, who was working at a San Francisco firm doing interaction and visual design and brought him in as a cofounder. The three spent the next several months building a prototype of their service, which they named Everpix. The service seamlessly found and uploaded photos from your desktop and from online services, then organized them to highlight the best ones. The service was fast, the design was clean, and it was simple to use.

Everpix raised a total of $1.8 million from angel investors and continued to work on the product. The first version of Everpix 1.0 rolled out in March 2013. A free option let you see all your photos from the past year or longer if you connected to Everpix's app. For $4.99 a month or $49 a year, the service would let you store an unlimited number of photos. One cool feature, called Flashbacks, sent users daily e-mail messages of their photos from the same day in prior years. The overall service got rave reviews, and its users seemed to love it. The Everpix app had a 4.5-star average rating (on a scale of 1–5) out of more than 1,000 reviews. It seemed as though the founders were solving the problem they had set out to solve with an attractive and solid product. Then, in the summer of 2013, Everpix closed. What went wrong?

In a nutshell, Everpix's founders spent too much time and energy perfecting their service at the expense of building a business. The service wasn't viral, meaning it wasn't easy for Everpix subscribers to share photos with friends and encourage them to become Everpix members. The Everpix team realized this was a problem and kicked around ways to make the service more viral. One idea was to require a subscriber's friends to create an account to download any photos that the subscriber shared with them, but the idea was killed as just the type of self-serving design choice that the team prided itself in avoiding. It also spent almost nothing on advertising or promotions. It had spent the $1.8 million it raised on building the service. So at the time when other photo apps were attracting millions of users, Everpix had fewer than 19,000 sign-ups.

In the weeks prior to closing, Everpix's founders scrambled to raise additional funding. Because they were well-connected in the angel investing and venture capital world, they got a number of meetings. They were consistently praised on the quality of their product and the quality of the team they had assembled, but the business was the problem. Investors were getting spooked, in part, by the sheer number of apps that were being created and the ease with which consumers could switch between them. In addition, a number of Everpix's competitors were giving their services away for free, while Everpix's business model relied on paid subscriptions. One by one, the investors turned them down. Several overtures were made to potential acquirers, but none panned out. Eventually, Everpix ran out of money and didn't have the capacity to continue.

Questions for Critical Thinking

1. In the context of this chapter, make a list of three "takeaways" from this feature that you can learn from and try to avoid if you set out to solve a problem by launching a business.
2. To what degree is there a difference between pursuing an opportunity to solve a problem and building a business? In what ways did Everpix fail to do both?
3. According to the feature, Everpix spent almost nothing on advertising and promotions. How large of a role do you think that decision played in Everpix's failure?
4. Venture capitalists are often accused of swinging for the fences—in other words, they don't invest in firms that are hitting singles, doubles, or triples. They want home runs. In hindsight, do you think Everpix was building a business that had the potential to hit singles, doubles, or triples, or a business that had the potential to be a home run? Explain your answer.

Sources: C. Newton, "Out of the Picture: Why the World's Best Photo Startup is Going Out of Business." The Verge, available at https://www.theverge.com/2013/11/5/5039216/everpix-life-and-death-inside-the-worlds-best-photo-startup (posted November 5, 2013, accessed March 19, 2014); The Sublog, "Everpix, Snapchat, and The Startup Life," November 7, 2013, available at http://subimage.com/blog/2013/11/07/everpix-snapchat-and-the-startup-lie/#.Uym15qMo670 (posted November 7, 2013, accessed March 19, 2014).

Personal Characteristics of the Entrepreneur

LEARNING OBJECTIVE

3. Discuss the personal characteristics of entrepreneurs that contribute to their ability to recognize business opportunities.

How did Michael Dell come up with the idea of a "build it yourself" computer company? How did Dave Roberts, the founder of PopCap Games, figure out that there is a large and growing market for "casual" electronic games?

Researchers have identified several characteristics that tend to make some people better at recognizing opportunities than others. We've already defined an opportunity as a favorable set of circumstances that create the need for a new product, service, or business; the term **opportunity recognition** refers to the process of *perceiving* the possibility of a profitable new business or a new product or service. That is, an opportunity cannot be pursued until it's *recognized*. Now let's look at some specific characteristics shared by those who excel at recognizing an opportunity.

Prior Industry Experience

Several studies show that prior experience in an industry helps entrepreneurs recognize business opportunities. For example, entrepreneur and teacher Michael Glauser says that *experience* is one of five criteria a start-up must satisfy if it is to succeed (a genuine need, adequate resources, buying customers, and a sound business model are the other four). Of course, working in an industry is the most significant way to gain insights about a particular industry's characteristics. Specifically, Glauser says the following about industry experience:

> Knowing the products, services, and problems in an industry not only helps you avoid the pitfalls of trial-and-error learning, but it also gives interested parties the confidence that you're the right person to build this business. Your experience and credibility are very important to potential team members, investors, customers, suppliers, and strategic partners. If you don't have the skills and experience to build your business, you'll be fighting an uphill battle.[18]

There are several explanations for the importance of industry experience for start-up success. By working in an industry, an individual may spot a market niche that is underserved. It is also possible that while working in a particular area, an individual builds a network of social contacts in that industry that may provide insights that lead to opportunities.[19]

Although prior experience is important in an industry in most instances, it is also important to say that there is anecdotal evidence suggesting that people outside an industry can sometimes enter it with a new set of eyes, and as a result innovate in ways that people with prior experience might find difficult. This sentiment was expressed by Richard Branson, the founder of the Virgin Group. In a blog post, Branson was asked whether an entrepreneur needs prior knowledge of an industry to start a business in it. Branson replied:

> Please don't get hung up on this question of whether you need to have experience in an industry before you launch your startup. Instead, think about changes you'd like to see as a customer—even if you've just noticed little details that need tweaking.

Branson went on to talk about the beginnings of Virgin Music, the Virgin Group's highly successful music label and chain of retail stores:

> We went from running a small record shop to starting up a record label with recording studios and then added our large music megastores to our portfolio. Though we were music fans, we knew little about any of those businesses. But what we learned was that this wasn't necessarily a drawback. We were young and stubborn, and we liked to do things our own way; paradoxically, our enterprises thrived as a result.[20]

There are other examples of people who started successful firms without prior industry experience. For example, Travis Kalanick, Garrett Camp, and Oscar Salazar, the founders of Uber, had no prior experience in the transportation industry. Similarly, Elon Musk, the founder of Tesla, had no prior experience in the automobile industry. The takeaway is that while prior industry experience may be preferable, it is not always necessary for start-up success. In fact, in some cases it may actually work against an entrepreneur by fixing his or her mind on the "traditional" ways of doing things in an industry.

Cognitive Factors

Opportunity recognition may be an innate skill or a cognitive process.[21] There are some who think that entrepreneurs have a "sixth sense" that allows them to see opportunities that others miss. This sixth sense is called **entrepreneurial alertness**, which is formally defined as the ability to notice things without engaging in deliberate search.[22] Most entrepreneurs see themselves in this light, believing they are more "alert" than others. Alertness is largely a learned skill, and people who have more knowledge of an area tend to be more alert to opportunities in that area than others. A computer engineer, for example, could be expected to be more alert to needs and opportunities within the computer industry than a lawyer would be.

The research findings on entrepreneurial alertness are mixed. Some researchers conclude that alertness goes beyond noticing things and involves a more purposeful effort. For example, one scholar believes that the crucial difference between opportunity finders (i.e., entrepreneurs) and nonfinders is their relative assessments of the marketplace.[23] In other words, entrepreneurs may be better than others at sizing up the marketplace and inferring the likely implications.

Social Networks

The extent and depth of an individual's social network affects opportunity recognition.[24] People who build a substantial network of social and professional contacts will be exposed to more opportunities and ideas than people with sparse networks. This exposure can lead to new business starts. Research results over time consistently suggest that somewhere between 40 percent and 50 percent of those who start businesses got their ideas through social contacts.[25] In a related study, the differences between **solo entrepreneurs** (those who identified their business ideas on their own) and **network entrepreneurs** (those who identified their ideas through social contacts) were examined. The researchers found that network entrepreneurs identified significantly more opportunities than solo entrepreneurs, but were less likely to describe themselves as being particularly alert or creative.[26]

A concept that sheds light on the importance of social networks to opportunity recognition is the differential impact of strong-tie versus weak-tie relationships. Relationships with other people are called "ties." We all have ties. **Strong-tie relationships** are characterized by frequent interaction, such as ties between coworkers, friends, and spouses. **Weak-tie relationships** are characterized by infrequent interaction, such as ties between casual acquaintances. According to research in this area, it is more likely that an entrepreneur will get a new business idea through a weak-tie than a strong-tie relationship, because strong-tie relationships —which typically form between like-minded individuals —tend to reinforce insights and ideas the individuals already have.[27] Weak-tie relationships, on the other hand, which form between casual acquaintances, are not as apt to be between like-minded individuals, so one person may say something to another that sparks a completely new idea. An example might be an electrician explaining to a restaurant owner how he solved a business problem. After hearing the solution, the restaurant owner might say, "I would never have heard that solution from someone in my company or industry. That insight is completely new to me and just might help me solve my problem."

Creativity

Creativity is the process of generating a novel or useful idea. Opportunity recognition may be, at least in part, a creative process. On an anecdotal basis, it is easy to see the creativity involved in forming many products, services, and businesses. Increasingly, teams of entrepreneurs working within a company are sources of creativity for their firm.[28]

For an individual, the creative process can be broken into five stages, as shown in Figure 2.4.[29] Let's examine how these stages relate to the opportunity recognition process. In the figure, the horizontal arrows that point from box to box suggest that the creative process progresses through five stages. The vertical arrows suggest that if at any stage an individual (such as an entrepreneur) gets "stuck" or doesn't have enough information or insight to continue, the best choice is to return to the preparation stage—to obtain more knowledge or experience before continuing to move forward.

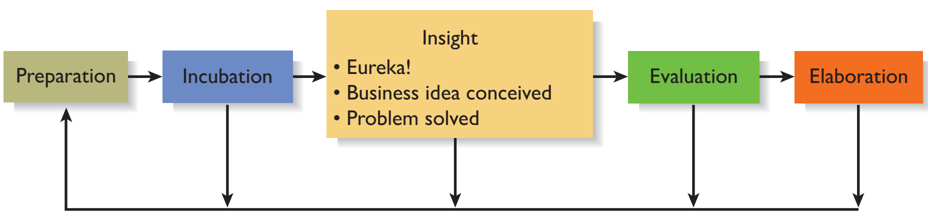
Preparation. Preparation is the background, experience, and knowledge that an entrepreneur brings to the opportunity recognition process. Just as an athlete must practice to excel, an entrepreneur needs experience to spot opportunities. Over time, the results of research suggest that as much as 50 to 90 percent of start-up ideas emerge from a person's prior work experience.

Incubation. Incubation is the stage during which a person considers an idea or thinks about a problem; it is the "mulling things over" phase. Sometimes incubation is a conscious activity, and sometimes it is unconscious and occurs while a person is engaged in another activity. One writer characterized this phenomenon by saying that "ideas churn around below the threshold of consciousness."

Insight. Insight is the flash of recognition when the solution to a problem is seen or an idea is born. It is sometimes called the "eureka" experience. In a business context, this is the moment an entrepreneur recognizes an opportunity. Sometimes this experience pushes the process forward, and sometimes it prompts an individual to return to the preparation stage. For example, an entrepreneur may recognize the potential for an opportunity, but may feel that more knowledge and thought is required before pursuing it.

Evaluation. Evaluation is the stage of the creative process during which an idea is subjected to scrutiny and analyzed for its viability. Many entrepreneurs mistakenly skip this step and try to implement an idea before they've made sure it is viable. Evaluation is a particularly challenging stage of the creative process because it requires an entrepreneur to take a candid look at the viability of an idea. We discuss how to evaluate the feasibility of new business ideas in Chapter 3.

FIGURE 2.4
Five Steps to Generating Creative Ideas



Elaboration. Elaboration is the stage during which the creative idea is put into a final form: The details are worked out and the idea is transformed into something of value, such as a new product, service, or business concept. In the case of a new business, this is the point at which a business plan is written.

Figure 2.5 illustrates the opportunity recognition process. As shown in the figure, there is a connection between an awareness of environmental trends and the personal characteristics of the entrepreneur because the two facets of opportunity recognition are interdependent. For example, an entrepreneur with a well-established social network may be in a better position to recognize emerging technological trends than an entrepreneur with a poorly established social network. Or the awareness of an emerging technology trend, such as digitization, may prompt an entrepreneur to attend conferences or workshops to learn more about the topic, expanding the social network.

Techniques for Generating Ideas

LEARNING OBJECTIVE

4. Identify and describe techiques entrepreneurs use to generate ideas.

In general, entrepreneurs identify more ideas than opportunities because many ideas are typically generated to find the best way to capitalize on an opportunity.[30] Several techniques are used to stimulate and facilitate the generation of new ideas for products, services, and businesses. Let's take a look at several of them.

Brainstorming

A common way to generate new business ideas is through **brainstorming**. In general, brainstorming is simply the process of generating several ideas about a specific topic. The approaches range from a person sitting down with a yellow legal pad and jotting down interesting business ideas to formal "brainstorming sessions" led by moderators that involve a group of people.

In a formal brainstorming session, the leader of the group asks the participants to share their ideas. One person shares an idea, another person reacts to it, another person reacts to the reaction, and so on. A flip chart or an electronic whiteboard is typically used to record all the ideas. A productive session is freewheeling and lively. The session is not used for analysis or decision making—the ideas generated during a brainstorming session need to be filtered and analyzed, but this is done later.

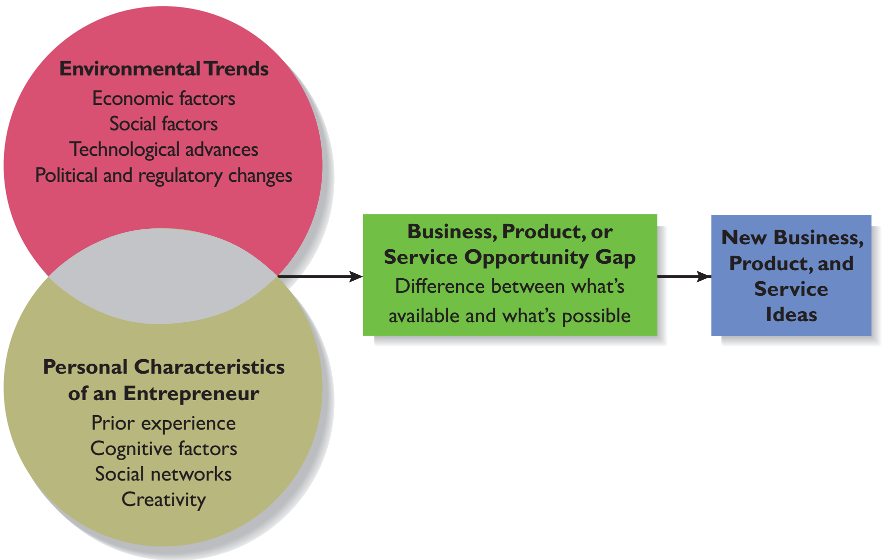


FIGURE 2.5
The Opportunity Recognition Process

ESB Professional/Shutterstock

Organizations vary in terms of how they brainstorm and generate new ideas. This start-up uses Post-it notes on a designated wall in its office suite.

We show the four strict rules for conducting a formal brainstorming session in Table 2.4. As you'll see, the number one rule for a brainstorming session is that no criticism is allowed, including chuckles, raised eyebrows, or facial expressions that express skepticism or doubt. Criticism stymies creativity and inhibits the free flow of ideas.

Brainstorming sessions dedicated to generating new business ideas are often less formal. For example, while creating Proactiv, a popular acne treatment product, Dr. Katie Rodan, one of the company's founders, hosted dinner parties at her house and conducted brainstorming sessions with guests. The guests included business executives, market researchers, marketing consultants, an FDA regulatory attorney, and others. Rodan credits this group with helping her and her cofounder brainstorm a number of ideas that helped shape Proactiv and move the process of starting the company forward.[31]

As part of the brainstorming process, some people and groups construct mind maps to organize their thoughts. A **mind map** is a diagram used to visually organize information.[32] It is hierarchical and shows the relationships

TABLE 2.4 Rules for a Formal Brainstorming Session

Rule	Explanation
1	No criticism is allowed, including chuckles, raised eyebrows, or facial expressions that express skepticism or doubt. Criticism stymies creativity and inhibits the free flow of ideas.
2	Freewheeling, which is the carefree expression of ideas free from rules or restraints, is encouraged; the more ideas, the better. Even crazy or outlandish ideas may lead to a good idea or a solution to a problem.
3	The session moves quickly, and nothing is permitted to slow down its pace. It is more important to capture the essence of an idea than to take the time to write it down neatly.
4	Leapfrogging is encouraged. This means using one idea as a means of jumping forward quickly to other ideas.

among pieces of the whole. It is created around a single concept, which is placed at the center of the page. From the center, branches are created, which reflect new and associated ideas that branch out from the central idea. Each branch can then be built on to create sub branches with additional detail. So, imagine if the creators of Coolest (www.coolest.com) had used mind mapping as part of their initial brainstorming process. Coolest makes the Coolest Cooler, which is the world's first rolling cooler with a built-in blender, Bluetooth speakers, tie-down straps (to carry items on top of the cooler), LED lights, oversized tires (great for sandy beaches), built-in USB charger, and built-in storage. In building their mind map, the founders of Coolest would have put "New Innovative Cooler" at the center of their mind map, and would have had branches that described features to be built into the cooler. Each branch would have had sub-branches further defining the feature. Ultimately, some of the features would be accepted and some would be discarded. Additional branches may have referred to topics such as costs, marketing, manufacturing, etc. The point is that a mind map may have helped the Coolest team visually organize their ideas and better see interrelationships. There are a number of online tools, such as Bubble.us, MindMode, and Mindomo that are available to assist with mind mapping.

An individual's imagination is the only limiting factor to brainstorming. Asking students to complete a **bug report** is a popular technique that is used in classrooms to teach brainstorming. To compile a bug report, students are instructed to list 50 to 75 conditions or "things" that "bug" them in their everyday lives. Asking students to identify a number of conditions or things that bug them reduces the likelihood that they will specify only obvious things that bug them (e.g., campus parking, dorm food, and untidy roommates). Students can also be encouraged to hold focus groups with friends to brainstorm conditions that can be included on their "bug" list.

Focus Groups

A **focus group** is a gathering of 5 to 10 people who are selected because of their relationship to the issue being discussed. Focus groups are used for a variety of purposes, including the generation of new business ideas.

Focus groups typically involve a group of people who are familiar with a topic, are brought together to respond to questions, and who are able to shed light on an issue through the give-and-take nature of a group discussion. Focus groups usually work best as a follow-up to brainstorming, when the general idea for a business has been formulated—such as casual electronic games for adults—but further refinement of the idea is needed. Usually, focus groups are conducted by trained moderators. The moderator's primary goals are to keep the group "focused" and to generate lively discussion. Much of the effectiveness of a focus group session depends on the moderator's ability to ask questions and keep the discussion on track. For example, a local retail establishment in which coffee is sold (think of the local coffee shop you and/or your friends frequent), might conduct a focus group consisting of 7 to 10 frequent customers and ask the group, "What is it that you *don't* like about our coffee shop?" A customer may say, "You sell 1-pound bags of your specialty ground coffees for people to brew at home. That's okay, but I often run out of the coffee in just a few days. Sometimes it's a week before I get back to the shop to buy another bag. If you sold 3-pound or 5-pound bags, I'd actually use more coffee because I wouldn't run out so often. I guess I could buy two or three 1-pound bags at the same time, but that gets a little pricey. I'd buy a 3- or 5-pound bag, however, if you'd discount your price a little for larger quantities." The moderator may then ask the group, "How many people here would buy 3-pound or 5-pound bags of our coffee if they were available?" If five hands shoot up, the coffee shop may have just uncovered an idea for a new product line.

A relatively new service called Napkin Labs helps companies funnel followers from Facebook and other sites into more intimate structured online communities that are intended to serve as focus groups. For example, Modify is a company that creates custom watches. The watches have interchangable faces, straps, and sliders and come in two sizes. Modify uses Napkin Labs to get people to chime in on what new colors and designs they'd like to see, and where they'd like to see the watches sold. Each lab poses a challenge, such as "Where should our watches be sold?" A dialogue is created among the participants. Each participant knows what the other ones are saying and can react to their comments. According to Aaron Schwartz, Modify's founder, one lab showed a surprisingly big interest in seeing his company's watches sold in surf shops. Other online companies, such as UserVoice and Get Satisfaction, help firms connect with their users in a similar manner.[33]

Library and Internet Research

A third approach to generating new business ideas is to conduct library and Internet research. A natural tendency is to think that an idea should be chosen, and the process of researching the idea should then begin. This approach is too linear. Often, the best ideas emerge when the general notion of an idea—like creating casual electronic games for adults—is merged with extensive library and Internet research, which might provide insights into the best type of casual games to create.

Libraries are often an underutilized source of information for generating business ideas. The best approach to utilizing a library is to discuss your general area of interest with a reference librarian, who can point out useful resources, such as industry-specific magazines, trade journals, and industry reports. Simply browsing through several issues of a trade journal on a topic can spark new ideas. Very powerful search engines and databases are also available through university and large public libraries, which would cost hundreds or thousands of dollars to access on your own. An example is IBISWorld (www.ibisworld.com), a company that publishes market research on all major industries and subcategories within industries.

Internet research is also important. If you are starting from scratch, simply type "new business ideas" into Google or Bing. Taking this action will allow you to see links to newspaper and magazine articles about the "hottest" and "latest" new business ideas. Although these types of articles are general in nature, they represent a starting point if you are trying to generate new business ideas from scratch. If you have a specific idea in mind, a useful technique is to set up a Google "e-mail alert" using keywords that pertain to your topic of interest. Google e-mail alerts are e-mail updates of the latest Google results including press releases, news articles, and blog posts based on your topic. This technique, which is available for free, will feed you a daily stream of news articles and blog postings about specific topics. Another approach is to follow business leaders and experts in the industries you're interested in on Twitter. The best way to locate people on Twitter you might be interested in following is by typing into the search bar relevant keywords preceded by the "#" sign. For example, if you are interested in solar power, type "#solarpower" into the search bar. All the results will be people or companies who tweet about solar power topics.

Once an entrepreneur has an idea, the challenging process of converting the idea into a profitable business begins. The remaining chapters of the book focus on this process. As explained in the nearby "Partnering for Success" feature, obtaining a mentor is one way entrepreneurs can enhance the probability of successfully using the entrepreneurial process. The feature provides a three-step process for finding a mentor and persuading the person to agree to a mentor/mentee relationship.

PARTNERING FOR SUCCESS

Want Help Converting a Business Idea into a Profitable Company? Find a Mentor

Converting a business idea into a profitable company isn't easy. Finding and using a mentor is one approach entrepreneurs can use to increase the probability of being able to convert an idea into an opportunity and company. A **mentor** is someone who is more experienced than you and is willing to offer you counsel and advice. He or she will typically have experience in some facet of your market or business. While there are many books and websites that offer advice about how to start a business, there is nothing like having an experienced person in your corner to answer questions, provide support, and help you over the rough spots.

So how does one go about finding a mentor and persuading the person to agree to a mentor/mentee relationship? It's a three step process.

Step 1: Identifying Potential Mentors

First, consider your network of acquaintances—professors, business owners, coaches—to identify if there is someone you believe could be helpful to you. Many first-time entrepreneurs are surprised by the number of people who are eager to share their expertise and enter into a mentoring relationship. Second, if you're currently in college or are a college graduate, look for someone in your college or university's alumni network. Alumni often serve as judges for college-sponsored pitch or business plan competitions, so that's one way to connect. Another way is via LinkedIn. In the LinkedIn search bar you can type in the name of your university and then the functional title of the type of help you're looking for. For instance, if you're a student at Oklahoma State University and you're looking for help raising money, you might type in CFO Oklahoma State University. The results will list everyone who has a LinkedIn Profile who identifies themselves as a CFO (Chief Financial Officer) and is a graduate of Oklahoma State University. You can then connect with that person through the private e-mail service within LinkedIn. Most people have fond memories of their college days and are delighted to connect with a student at their alma mater.

A third approach is to search through websites, magazine articles, and attend networking events that might alert you to someone who could be a good fit. For example, 1 Million Cups is a networking event that is sponsored by the Kauffman Foundation and meets once a week in 111 cities across the United States. You can go to the 1 Million Cups website (www.1millioncups.com) and find the location nearest you. Every Wednesday morning, one or two early stage start-ups present their companies to a diverse audience of peers, educators, and advisors. It's a great place to make connections.

Step 2: Making the Initial Contact

Reaching out to potential mentors is a tricky process. The type of person you'll want as a mentor is in a leadership position and is busy so the way you approach them matters. Most people reach out by e-mail. If you follow this route, here are some rules-of-thumb for approaching a potential mentor via e-mail:

- Put thought into the subject line. Think of something that will resonate with the recipient. For example, if you're a student at Notre Dame and you're trying to connect with a Notre Dame alumni, you might put "Notre Dame student looking for quick advice on how to connect with an angel investor."
- Keep the e-mail short and to the point. Long e-mail messages won't be read.
- Tell the person why you're reaching out to him or her specifically to avoid the impression that your e-mail is a mass mailing.
- Give a precise summary of who you are, what you want to accomplish, and, if possible, something you can offer. Sometimes, all you have to offer is heartfelt appreciation. If that's the case, make sure to offer it.
- Ask for something specific. Don't say something along the lines of, "I am looking for an experienced entrepreneur to mentor me through the start-up process." In most cases, that's asking for too much, at least to start. Instead, ask for something specific. For example, if you're starting a food company and the person you're reaching out to sells products at Whole Foods, you might ask for advice about how to approach Whole Foods to carry your product.

Step 3: Managing the Mentor/Mentee Relationship

Be patient. Mentor relationships take time to develop. Your early interactions may be brief and to the point, and grow in length and substance over time. Also, make it easy for your mentor to work with you. If your mentor's best time to talk is from 6:00 to 6:30 pm while he or she is driving home from work, make it work on your end. Also, remember that people are much more apt to maintain a relationship with someone who is respectful, polite, humble, and fun.

Be sure to follow-up with your mentor with updates as you make progress. If your mentor gives you a piece of advice that leads to a positive outcome for your business, let the mentor know that their advice paid off. Develop a little bit of a thick skin, and let your mentor know that it is fine with you for her or him to tell you that you made a mistake or that your approach is all wrong. Also, don't be reluctant to ask your mentor penetrating questions such as, "What would you do if you were in my shoes?" or "What are the areas you think I need to improve on the most?"

Finally, if you develop a relationship with a mentor that's paying off, protect it. Be respectful of their time, be appreciative, and don't recommend them to others without their permission. Also, find ways to give back, even if it's something as simple as occasionally shooting your mentor a link to an article on a subject in which you know your mentor has an interest.

Questions for Critical Thinking

1. At this point in your educational process, your business (if you're starting one), and in your life in general, in what areas do you believe you could benefit the most from having a mentor? What would your expectations be for the mentor/mentee relationship?
2. Make a list of the opportunities on your campus and the surrounding community for connecting with potential mentors. Which opportunities do you think would be the best bet for you in terms of connecting with a potential mentor?
3. Go to LinkedIn and type in the name of your university and a functional area (marketing, finance, entrepreneurship, engineering, etc.) in which you have an interest. How many search results did the query produce? As you scanned the search results, did you notice anyone with whom you would like to connect?
4. To what degree do you believe having a mentor can make the difference between an entrepreneur succeeding or failing? Have you had a mentor at any point in your life? If so, briefly relate the manner in which your mentor was able to help you.

Sources: S. Shellenbarger. "Cold Call Your Future Mentor," *The Wall Street Journal*, October 19, 2016, D1; R. DiResta, B. Forrest, and R. Vinyard. *The Hardware Startup*, Cambridge, England: O'Reilly, 2015.

Other Techniques

Firms use a variety of other techniques to generate ideas. Some companies set up **customer advisory boards** that meet regularly to discuss needs, wants, and problems that may lead to new ideas. Other companies conduct varying forms of anthropological research, such as **day-in-the-life research**. Intuit practices day-in-the life research. The company routinely sends teams of testers to the homes and businesses of its users to see how its products are working and to seek insights for new product ideas. Intuit uses this technique for its major products: Turbotax (tax preparation and return services), Mint (helps customers manage their everyday finances), Quickbooks (companies are able to track sales, expenses, accept payments, and so forth), and Proconnect (professional tax software).

Chapter Summary

LO1. An idea is a thought, an impression, or a notion. An opportunity is an idea that has the qualities of being attractive, durable, and timely and is anchored in a product or service that creates value for its buyers or end-users. Not all ideas are opportunities. Once an opportunity is recognized, a window opens, and the market to fill the opportunity grows. At some point, the market matures and becomes saturated with competitors, and the window of opportunity closes.

LO2. Observing trends, solving a problem, and finding gaps in the marketplace are the three general approaches entrepreneurs use to identify a business opportunity. Economic forces, social forces, technological advances, and political action and regulatory changes are the four environmental trends that are most instrumental in creating opportunities. Through the second approach, entrepreneurs identify problems that they and others encounter in various parts of their lives and then go about developing a good or service that is intended to solve the identified problem. Carefully observing people and the actions they take is an excellent way to find problems that, when solved, would create value for a customer. Finding gaps in the marketplace is the third way to spot a business opportunity. Typically, the way this works is that an entrepreneur recognizes that some people are interested in buying more specialized products, such as guitars that are made for left-handed players or scissors for people who are dominant left-handers.

LO3. Over time, research results and observations of entrepreneurs in action indicate that some people are better at recognizing opportunities than others. Prior experience, cognitive factors, social networks, and creativity are the main personal characteristics researchers have identified and that observation indicates tend to make some people better at recognizing business opportunities than others.

LO4. Entrepreneurs use several techniques for the purpose of identifying ideas for new products and services. Brainstorming, which is a technique used to quickly generate a large number of ideas and solutions to problems, is one of these. One reason to conduct a brainstorming session is to generate ideas that might represent product, service, or business opportunities. A focus group, a second technique entrepreneurs use, is a gathering of 5 to 10 people who have been selected on the basis of their common characteristics relative to the issue being discussed. One reason to conduct a focus group is to generate ideas that might represent product or business opportunities. Careful and extensive searches of a physical library's holdings and of Internet sites are a third technique. Here, the entrepreneur uses an open mind to sort through large amounts of information and data to see if he or she can identify a problem that could be solved by creating an innovative product or service.

Key Terms

brainstorming, **89**
bug report, **91**
creativity, **88**
customer advisory boards, **94**
day-in-the-life research, **94**
entrepreneurial alertness, **87**
focus group, **91**
idea, **74**
mentor, **93**
mind map, **90**
network entrepreneurs, **87**
opportunity, **72**
opportunity gap, **73**
opportunity recognition, **86**
solo entrepreneurs, **87**
strong-tie relationships, **87**
weak-tie relationships, **87**
window of opportunity, **73**

MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

2-1. What is a product opportunity gap?
2-2. How can an entrepreneur tell if a product opportunity gap exists?
2-3. What is an opportunity?
2-4. What are the qualities of an opportunity, and why is each quality important?
2-5. What four environmental trends are most instrumental in creating business opportunities? Provide an example of each environmental trend and the type of business opportunity it might help create.
✪ 2-6. How can "solving a problem" create a business opportunity for an entrepreneur to pursue?
2-7. How can finding a gap in the marketplace create a business opportunity?
2-8. What is the meaning of the term opportunity recognition?
2-9. What are the two caveats that an entrepreneur should keep in mind when observing environmental trends to create new business opportunities?
2-10. What is entrepreneurial alertness and why is it important to entrepreneurs?
2-11. How does an extensive social network provide an entrepreneur an advantage in recognizing business opportunities?
✪ 2-12. What is the difference between a weak-tie and a strong-tie relationship? Which type of tie is most likely to help an entrepreneur find an idea and why?
2-13. What is brainstorming?
2-14. How does creativity contribute to the opportunity recognition process?
2-15. What are the five stages of the creative process for an individual?
2-16. What are the differences between an opportunity and an idea and why are those differences important for entrepreneurs?
2-17. Why is "no criticism" the number-one rule for brainstorming?
2-18. How is a focus group used to generate new business ideas?
2-19. How does a firm encourage and protect new ideas?

Application Questions

2-20. Sean Parker has decided to start his own business. He plans to find an attractive opportunity and start an e-commerce company, just as Jeff Bezos did when he created Amazon.com. As a new entrepreneur fresh out of college, he needs to recognize a problem or an opportunity gap and create a business to address the problem or fill the identified gap. However, he still does not understand the difference between an idea and an opportunity. How can he ensure that his new idea is an opportunity for him instead of just an idea?

2-21. Identify three start-ups, other than those discussed in this chapter or listed in Table 2.2, that were started to solve a problem. Briefly describe the problems the three start-ups are solving and how they are going about doing so.

2-22. Second-hand and vintage clothes shops were once regarded as the shopping venue for the less fortunate. In many cities and towns around the world, these stores have now become must-visit locations over common chain retailers. The draw is being able to find fashionable clothes that regular retailers do not stock as they are tied to fast-moving fashion trends. At second-hand and vintage clothes shops, customers can instead find timeless, stylish, and durable pieces at reasonable prices. As an entrepreneur, how would you assess the demand for this type of retail outlet?

2-23. As the founder of Masie's Ice-Cream Parlor, James North has newly appointed a creative manager for his outlet. He needs to advise his new manager to keep a lookout for new ideas and opportunities that can be introduced to his business. What are the key points he needs to mention to his manager?

2-24. It is commonly believed that business cannot happen in a bubble, so do solo entrepreneurs actually exist? If an entrepreneur attempts to create and run a business based on their own hard work and without a support network, it cannot succeed. Are solo entrepreneurs doomed to fail, then? Are such individuals as solitary as we think?

2-25. Make a list of your strong-tie and weak-tie relationships. Include at least five ties on each list. Select two names from your list of weak-tie relationships and speculate on the types of new business ideas you think these individuals would be uniquely qualified to help you contemplate.

2-26. Haley Branson, an enthusiastic young entrepreneur, has tried a few times to establish a business based on ideas in her area of interest. However, all her previous ventures have failed. She is quite upset, especially because she had a lot of faith in her ideas. How would you explain to Haley why her ideas were not successful?

2-27. How could Jamie Heywood and Ben Heywood, the cofounders of PatientsLikeMe, the subject of Case 1.2 in Chapter 1, have utilized library and Internet research to flesh out their business idea?

YOU BE THE VC 2.1 COMPANY: PillPack

• **Web: www.pillpack.com** • **Facebook: PillPack** • **Twitter: @PillPack**

Business Idea: Create an online pharmacy that is easier to navigate than traditional pharmacies by (1) syncing all prescriptions so they can be refilled at the same time, (2) delivering by mail exactly what each customer is required to take for 14 days, and (3) sorting each customer's medications into a chain of small plastic envelopes that contain the exact medications that a customer needs to take labeled by day and time of day.

Pitch: Approximately 10.6 percent of the American population, or 30 million people, take five or more prescription drugs per day. Many people in this category visit their pharmacy multiple times per month because their prescriptions aren't synced. Once they get home, they have to sort their medications into daily doses. This task can be difficult for elderly patients, who may be taking different meds at different times of the day. It's also hard for people who have hands that shake or whose eyesight is failing, and who find it difficult to sort medications into pill boxes as a result.

PillPack, which is an online pharmacy, has developed a system that provides a solution to these problems. First, the company syncs all of its customers' prescriptions so they can be refilled at the same time. Second, the prescriptions are delivered by mail every two weeks in a small, discreet, tamper-evident box. Third, inside the box is a recyclable plastic dispenser—a PillPack—with a large decal on the side displaying images and descriptions of each of the medications inside. Rolled inside each PillPack is a chain of small plastic envelopes, each of which holds the specific prescriptions, over-the-counter medications, and vitamins that a customer is supposed to take, labeled by day and time of day. Each envelope can easily be torn from the chain. No more sorting. No more pill boxes. No more waiting in line at the pharmacy. PillPack applied design thinking principles (see https://designthinking.ideo.com/?p=409 for a description of these principles) to make the ordering and taking of medications as simple and error-free as possible.

PillPack's target market is individuals who take five or more prescription drugs a day. It was conceived by T. J. Parker, who grew up working in his father's family-owned pharmacy. He often delivered medications to his father's customers, and the sight of customers with piles of pill bottles and computer spreadsheets taped to refrigerator doors (to help them sort and remember to take their medications on time) convinced him there had to be a better way. After graduating from the Massachusetts College of Pharmacy and Health Sciences in 2012, Parker started the process of creating PillPack.

PillPack, which launched in early 2014, is a full-service pharmacy available in 49 states. Its service is free, and its customers generally pay only their usual co-pay. To sign up for PillPack, individuals go to PillPack's website and enter the names of all the medications they are taking and the pharmacy they are currently using. PillPack takes care of the rest.

2-28. Based on the material covered in this chapter, what questions would you ask the firm's founder before making your funding decision? What answers would satisfy you?

2-29. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 2.2 COMPANY: soleRebels

• **Web: www.solerebels.com, gardenofcoffee.com** • **Facebook: www.facebook.com/soleRebels** • **Twitter: @solerebels**

Business Idea: Create products that utilize recycled and natural products and use handcrafting skills.

Pitch: Bethlehem Tilahun Alemu was born and raised in Addis Ababa, Ethiopia. When she left college in 2005, she founded what would become Ethiopa's first global brand, soleRebels. The footwear company is a community-based operation that has grown into a World Fair Trade Federation (WFTO) fair trade–certified business as well as the very first global footwear brand created in a developing nation.

In just a decade, the business has come to be described as Africa's Nike, with an international presence. The company sold around 125,000 pairs of shoes in 2016 and has created over 1,200 jobs. In 2018, the company will expand to 3,000 Ethiopian employees when their new production facilities have been built, and it will have increased revenues to over $10 million.

From the outset, the company was determined to distance itself from the concept of "pity purchasing," the notion that consumers would be encouraged to buy the product based on charity and to support developing nations rather than on the basis of its quality, design, and value. As a result, the brand is artisan-oriented; it wants its consumers to know, understand, and appreciate the individuals involved in the design and creation process.

Cultural preservation is also important to the brand. The products aim to use the cultural arts of Ethiopia. Original designs use car tyres as soles, and the sandals are the traditional styles worn by Ethiopian soldiers and civilians for generations. Each style has a range of unique colors aiming to appeal to an international market.

In 2016, Alemu launched a new venture in Addis Ababa, Ethiopia's first branded roastery café. The concept was to redefine the coffee supply chain and create a brand that celebrated the best in Ethiopian coffee culture. Alemu christened the concept "origin trade," as opposed to fair trade and other derivatives. Alemu has learned a great deal from her soleRebels business, and her new enterprise, Garden of Coffee, is set to open roastery cafés in the United States, Germany, China, Japan, the United Kingdom, and Australia.

The key differentiator is that the whole operation will be controlled, owned, and run by Ethiopians from bean to cup. Garden of Coffee will source, export, roast, and retail the coffee. In the roastery cafés, customers will be able to have their coffee roasted to order on site. The skilled roasters will use traditional pan-roasting techniques, with customers able to choose from six roasting levels. The customers will also be able to choose from a wide range of green coffees from established Ethiopian coffee-growing regions. Garden of Coffee has developed a distinctive image for each Ethiopian growing region. The packaging features traditional colors and crafts associated with the region and incorporates a map to show where the coffee was grown. The packaging also features the bean variety, the roast level and date, the name of the roaster, and where it was roasted.

2-30. Based on the material covered in this chapter, what questions would you ask the firm's founder before making your funding decision? What answers would satisfy you?

2-31. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 2.1

PledgeMusic and Zinepak: Creating New Businesses in the Music Industry by Directly Engaging Fans

• Web: www.pledgemusic.com • Facebook: PledgeMusic • Twitter: @PledgeMusic
• Web: www.zinepak.com • Facebook: The ZinePak • Twitter: @ZinPak

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Opportunities are tough to spot, but once spotted, can lead to the creation of businesses that bring renewed excitement to an industry. That's the case with the two start-ups featured in this case. They're both music industry start-ups, and are both based on the recognition that so called "Super Fans" of entertainers weren't getting everything they wanted. They've both brought fresh new concepts to the music industry, and in the process have created new revenue streams for musicians and new ways for fans to engage with their favorite bands. We first describe PledgeMusic and then ZinePak.

PledgeMusic

In the early 2000s, Benji Rogers was making a living as a musician. When he did live shows and played the songs that were familiar to his fans, people would often come up to him and say, "What are you working on next? Are you working on any demos?" So, he'd put the demos up for free in various places, but they weren't making any money for him. The thought occurred to him that what he really wanted was a solution that would allow him to say to his fans, "Pre-order my next album now, it will fund the entire recording process, and in addition to shipping you the album when it's done I'll let you watch the entire process." As a musician, one thing that frustrated Rogers was that music fans were limited in the amount of money they could spend. They could buy an artist's music, go to concerts, and buy t-shirts if they were available, but there was no way to go beyond that. In Rogers' view, the music industry was literally leaving money on the table. Each band has "Super Fans" who would gladly spend more money if there was something to spend it on.

Rogers suggested his idea to several music industry executives thinking that the notion was good enough that someone would run with it. In each instance the reply he got was "Why don't you build it yourself?" A pivotal moment came at a show Rogers was playing in Amsterdam. A fan who came up to him afterwards turned out to be an intellectual property lawyer. Rogers shared his idea with him about creating a platform that would allow fans to pre-order albums in exchange for the album and for getting to watch how the album was made, and the fan said, "Don't tell anyone else this idea—I want to help you bring it to market."

In 2009, PledgeMusic, the company Rogers started to bring his idea to market, was born. The fan he met in Amsterdam helped provide funding. Broadly speaking, PledgeMusic resembles crowdfunding platforms like Kickstarter and Indiegogo, where people are able to raise money to fund projects. The original setup closely resembles how PledgeMusic operates today.

Here's how it works. Musicians are able to setup one of two types of projects with the first one being a targeted project. Targeted projects have a specific monetary goal they are trying to reach. Usually, this means the artist needs that amount of money to complete a project (such as a CD). Similar to Kickstarter, targeted projects need to reach their funding goal to be successful. They can go over the goal but not under. If a project's goal isn't met, anyone who made a pledge will not be charged. The second type is a non-targeted project. Normally, these are pre-orders for things that are already going to be made.

Similar to most crowdfunding platforms, a project includes a page where the musician or band posts a video that explains the purpose for which money is being raised. It can be an album, music video, concert tour, or some other music-related initiative. The album, music video, or whatever the band is raising money for can be pre-ordered. You can also pledge varying amounts of money in exchange for some type of amenity. The amenities vary with the amount of the pledge. A $10 pledge may get you a digital download of the album when it comes out, while larger pledges get you highly personalized products like a Skype chat with the artist, a day in the artist's studio watching him or her record, or even an appearance on an album. Some of the personalized experiences are pricy, but provide once-in-a lifetime experiences. For example, when this feature was written (Spring 2017) Morgan Jones, a soul, rhythm and blues singer and songwriter was running a PledgeMusic project to sell pre-orders for a new album. A $10 pledge earned you a digital download of the album, a $55 pledge got you a signed copy of the album along with several others items, and a $100 pledge netted you lyrics of your favorite Morgan Jones song handwritten and signed by the artist. A $25,000 pledge got Jones and her entire band to play at your wedding! Each PledgeMusic pledge is accompanied by AccessPass, which is integral to Rogers' original vision and the unique way in which PledgeMusic adds value. The AccessPass is what allows you to watch how the project to which you pledged is made. As the album or music video is being produced, you'll be sent a steady stream of exclusive content that shares the journey with you. The content will include video, audio, and photos. The content provides a window into the creative process, and shares with you how an album or music video is made and what your favorite musicians are like in private. From the musician's perspective, the AccessPass provides an incentive for a fan to make a pledge, helps create a community of fans, and builds interest for the release of the album or video. From an opportunity recognition perspective, the engagement opportunities that PledgeMusic offers music fans is the gap it is filling in the marketplace. Refer to the figure shown below. The figure shows three sectors of the music industry and the specialty or emphasis of each sector. The music industry (broadly) allows fans to consume, the traditional crowdfunding platforms allow musicians to fund (raise money) and PledgeMusic allows music fans to engage.

ZinePak

Similar to PledgeMusic's founder Benji Rogers, Brittany Hodak and Kim Kaupe, the founders of ZinePak, recognized that passionate music fans want more than music. They want to connect with their favorite musicians in deeper ways. Attending a concert may achieve that in part. But concerts are not only expensive but are few and far apart. Many people who are Katy Perry fans, for instance, want to know more about her but may never attend a Katy Perry concert. This is where ZinePak comes in.

Hodak and Kaupe met in 2010 while working at an advertising agency in New York City. Hodak came from a background in music while Kaupe came from a publishing background. At that time, musicians were just learning how to connect with their fans beyond the music. Facebook was in place and Twitter was just catching on. Most musicians updated their Facebook pages once a week and were just learning how to Tweet. There was no Instagram, Snapchat, or Periscope and Spotify was just making its way across the ocean from the United Kingdom. Hodak had the idea that she and Kaupe should start a business together. Her idea was based on the premise that while a musician's casual fans may be satisfied buying a CD and listening to the music, passionate—so called "Super Fans"—want more. The specific idea, which Hodak had had since college, was to start a company that would create custom, interactive content for music super fans. An example would be to create a limited-edition version of Taylor Swift's new CD. The limited-edition version would include the CD, which alone would sell for $15.99, along with a 64-page magazine-style book that would include an interview with Swift, interviews with her hair stylist and videographer, stickers, temporary tattoos, posters, magnets, behind-the-scenes photos, and other items of interest. That package could sell for more and provide Swift's fans a way to "engage" with her and her music on a deeper level. There was one more piece to the puzzle. Retailers who sold CDs were experiencing shrinking sales. Providing them a way to increase CD sales, Hodak reasoned, by bundling CDs with engaging content, would be appealing to potential sellers of their product.

Hodak and Kaupe decided to run with the idea and ZinePak was launched in 2011. The custom products they envisioned creating for musicians would carry the same name as their company and be called ZinePaks. The business followed the agency model, where they would create the ZinePak and then hand it off to a band or a retailer to be distributed and sold. That would keep their initial investment low and allow them to self-fund the company. Their first client was Kidz Bop, which is brand of album featuring kids singing contemporary

What Different Sectors of the Music Industry Specialize In

Music Industry	Crowdfunding Platforms	PledgeMusic
Consume (buy music)	Fund (raise money)	Engage (share the journey)

Billion Photos/Shutterstock

PledgeMusic provides a platform for musicians like this country singer to raise money. The money can be for a CD, music video, concert tour or any other music-related initiative.

popular songs. The project went well and provided them their first proof of concept. The first year they did a total of 6 projects and the following year they did 24. Hodak, Kaupe, and one employee were "it" the first two years, with the assistance of freelancers. The printing and binding was done by third party vendors, but Hodak and Kaupe maintained control of the process. Most ZinePak's are sold for $3 to $5 more than the CD alone. Some are sold by musicians and bands while they're on tour and some are sold through retailers like Walmart.

In 2014, Hodak and Kaupe were approached by Shark Tank to appear on an episode. The episode was taped in September 2014 and aired in April 2015. To prepare for the show, they watched two seasons of Shark Tank episodes, and made a list of all the questions the sharks asked the participants. They then rehearsed how they would answer the most frequently asked questions. They asked for $725,000 in exchange for 10 percent equity in their company. They ended up making a deal with Robert Herjavec and Barbara Corcoran, for slightly different terms, which, after the show, didn't pan out. They did experience the "Shark Tank Bounce" that many Shark Tank contestants experience. They picked up jobs from both the New York Mets and the Boston Red Socks as a result of the Shark Tank episode. Both organizations contacted them because they had seen the show.

To grow the company, ZinePak has expanded beyond music and now creates ZinePaks for professional sports teams, brands, movie studios, athletes, and fashion labels. It takes 8–10 weeks to complete a ZinePak. The idea remains engagement. It benefits almost any entertainer, sports team, personality, or major event (like the Academy of Country Music Awards) to have high-quality content to sell to their most passionate fans. In fact, although ZinePak started as an unknown, the tables have turned some and artists are now calling the company saying, "We have to have a ZinePak." That demonstrates the quality of the idea and the need ZinePak is filling in the marketplace.

The table shown below provides a sample of the entertainers and others for whom ZinePak has produced limited-edition ZinePaks.

A Sample of the Entertainers and Others for Whom ZinePak Has Created ZinePaks

Katy Perry	Academy of Country Music
Brad Paisley	Disney's Frozen
KISS	American Girl
Johnny Cash	New York Mets Kids Club
Toby Keith	Boston Red Socks Kid Nation Passports
Taylor Swift	Duke Basketball Camp
Justin Bieber	DigiTour

Discussing Questions

2-32. What environmental trends are working in favor of PledgeMusic and ZinePak? What environmental trends are working against each company?

2-33. What gap or gaps in the marketplace does both PledgeMusic and ZinePak fill? On a scale of 1 to 10 (10 is high), how elegantly do you think each company is filling the gap or gaps you identified?

2-34. Suggest one or two additional business ideas that would allow musicians to better engage with their Super Fans.

Sources: PledgeMusic Homepage, www.pledgemusic.com (accessed February 4, 2017); ZinePack Homepage, www.zinepack.com (accessed February 4, 2017); B. Rogers and A. Warner, "How Benji Rogers is Revolutionizing the Music Industry with PledgeMusic," Mixergy Podcast, available at https://mixergy.com/interviews/benji-rogers-pledgemusic/ (posted April 20, 2015, accessed February 4, 2017); K. Kaupe and J. Agolli. "TE 2.7 Kim Kaupe: Co-Founder of Zinepak, available at https://www.stitcher.com/podcast/jordan-agolli/teenage-entrepreneur/e/te-27-kim-kaupe-cofounder-of-zinepak-44963070 (posted June 19, 2016, accessed February 4, 2017).

CASE 2.2

Rover.com: Don't Chuckle: This Is One Impressive Business Idea

• Web: www.rover.com • Facebook: Rover.com • Twitter: @RoverDotCom

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Jill is a 26-year-old sales rep for a technology company. She lives in a two-bedroom townhouse with her golden retriever Rex. Jill travels about twice a month, and when she's gone, she has three options regarding care for Rex. Option #1—She can ask a neighbor to watch him, but that's hit-and-miss, and she hasn't found anyone she can depend on; Option # 2—She can take him to her parents' house, but they live about an hour away; and Option #3—She can take Rex to one of the two kennels that are close to where Jill lives. There is nothing wrong with them, but they are typical kennels. The dogs are cooped up most of the day, and a month ago, Rex came home from the kennel with a cough he picked up from another dog.

Jill loves Rex and has no plans to give him up, but every time she travels, it's a problem to decide what to do with Rex.

A Bad Experience at a Kennel Leads to a Business Idea

Many people are just like Jill. They either have trouble finding suitable arrangements for their dog when they travel, or they feel badly when they're packing for an exciting trip with their dog's big, sad eyes staring at them. The idea for Rover.com—a service that connects dog owners with dog sitters and walkers—occurred to Greg Gottesman after his yellow Labrador Ruby Tuesday had a bad experience at a traditional kennel. To see if the idea had legs, Gottesman pitched it at a Startup Weekend event in Seattle in 2011. Startup Weekends are events held across the country. Anyone can pitch a business idea and get feedback from peers. Gottesman's idea received top prize, and six months later, he launched Rover.com.

Although Gottesman may have had a good pitch, a little research helped validate the business idea. More than 54 million U.S. households have a dog. The pet grooming and boarding market is about $5.7 billion a year. More encouraging is that the market could be much larger in that, currently, only 8 percent of dog owners take their dog to a kennel when they are out of town. As a result, 92 percent of dog owners are like Jill, the dog-owner profiled above, who scrambles to find a place for her dog while she's planning a trip. In addition, surveys show that the majority of Americans see their pets as family members. In fact, those with dogs are more likely to see themselves at pet "parents" than dog "owners." Overall, annual spending on pet food and products in America has risen by around 40 percent over the past 10 years. There is another factor that plays a critical role; namely, the rise of the peer-to-peer economy, pioneered by companies such as Airbnb, Uber, and Lyft, shows that people are willing to use online platforms to connect with other people to satisfy a need. Putting all these factors together, to Gottesman it didn't seem like a stretch to believe that people would spend money on a service that would connect people who needed their dogs watched with people willing to do it. Gottesman's intuitions have proven to be correct. In 2016, Rover.com took in more than $100 million connecting dog owners and dog sitters. It has 65,000 sitters in 10,000 U.S. communities, and someone books its service every eight seconds. And just as Gottesman suspected, two-thirds of Rover's customers come from people who previously used family, friends, and neighbors for pet care.

How Rover Works

Rover's service is run through its website and app. If you are a dog owner, you simply follow the prompts on the website, which ask you to identify your location and select the dates you need your dog to be watched. You can indicate whether you'd like your dog to be watched at your home or the sitter's household. You're then provided profiles of Rover approved dog sitters in the area. The profile includes prices (per night), photos, reviews, certifications, and a full description of the sitter. The reviews are particularly helpful. For example, a Rover.com customer wrote the following about Ella, a Rover.com sitter in Stillwater, Oklahoma: "Ella has taken care of my high maintenance dogs on several occasions and has done a wonderful job. My dogs are both rescues so they are very skittish around new people. Ella was more than happy to spend all the time necessary to get my pups comfortable with her in order to provide the best care. I would recommend Ella to anyone who is looking for a very personable, caring dog-sitter/walker." Rover sitters charge between $10 and $150 per night (Ella charges $40). In San Francisco, Rover's biggest market, there are over 500 sitters registered on the site.

Rover also offers drop-in visits, doggy day care, and dog walking. A drop-in visit consists of a sitter stopping by your home for 30 visits to feed and play with your dog. Clients are charged on a per-visit basis (usually around $15). This service works particularly well for elderly people who want to keep their dogs but struggle to provide basic care. Doggy day care allows you to drop off your dog at a sitter's house, while you are at work or unavailable during the day. It can be a one-time visit, or follow a regular schedule, like Monday through Friday from 7:30 am to 5:30 pm. The sitter will care for the dog and make sure it gets plenty of play time. Dog walking is similar to drop-in visits. A sitter will stop by your house and walk your dog for 30 minutes. That usually costs around $15 per visit. When Rover launched in 2011, it offered only its overnight pet watching service. Adding the additional services has not only been good for Rover, but it's been good for its 65,000 sitters. It has provided them additional streams of income, which has encouraged some of them to quit their regular jobs and make Rover their full-time living.

If you'd like to become a Rover sitter, the website walks you through the application process. You must create a profile and be approved by Rover. There is a careful vetting process, and the company approves about 20 percent of its applicants. Rover handles client billing and takes a 15 percent commission for its part. Top Rover sitters earn several thousand dollars a month. A Rover sitter can also work as much or as little as they want. A sitter's profile includes a calendar indicating when the sitter is available. The average stay for a dog at a sitter's home is just over four days. Rover tries to take care of both the dog owner and dog sitter by offering additional layers of protection. For example, every stay booked through Rover includes premium insurance for emergency vet bills, property damage, liability, and more.

Making Things Fun

Rover makes things fun for both its dog owners and dog sitters. In 2013, for example, it introduced Rover Reel, which offers Rover customers free videos of their dog's experience during their stay with a Rover sitter. All the sitter has to do is take five or more photos of the dog under his or her care, send the

To assure dog owners and make things fun, Rover.com has an app that allows sitters to send photos of the dogs they are watching during their stay.

Martin Novak/Shutterstock

pictures to Rover's support team, and the support team will create a video album with background and music, and send a copy of it to the dog owner. It's pretty cool and can be shared online. Rover's newest invention is Rover Cards, which is now part of its mobile app. Rover Cards let care providers share real-time information with the dog's owner, such as a GPS-powered map of the dog's walk, photos, and other messages.

Rover also encourages a "meet-and-greet" session before a dog owner tries a sitter. This suggestion recommends that the dog owner (with their dog in tow) meet the dog sitter at a mutually agreed upon time and place to talk before they try each other out. The meet-and-greet can be arranged through Rover's website.

Challenges Ahead and Growth Plans

Rover's potential has garnered plenty of attention. It now has several direct competitors, including Jogs for Dogs and DogVacay. Rover plans to expand internationally. Several similar services have popped up in different countries, including Australia, Brazil, and Britain. Even though Rover is in 10,000 communities, the majority of its business is centered in large cities. One thing the company hopes to do is expand its business in suburban areas and smaller towns.

To date, Rover has raised $90.9 million in funding. Its latest raise was a Series E round of funding of $40 million in September, 2016. It anticipates an initial public offering in 2018. The company doubled its size from 2015 to 2016 and now has 175 employees.

Discussion Questions

2-35. In the United States, what environmental trends are supporting the development of Rover.com's business?

2-36. How might Rover.com use focus groups to gain a better understanding of its current and potential customers and their needs?

2-37. In this chapter, we noted that a true business opportunity is attractive, durable, timely, and anchored in a product or service that creates value for a buyer. To what extent does Rover's service satisfy each of these criteria?

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ESSAY QUESTIONS

1. Janet Parrish and her long-time friend Allison Graebner are thinking about starting an online business to sell used children's clothing. Their enjoyment of being around children and their desire to help families with relatively low incomes to be able to purchase "good" clothing at a price they can afford is a strong force behind their entrepreneurial intentions. They want to use "brainstorming" to generate ideas about how to launch their business. How would you explain brainstorming as a technique and describe its use to Janet and Allison? What specific problems should they avoid while using brainstorming and why is it important to avoid the problems you identified?
2. In You Be the VC 2.2, we saw that Bethlehem Tilahun Alemu built two businesses using key elements of Ethiopian artisanal skills and traditions. What steps could an entrepreneur take to identify these skills and opportunities and build a business around them? Write a paragraph explaining this kind of problem-solving process showing the necessary connections.

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Getting Personal with OWLET BABY CARE

Owlet Baby Care, Inc./Photo Credit: Jacob B. Colvin

Cofounders

JACOB COLVIN

BS in European Studies, Brigham Young University, 2014

KURT WORKMAN

BS in Chemical Engineering, Brigham Young University, undecided

ZACK BOMSTA

BS in Electrical Engineering, Brigham Young University, 2014

JORDAN MONROE

BS in Business Management, Brigham Young University, 2014

Dialogue *with* Jacob Colvin

WHAT I DO WHEN I'M NOT WORKING

Spend time with my beautiful wife and 3 kids, train horses, or otherwise just be outdoors

MY BIGGEST SUPRISE AS AN ENTREPRENEUR

How much support is available—if you are willing to know where to look for it

MY FAVORITE SMARTPHONE APP

Google Translate

FAVORITE BAND ON MY SMARTPHONE MUSIC LIST

Jack Johnson

MY ADVICE FOR NEW ENTREPRENEURS

Be passionate, be balanced, see it through

BEST PART OF BEING A STUDENT

Access to fantastic mentors, professors, and resources right at your fingertips, and the ability to positively influence other students

CHAPTER 3

Feasibility *Analysis*

OPENING PROFILE

OWLET BABY CARE

The Value of Validating a Business Idea

• *Web: www.owletcare.com* • *Facebook: Owlet Baby Monitors* • *Twitter: @owletbabycare*

Imagine yourself bringing a newborn baby home from the hospital. At night, your continual worry is if your baby is sleeping peacefully or if something is wrong. This is a concern to which every parent can relate. To provide parents peace of mind, four students from Brigham Young University—Jacob Colvin, Kurt Workman, Zack Bomsta, and Jordan Monroe—created the Owlet smart sock. The Owlet smart sock is made by the company they started, Owlet Baby Care. Once a parent buys the sock, they download the Owlet app, connect the base station, and slip the sock onto their baby's foot; the sock then silently checks on him while he sleeps.

Owlet notifies you if your baby's heart rate or oxygen level move outside of set parameters. It uses a proven technology called pulse oximetry that clinics and hospitals have used for years. Notifications are delivered to your smartphone via Wi-Fi, and are also delivered to your base station, which is a device about the size of a small serving bowl, via Bluetooth technology. The base station glows green when everything is okay, but changes color and plays different sounds for different situations. A yellow flashing light, accompanied by a lullaby, means that the sock isn't getting a good read and needs to be adjusted or that it fell off. A blue flashing light, also accompanied by a lullaby, means the sock's Bluetooth has disconnected from the base station. And a red flashing light, accompanied by an audible alarm, means that your baby's oxygen level has dropped below a set parameter or that the heart rate is too low or too high.

The idea for the Owlet smart sock originated when Workman and Colvin were students at BYU. They were in a program that challenged them to come up with a business idea and provided a small amount of seed funding to all the teams involved. The product concept started with Workman and his friend, Tanor Hodges, who was a student working at the University of Utah Hospital and who had worked extensively with pulse oximetry technology. Pulse oximetry is used to measure the oxygen levels and heart rates of acute patients. They began working together to try to develop wireless pulse oximetry for hospital use to address some of the technological pains Hodges had identified. At the same time, Workman and his wife were expecting a baby and were concerned that their baby might have some health issues stemming from their family history. They were also helping a relative who had come home with premature twins. The twins needed to be constantly monitored and

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain what a feasibility analysis is and why it's important.
2. Describe a product/service feasibility analysis, explain its purpose, and discuss the two primary issues that a proposed business should consider in this area.
3. Describe an industry/market feasibility analysis, explain its purpose, and discuss the two primary issues to consider when completing this analysis.
4. Explain what an organizational feasibility analysis is and its purpose and discuss the two primary issues to consider when completing this analysis.
5. Describe what a financial feasibility analysis is, explain its importance, and discuss the most critical issues to consider when completing this analysis.
6. Describe a feasibility analysis template and explain why it is important for entrepreneurs to use this template.

the thought occurred to Workman "Why doesn't something exist (other than standard baby monitors) for parents in their homes to ensure them that their babies are okay?" If there were a way, he reasoned, to get wireless pulse oximetry technology into the home nursery, it would give parents incredible peace of mind and help keep babies safe.

The idea stuck with Workman and he, Colvin, and Hodges started entering business plan competitions, along with other class team members. The idea was to create a device that would use pulse oximetry technology to monitor a baby's oxygen level and heart rate in the home, and provide parents notifications if levels dropped outside set parameters. They made a video of their early conception of the idea, which included a home-made baby bootie with nothing more than a blinking light. Somehow, the video got out. They started getting e-mail messages from parents asking if they could acquire the device. The device wasn't anywhere near ready to be sold, but the interest validated the notion that they were onto something that parents saw as valuable and for which they were willing to pay.

In January 2013, Owlet Baby Care was launched and the three were joined by Zack Bomsta and later Jordan Monroe, also students at Brigham Young University. They continued to participate in business plan competitions, which funded their early efforts. They also ran a crowdfunding campaign. At the time, Kickstarter did not allow campaigns for baby products, so they ran the campaign from their own website. They raised over $300,000 which further validated interest in their idea. They were then approached by TechStars, an accelerator based in Boulder, CO, and were asked to join a TechStars program in New York City focused on the Internet of Things. They accepted, and spent the next three months in New York City getting coaching and meeting with mentors who helped them further flesh out their idea. Based on the progress they made, in addition to a small amount of angel investment, they were able to raise a larger seed round of $1.8 million in April, 2014.

Owlet did an extensive product feasibility analysis to get the smart sock right. The smart sock, along with its supporting components, involved fabrics, software, hardware, firmware, an app, connectivity, and user experience. Their task was to test each part separately, and then test how the parts interacted with one another. To test the prototypes, they interacted with medical professionals and went into the homes of newborn babies. To gain access to homes they e-mailed or called friends, family members, doctors' offices, clinics, and others to ask if anyone knew a family with a new baby. They would then approach parents to ask if they would participate in the tests. They found parents to be very receptive. Early versions of the smart sock and other parts of the system were very rough. For example, they used a piece of foam to represent what the base station might look like. They asked questions such as, "How would you use this device in your home?," "Where would you put it?," "Would you put this sock on your child?," and so forth. Each series of tests was followed by a survey that asked the participants what they liked and didn't like about the system. The tests were very helpful and led to hundreds of iterations. In regard to price, they did substantial A/B testing of various prices. They knew they needed a certain price point for their company to be profitable, and tried different prices for the Owlet Baby Care system—$159, $179, $249. Curiously, they got higher conversions at the higher price points. The system now sells for $250.

Today, Owlet Baby Care is a thriving company, with over 70 employees and more than $20 million in annual sales. Eighty-three percent of the parents who own the device report better sleep when the device is in use. In 2016, Owlet was awarded a $1.5 million dollar grant from the National Institute of Health (NIH) which is growing the company in ways the cofounders never imagined. Because Owlet smart socks are connected to the

Internet, cloud-based servers allow for broad aggregation of the smart sock data created. As a result, Owlet is now collecting the largest infant health data set in the world. Just shy of one billion infant heartbeats are recorded nightly via Owlet smart socks. That data, along with several other biometrics the product collects, is being used to produce valuable medical research.

Feasibility Analysis

LEARNING OBJECTIVE

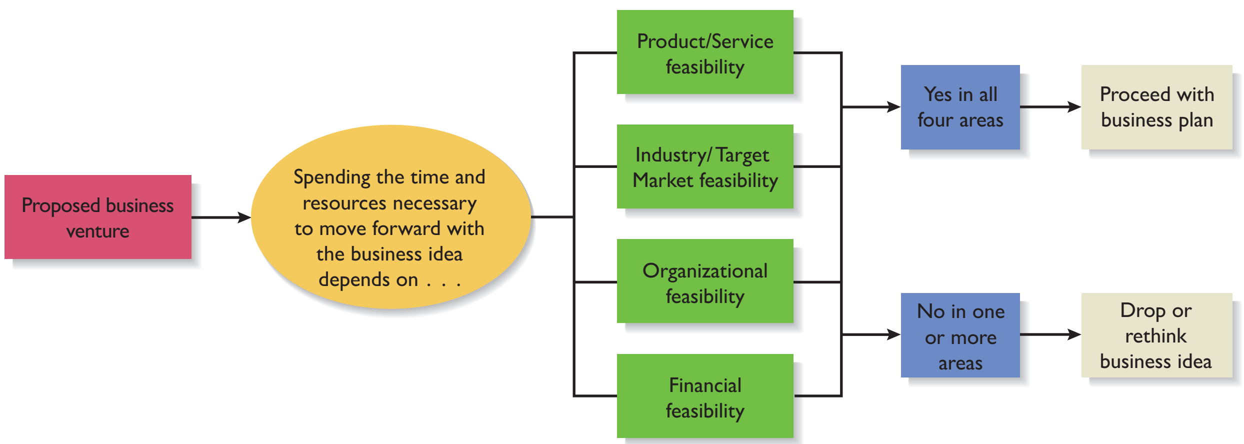
1. Explain what a feasibility analysis is and why it's important.

Feasibility analysis is the process of determining if a business idea is viable (see Figure 3.1). If a business idea falls short on one or more of the four components of feasibility analysis, it should be dropped or rethought, as shown in the figure. Many entrepreneurs make the mistake of identifying a business idea and then jumping directly to developing a business model (see Chapter 4) to describe and gain support for the idea. This sequence often omits or provides little time for the important step of testing the feasibility of a business idea.

A mental transition must be made when completing a feasibility analysis from thinking of a business idea as just an idea to thinking of it as a business. A feasibility analysis is an assessment of a potential business rather than strictly a product or service idea. The sequential nature of the steps shown in Figure 3.1 cleanly separates the investigative portion of thinking through the merits of a business idea from the planning and selling portion of the process. Feasibility analysis is investigative in nature and is designed to critique the merits of a proposed business. A business plan (see Chapter 6) is more focused on planning and selling. The reason it is important to complete the entire process, according to John W. Mullins, the author of the highly regarded book *The New Business Road Test*, is to avoid falling into the "everything about my opportunity is wonderful" mode. In Mullins' view, failure to properly investigate the merits of a business idea before developing a business model and a business plan is written runs the risk of blinding an entrepreneur to inherent risks associated with the potential business and results in too positive of a plan.[1]

This chapter provides a methodology for conducting a feasibility analysis by describing its four key areas: product/service feasibility, industry/target market feasibility, organizational feasibility, and financial feasibility. We introduce supplemental material in three appendices to the chapter. Appendix 3.1 provides tips for conducting a feasibility analysis interview and presents you with both effective and ineffective questions to ask. Appendix 3.2 contains a tool called First Screen, which is a template for completing a feasibility analysis. Appendix 3.3 contains an Internet Resource Table that provides information on Internet resources that are helpful when completing First Screen.

FIGURE 3.1
Role of Feasibility Analysis in Developing Successful Business Ideas



An outline for the approach to feasibility analysis we describe in this chapter is provided in Table 3.1. Completing a feasibility analysis requires both primary and secondary research. **Primary research** is research that is collected by the person or persons completing the analysis. It normally includes talking to prospective customers, getting feedback from industry experts, conducting focus groups, and administering surveys. **Secondary research** probes data that is already collected. The data generally includes industry studies, Census Bureau data, analyst forecasts, and other pertinent information gleaned through library and Internet research. The Internet Resource Table in Appendix 3.3 is useful for conducting secondary research.

It should be emphasized that while a feasibility analysis tests the merits of a specific idea, it allows ample opportunity for the idea to be revised, altered, and changed as a result of the feedback that is obtained and the analysis that is conducted. The key objective behind feasibility analysis is to put an idea to the test—by eliciting feedback from potential customers, talking to industry experts, studying industry trends, thinking through the financials, and scrutinizing it in other ways. These types of activities not only help determine whether an idea is feasible but also help shape and mold the idea. In some cases, it will be decided that the idea is not feasible. Although regrettable, it is better to know early rather than later if an idea doesn't have sufficient merit to become a business.

Now let's turn our attention to the four areas of feasibility analysis. The first area we'll discuss is product/service feasibility.

Product/Service Feasibility Analysis

LEARNING OBJECTIVE

2. Describe a product/service feasibility analysis, explain its purpose, and discuss the two primary issues that a proposed business should consider in this area.

Product/service feasibility analysis is an assessment of the overall appeal of the product or service being proposed. Although there are many important things to consider when launching a new venture, nothing else matters if the product or service itself doesn't sell. There are two components to product/service feasibility analysis: product/service desirability and product/service demand.

TABLE 3.1 Feasibility Analysis

Part 1: Product/Service Feasibility
A. Product/service desirability
B. Product/service demand
Part 2: Industry/Target Market Feasibility
A. Industry attractiveness
B. Target market attractiveness
Part 3: Organizational Feasibility
A. Management prowess
B. Resource sufficiency
Part 4: Financial Feasibility
A. Total start-up cash needed
B. Financial performance of similar businesses
C. Overall financial attractiveness of the proposed venture
Overall Assessment

Product/Service Desirability

The first component of product/service feasibility is to affirm that the proposed product or service is desirable and serves a need in the marketplace. You should ask yourself, and others, the following questions to determine the basic appeal of the product or service:

- Does it make sense? Is it reasonable? Is it something real customers will buy?
- Does it take advantage of an environmental trend, solve a problem, or fill a gap in the marketplace?
- Is this a good time to introduce the product or service to the market?
- Are there any fatal flaws in the product or service's basic design or concept?

The best way to answer these questions is to "get out of the building" and talk—and, more importantly, listen to—potential customers. Appendix 3.1 provides tips for conducting feasibility analysis interviews and presents you with examples of effective and ineffective questions to ask. Conducting interviews with prospective customers is the primary mantra of the Lean Startup movement, referred to in more detail in Chapter 6. A tool that is particularly useful in soliciting feedback and advice from prospective customers is to administer a concept test.

Concept Test. A **concept test** involves showing a preliminary description of a product or service idea, called a **concept statement**, to prospective customers and industry experts to solicit their feedback. It is a one-page document that normally includes the following:

- A description of the product or service. This section details the features of the product or service. You probably won't have a working prototype of your product at this point, but you might have a sketch or a rough model to show your participants.
- The intended target market. This section lists the consumers or businesses who are expected to buy the product or service.
- The benefits of the product or service. This section describes the benefits of the product or service and includes an account of how the product or service adds value and/or solves a problem.
- A description of how the product or service will be positioned relative to competitors. A company's position describes how its product or service is situated relative to its rivals.
- A brief description of the company's management team.

After the concept statement is developed, it should be shown to at least 25 people who are familiar with the industry that the firm plans to enter and who can provide informed feedback. The temptation to show it to family members and friends should be avoided because these people are predisposed to give positive feedback. Instead, it should be distributed to people who will provide candid and informed feedback and advice. Prospective customers are the richest source of valuable feedback.

The concept statement for a fictitious company named New Venture Fitness Drinks is provided in Figure 3.2. New Venture Fitness Drinks sells a line of nutritious fitness drinks and targets sports enthusiasts. The firm's strategy calls for it to place small restaurants, similar to smoothie restaurants, near large sports complexes. It is important to keep a concept statement relatively short (no more than one page) to increase the likelihood that it will be read. The concept statement is followed by a short buying intentions survey. The information gleaned from the survey should be tabulated and carefully read. The statement

FIGURE 3.2
New Venture Fitness Drinks' Concept Statement

New Business Concept
New Venture Fitness Drinks Inc.

Product

New Venture Fitness Drinks will sell delicious, nutrition-filled, all-natural fitness drinks to thirsty sports enthusiasts. The drinks will be sold through small storefronts (600 sq. ft.) that will be the same size as popular smoothie restaurants. The drinks were formulatedby Dr. William Peters, a world-renowned nutritionist, and Dr. Michelle Smith, a sportsmedicine specialist, on behalf of New Venture Fitness Drinks and its customers.

Target Market

In the first three years of operation, New Venture Fitness Drinks plans to open three or four restaurants. They will all be located near large sports complexes that contain soccer fields and softball diamonds. The target market is sports enthusiasts.

Why New Venture Fitness Drinks?

The industry for sports drinks continues to grow. New Venture Fitness Drinks will introduce exciting new sports drinks that will be priced between $1.50 and $2.50 per 16-ounce serving. Energy bars and other over-the-counter sports snacks will also be sold. Each restaurant will contain comfortable tables and chairs (both inside and outside) where sports enthusiasts can congregate after a game. The atmosphere will be fun, cheerful, and uplifting.

Special Feature—No Other Restaurant Does This

As a special feature, New Venture Fitness Drinks will videotape select sporting events that take place in the sports complexes nearest its restaurants and will replay highlights of the games on video monitors in their restaurants. The "highlight" film will be a 30-minute film that will play continuously from the previous day's sporting events. This special feature will allow sports enthusiasts, from kids playing soccer to adults in softball leagues, to drop in and see themselves and their teammates on television.

Management Team

New Venture Fitness Drinks is led by its cofounders, Jack Petty and Peggy Wills. Jack has 16 years of experience with a national restaurant chain, and Peggy is a certified public accountant with seven years of experience at a Big 4 accounting firm.

can be used in an iterative manner to strengthen the product or service idea. For example, you might show the statement to a group of prospective customers, receive their feedback, tweak the idea, show it to a second group of prospective customers, tweak the idea some more, and so on. The goal is to find a "**product/market fit**" between the benefits your product or service offers and what your prospective customers need and require. In his book *Running Lean*, Ash Maurya defines product/market fit as "Have I built something people want?"[2] If the results of your concept test suggest the answer is "yes," then this is the first significant milestone for fashioning a successful business.

The problem with not talking to potential customers prior to starting a business is that it's hard to know if a product is sufficiently desirable based simply on gut instinct or secondary research. A common reason new businesses fail is that there isn't a large enough market for the venture's product. This scenario played out for Matt Cooper, who was a partner in a business called Soggy Bottom Canoe and Kayak Rental. It was his first start-up and turned out to be, as Cooper put it, an "unmitigated disaster." Cooper and his partner owned 10 acres near a national forest in Mississippi, where they decided to launch a canoe rental business. They invested heavily in finishing out the facilities on the property and bought 32 canoes, 16 kayaks, 4 trailers, and 2 vans. They opened on a July 4th weekend and everything was immaculate. The following is what happened, in Cooper's words:

> In our quest to have the best facilities and equipment, we neglected to speak to a single prospective customer. No Boy Scout troops, no church youth groups, no fraternities from Southern Mississippi University. As a result, I can count on only

one hand the number of times, in the seven years that we owned the business that we reached even half of our booking capacity.[3]

Cooper goes on to admit that he's learned his lesson. Reflecting on his Soggy Bottom Canoe and Kayak Rental experience he said:

Today, I still fight against the urge to make big investments before we've "beta tested." Every time that urge pops up, I picture gleaming new canoes hitched up to sad empty passenger vans.[4]

Rather than developing a formal concept statement, some entrepreneurs conduct their initial product/service feasibility analysis by simply talking through their ideas with prospective customers or conducting focus groups to solicit feedback. The ideal combination is to do both—distribute a concept statement to 25 or more people who can provide informed feedback and engage in verbal give-and-take with as many additional prospective customers and industry experts as possible. There are also a growing number of online tools that help entrepreneurs quickly and inexpensively make contact with prospective customers and complete other steps in the feasibility analysis process. These tools range from services such as Growth Hackers, which is a forum suitable for getting feedback on business ideas and how to go about acquiring your first customers, to 3D printing services like Shapeways, which convert CAD drawings of product ideas into physical prototypes that you can show to potential customers. We provide a sample of the online tools that are available in Table 3.2.

TABLE 3.2 Online Tools Available for Completing a Feasibility Analysis

Tool	Description	URL
3D Printing Services		
i.materialise	Allows you to convert your ideas into physical objects via a 3D printing service. Also provides a platform for sharing and selling your designs.	http://i.materalise.com
Shapeways	Provides a platform for converting ideas into physical objects to use as product prototypes or to sell through the Shapeways community.	www.shapeways.com
A/B Split Testing		
3 Minute Optimizer	Easy and effective A/B testing for both tech and non-tech start-ups. Provides both A/B testing and conversion tracking.	www.3minuteoptimizer.com
Optimizely	Robust A/B testing platform that allows you to fine tune your Web pages to optimize conversion and reach your goals.	www.optimizely.com
Feedback on Business Ideas		
Growth Hackers	Forum suitable for getting feedback on business ideas regarding how to go about acquiring your first customers.	www.growthhackers.com
Meetup	Online portal that provides information about offline group meetings. Meetup allows members to find and join groups that meet their interests. Becoming part of a "meetup group" is an excellent way to receive feedback on business ideas.	www.meetup.com
Reddit	Great place to hold an online discussion about virtually any topic. It's easy to start a thread on Reddit, and you can get feedback on business ideas.	www.reddit
Unassumer	Helps you learn quickly what your customers really want, so you can focus on delivering the best product.	www.unassumer.com
Landing Pages		
LaunchRock	Allows you to create a "coming soon" landing page in minutes and collect e-mail addresses and other useful analytics on potential early users of your product.	www.launchrock.com

(*continued*)

TABLE 3.2 Continued

Tool	Description	URL
Ubounce	Allows you to create simple landing pages and do A/B Split Testing without involving developers or needing coding skills.	www.ubounce.com
WuFoo	Lets you easily create forms that can be embedded onto your site or landing page. Often used for e-mail signup forms on landing pages.	www.wufoo.com
Market Research		
AskYourTargetMarket	Allows you to setup surveys that reach a specific target market.	www.aytm.com
CrowdPicker	Allows you to ask a "crowd" of potential customers which logo, tagline, company name, packaging design, etc. is the best choice for your start-up.	www.crowdpicker.com
Google Trends	Allows you to enter a search term (such as running or swimming) and see if it's trending upwards or downwards in Google search queries.	www.google.com/trends
Facebook Ads	Allows you to put together a Facebook ad campaign to assess how a specific target market responds to a new product idea. Can be something as simple as "fill out this form to be one of our first beta testers."	www.facebook.com/ads
Google AdWords	Allows you to put together an AdWords campaign, which usually directs prospective customers to landing pages that assess the demand for a new product or service idea.	www.google.com/adwords
Online Whiteboard		
RealTimeBoard	Allows you to create a whiteboard on your computer (with the capability to draw and erase) and collaborate with team members in real time.	http://realtimewhiteboard.com
Ziteboard	Zoomable online whiteboard that is ideal for team collaboration.	www.ziteboard.com
Prototyping Services		
Proto Labs	Get prototypes built from CAD drawings.	www.protolabs.com
ThomasNet	ThomasNet is not a prototyping service itself, but is a platform that allows you to find prototyping services in your local area.	www.thomasnet.com
Q&A Sites		
Bright Journey	Q&A site for any start-up question.	www.brightjourney.com
Stack Overflow	Q&A site for programmers.	www.stackoverflow.com
Quora	Platform allows you to ask any business-related question and get answers from the Quora community.	www.quora.com
Surveys		
Google Consumer Surveys	An easy, quick, and inexpensive way to create online surveys.	www.google.com/consumersurveys
Survey.io	A customer development platform that helps start-ups quickly learn what customers like and don't like about their product offerings.	www.survey.io
Survey Monkey	A popular and inexpensive way to create and distribute online surveys.	www.surveymonkey.com
Website Usability Testing		
Usertesting	The company's network of testers will review your website and provide audio commentary while they are using it.	www.usertesting.com
Verify	Fast way to collect and analyze user feedback on screens or mockups. See what people click, what they remember, and how they feel.	www.verifyapp.com

kzenon/123rf.com

This young entrepreneur is out talking to potential customers. She's assessing the feasibility of a new travel service that she and two other entrepreneurs are thinking about launching.

Product/Service Demand

The second component of product/service feasibility analysis is to determine if there is demand for the product or service. Three commonly utilized methods for doing this are (1) talking face-to-face with potential customers, (2) utilizing online tools, such as Google AdWords and landing pages, to assess demand, and (3) library, Internet, and gumshoe research.

Talking Face-to-Face with Potential Customers. The only way to know if your product or service is what people want and need is by talking to them. Curiously, this often doesn't happen. One study of 120 business founders revealed that more than half fully developed their products without getting feedback from potential buyers.[5] In hindsight, most viewed this as a mistake. The authors of the study quoted one of the participants as saying "You'll learn more from talking to five customers than you will from hours of market research (at a computer)." The idea is to gauge customer reaction to the general concept of what you want to sell. Entrepreneurs are often surprised to find out that a product idea that they think solves a compelling problem gets a lukewarm reception when they talk to actual customers.

In some instances, you have to pause and think carefully about who the potential customer is. For example, in health care the "customer" is typically not the patient who will use the drugs or benefit from a medical procedure. Instead the actual customer, or the entity that will be paying the bill, is often an insurance company, hospital, or Medicare or Medicaid. You should also talk to as many of the relevant players in an industry as possible. Sometimes this involves a complex list of people, but it is necessary to fully vet the initial feasibility of an idea and get comprehensive feedback. For example, say you were thinking about launching an innovative new type of home health-care service. The service would allow elderly people to stay in their homes longer before going into assisted living or a nursing home, and it would help people remember to take their medicine on time and provide other health-care monitoring services. Table 3.3 contains a list of the categories of people that you might want to talk to as part of your product/service feasibility analysis. While the list is long,

TABLE 3.3 Categories of People to Talk to as Part of a Product/Service Feasibility Analysis for a New Type of Home Health-Care Service

Category of people to talk to
1. Potential users of the service
2. Family members of potential users of the service
3. Physicians
4. Nurses
5. Health insurance companies
6. Medicare and Medicaid personnel
7. Pharmaceutical companies
8. Owners/managers of assisted living facilities and nursing homes
9. Hospital and physician office administrators
10. Founders of other companies in the home health-care industry

imagine the rich insight that you could receive about your business idea from people in these categories.

One approach to finding qualified people to talk to about a product or service idea or to react to a concept statement is to contact trade associations and/or attend industry trade shows. If your product idea is in the digital media space, for example, you may be able to call the Digital Media Association (which is a national trade association devoted primarily to the online audio and video industries) and obtain a list of members who live in your area. Attending trade shows in the industry in which you have an interest will place you in direct contact with numerous people who might be of assistance. A website that provides a directory of trade associations is included in the Internet Resource Table in Appendix 3.3. Online surveys are also useful to reach a large number of people quickly. Services such as SurveyMonkey and Google Consumer Surveys are making it increasingly easy to survey specific target markets and receive detailed analytics for a very affordable price.

Utilizing Online Tools to Assess Demand. Another common approach to assessing product demand is to use online tools, such as administering surveys, utilizing Q&A sites, and conducting online marketing research. Surveys are most effective in validating what you've learned from face-to-face interviews, rather than collecting initial data. For example, referring to Table 3.3, if you've interviewed a number of people about the home health-care service you'd like to start, and through several iterations of your idea feel that you're getting close to product/market fit, you can further validate your idea by reaching a larger audience via an online survey. Be careful to avoid **confirmation bias**, which is a tendency to search for information that validates your preconceptions. Make sure to ask questions that allow for a wide range of responses. SurveyMonkey and Google Consumer Surveys are excellent online survey platforms. There are many resources available in print and online that provide instructions about how to create effective online surveys. It is better to not conduct a survey than to administer one in an uninformed and/or haphazard manner.

There are several Q&A sites that can be utilized to get feedback about product/service demand. While the results will be coarse grained in nature, it may still be a good use of your time. Quora is an excellent Q&A site. Say you are contemplating launching a food delivery service in Chicago. On Quora, you wouldn't post a business plan and ask for feedback, but you could ask a question such as, "What are the best food delivery services in Chicago?" or "Does Chicago need better food delivery services?" Quora has enough traffic that you'll get responses, and the responses may provide insight into the demand for food delivery services in Chicago and who your toughest competitors will be. Another useful Q&A site is Bright Journey. On Bright Journey you can ask any start-up-related question and are likely to receive responses.

Market research can also be completed online. Google Trends, for example, allows you to enter a search term (such as skiing or running) to see if the term is trending upwards or downwards in Google search queries. For example, while writing this chapter during the spring of 2017, we entered the term "running" into the Google Trends search bar. The trend on searches for running showed a continual upward trajectory. While this result may not tell someone with a running related start-up idea anything about the likely demand for his or her specific idea, it does affirm that interest in running remains strong. A more narrowly focused approach for assessing demand for a product or service idea is to use a combination of Google AdWords and landing pages. The way this works is as follows. Suppose you've developed a new type of sunglasses for snowboarders and want to assess likely demand. One way of doing this is to buy keywords on the Google search page such as "snowboarding" and "sunglasses." You can purchase the keywords through Google's AdWords program. Once you buy the keywords, when someone searches for the term "snowboarding" or "sunglasses" a link to an ad you have prepared will show up either at the top or to the right of the organic search results. The text below the link will say something such as "Innovative new sunglasses for snowboarders." If someone clicks on the link, they'll be taken to what online marketers call a landing page. A **landing page** is a single web page that typically provides direct sales copy, like "Click here to buy a Hawaiian vacation." Your landing page, which can be inexpensively produced through a company such as LaunchRock (see Table 3.2), will show an artist's depiction of your innovative new sunglasses, provide a brief explanation, and will then say something along the lines of, "Coming Soon—Please Enter Your E-mail Address for Updates." How often your ad appears will depend on what you purchase through Google's automated AdWord's keyword auction. Google will provide you analytics regarding how many people click on the ad and how many follow through and provide their e-mail address. You can also capture the e-mail addresses that are provided.

The beauty of using Google AdWords is that the people who click on the ad were either searching for the term "snowboarding" or "sunglasses" or they wouldn't have seen the ad. So you are eliciting responses from a self-selected group of potential buyers. The overarching purpose is to develop a sense of interest in your product. If, over a three-day period, 10,000 people click on the ad and 4,000 provide their e-mail address to you, those results might signal a fairly strong interest in the product. On the other hand, if only 500 people click on the ad and 50 give you their e-mail address, that's a much less affirming response. It's strictly a judgment call regarding how many clicks represent an encouraging response to your product idea. Normally, utilizing an AdWords and landing page campaign wouldn't be the only thing you'd do to assess demand. You'd still want to talk to prospective customers face-to-face, as discussed earlier. Running an AdWords and landing page campaign is, however, a practical and often surprisingly affordable way to get another data point in regard to assessing demand for a new product or service idea.

Library, Internet, and Gumshoe Research. The third way to assess demand for a product or service idea is by conducting library, Internet, and gumshoe research. Although talking to prospective customers is critical, collecting secondary data on an industry is also helpful. For example, Wonder

Workshop makes educational toys that teach kids how to code. Sounds like a good idea. But "sounds like a good idea," as mentioned in previous sections, isn't enough. We need feedback from prospective customers and industry-related data to make sure. Industry-related data can help us answer the following types of questions: What's the trajectory of the toy industry? What do industry experts say are the most important factors that parents consider when buying toys for their children? Is there an "educational toy" segment within the larger toy industry? If so, is this segment growing or shrinking? Is there a trade association for the makers of educational toys that already has statistics about the market demand for educational toys?

The main point here is that for your particular product or service you need archival as well as primary forms of research to assess likely demand. Your university or college library is a good place to start, and the Internet is a marvelous resource. The Internet Resource Table in Appendix 3.3 provides specific recommendations of online resources to utilize. For example, IBISWorld, which is available for free through most university libraries, provides current industry reports on hundreds of industries. It produces several reports on the toy industry, which are updated frequently, including a report titled "Toy, Doll & Game Manufacturing in the US." This report would be a good place to start in terms of understanding relevant industry trends with respect to the toy industry. More general Internet research is also often helpful. Simply typing a query into the Google or Bing search bar such as "market demand for educational toys" will often produce helpful articles and industry reports.

Simple gumshoe research is also important for gaining a sense of the likely demand for a product or service idea. A gumshoe is a detective or an investigator that scrounges around for information or clues wherever they can be found. Don't be bashful. Ask people what they think about your product or service idea. If your idea is to sell educational toys, spend a week volunteering at a day care center and watch how children interact with toys. Take the owner of a toy store to lunch and discuss your ideas. Spend some time browsing through toy stores and observing the types of toys that receive the most attention. If you actually launch a business, there is simply too much at stake to rely on gut instincts and cursory information to assure you that your product or service will sell. Collect as much information as you can within reasonable time constraints.

If your business idea involves a physical product, the steps described above should be followed by building a prototype of the product and testing it with potential customers. The "Savvy Entrepreneurial Firm" feature shown nearby describes how the prototyping process works. As explained in the feature, the end goal is to build the version of your product that customers want rather than the version you set out to build and hope customers will buy.

Industry/Target Market Feasibility Analysis

LEARNING OBJECTIVE

3. Describe an industry/market feasibility analysis, explain its purpose, and discuss the two primary issues to consider when completing this analysis.

Industry/target market feasibility is an assessment of the overall appeal of the industry and the target market of the product or service being proposed. There is a distinct difference between a firm's industry and its target market; having a clear understanding of this difference is important. An **industry** is a group of firms producing a similar product or service, such as computers, children's toys, airplanes, or social networks. A firm's **target market** is the portion of the industry that it goes after or to which it wants to appeal. Most firms, and certainly entrepreneurial start-ups, typically do not try to service an entire industry. Instead, they select or carve out a specific target market and try to service that group of customers particularly well. Wonder Workshops, for example, is not trying to target the entire children's toy industry. Its target market is the set of parents who are willing to pay a premium for educational toys that teach kids how to code.

SAVVY ENTREPRENEURIAL FIRM

Prototyping: How to Build What the Customer Wants

A **prototype** is an early sample, model, or release of a product that is built to test a concept or a process. The idea is to show the sample or model to potential users and then use their feedback to improve the product. If you are making a hardware product, like the Owlet Baby Monitor, you may iterate on your prototype multiple times before you have a final design. One common phrase used to describe the process of iterative prototyping is "fail early and often." That phrase doesn't refer to failure in the broad sense. It's more about the little things. It's a philosophy that suggests that developing a product involves running a lot of tests with potential customers. Each test will allow you to discard the part of the product the potential customers didn't like and build upon the parts of the product they did. You'll also learn things. For example, Owlet learned by watching customers that after they put their baby to sleep, they liked to move their Owlet Baby Monitor Base Station from room to room as they moved about the house, so they could monitor their baby. This told Owlet that the Base Station couldn't rely on being plugged into the wall to work.

As the tests continue—which involves allowing potential customers to touch and experiment with your evolving prototype—the product gets better and better. As you progress through the process, your prototype may evolve from a paper prototype, to a plastic prototype, to a metal prototype, to something that resembles the final design. Put in colorful language, Dave Lyons, an experienced product designer, said that the value of prototyping is to "shake the gremlins out of the design as fast as possible in different areas."

The following example describes how the prototyping process normally works.

A New Toaster Design

Most people have a toaster in their kitchen. Imagine that you have invented a new type of toaster. Your toaster looks like a large smartphone, turned on its side, perched on a pedestal. You feed your piece of bread into the top, it is pulled through the device, and drops into a tray below, perfectly toasted. The front of the device has a knob that allows you to regulate how well-done your toast will be. The advantage of the device is that it is sleek and takes up very little counter space. In your mind it would be perfect for a small apartment, a mobile home, a camper, a business' breakroom or anyplace with limited counter space where you'd like to have a toaster. For purposes of this example, we'll focus on prototyping the outer shell of the device and not the inner electronics.

Steps in the Prototyping Process

The proper steps in the prototyping process will vary depending on the type of device you have invented, but this is an example of how the prototyping process for the toaster might evolve.

Step 1: A Drawing. A simple drawing of the device, with a paragraph or two that describes how it will work. Show the drawing to 20 people. Ask them for feedback. In some situations it is helpful to have several drawings of a product, reflecting different design ideas, and ask people what they like and don't like about each design. Ask the people to whom you show the drawing if they would buy a toaster that toasts only one piece of toast at a time.

Step 2: Physical Mock-Up. Next, build an inexpensive mock-up of the device based on the feedback you received from the drawing. The mock-up could be made from cardboard, clay, foam, or wood. The mock-up should depict what you think the device will look like in terms of height, width, weight, color, and other qualities. Test your hypothesis that people with small kitchens would be attracted to the device. Identify people with limited counter space in their kitchens and ask if you can come into their homes. Ask them to pretend the mock-up is their toaster. Observe where they put it in their kitchen or pantry. Observe where their current toaster is and if it is taking up too much space. Ask the participants to keep the mock-up in their kitchen for a week. Observe whether they move it around. Ask your participants to keep track of the number of times it would have been "okay" to have a toaster that can only toast one piece of bread at a time, and the number of times it was an inconvenience. Administer a survey after the week has passed to get feedback. There are many things you may find out. For example, you might discover that the device is too tall to sit on a countertop under most kitchen cabinets. And, you might learn that the knob for adjusting the degree to which bread is toasted is hard to adjust easily.

Step 3: CAD Drawing. After you've got the most basic questions answered and you have honed in on a design, make CAD (computer aided design) drawings of the different components of the product and how the components will fit together. You can outsource this task to an experienced CAD designer or invest in one of the entry-level CAD programs that are inexpensive and make it easy for you to complete the drawing yourself. If you make the drawing yourself, it will be more limited than what an experienced CAD designer can do. The CAD file can be used to make a more sophisticated prototype of your device than the mock-up. Plastic pieces can be made via a 3D printer. Sheet metal parts can be made with waterjet and laser cutters. Sheet metal parts can be folded or pressed to a final shape. The more fully developed prototype should be shown to a fresh group of potential customers for feedback, and you should repeat the steps described in Step 2. Once a final design is determined, more sophisticated CAD drawings can be made in preparation for the device to be manufactured.

Summary. Prototyping is an iterative process. The feedback from one round of prototyping informs the next. The key is good user feedback. Ideally, the end result will be the version of your product that your customers tell you to build, rather than the version you set out to build and hoped someone would buy.

Questions for Critical Thinking

1. What are the advantages of showing rough prototypes to potential customers, like those produced for Step 1 and Step 2, rather than showing them a well-developed prototype to begin with?
2. Make a list of the things the inventor of the new toaster in the feature might learn as a result of the prototyping process.
3. For the prototyping process described above, why was it necessary to go into the homes of the people who might use the device? Couldn't similar information have been learned in a lab?
4. Do some Internet research and learn about the "Lean Startup" movement. In what ways is prototyping an essential part of the lean start-up approach?

Sources: R. DiResta, B. Forest, and R. Vinyard, *The Hardware Startup* (Sebastopol, CA: O'Reilly Media, Inc., 2015); G. Douglas, "How to Build It: Lean Prototyping Techniques for Hardware," Edited by T. Eisenman. *Managing Startups* (Sebastopol, CA: O'Reilly Media, Inc., 2013, 7–14).

There are two components to industry/target market feasibility analysis: industry attractiveness and target market attractiveness.

Industry Attractiveness

Industries vary in terms of their overall attractiveness.[6] In general, the most attractive industries have the characteristics depicted in Table 3.4. The top three factors are particularly important. Industries that are young rather than old, are early rather than late in their life cycle, and are fragmented rather than concentrated are more receptive to new entrants than industries with the opposite characteristics. You also want to pick an industry that is structurally attractive—meaning start-ups can enter the industry (in various target markets) and compete effectively. Some industries are characterized by such high barriers to entry or the presence of one or two dominant players that potential new entrants are essentially shut out.

Other factors are also important. For example, the degree to which environmental and business trends are moving in favor of rather than against the industry are important for its long-term health and its capacity to spawn new target or niche markets. Are changing economic and societal trends helping or hurting industry incumbents? Are profit margins increasing or decreasing? Is innovation accelerating or waning? Are input costs going up or down? Are new markets for the industry's staple products opening up or are current markets being shut down by competing industries? You can't cover every facet of an

TABLE 3.4 Characteristics of Attractive Industries

- Are young rather than old
- Are early rather than late in their life cycle
- Are fragmented rather than concentrated
- Are growing rather than shrinking
- Are selling products or services that customers "must have" rather than "want to have"
- Are not crowded
- Have high rather than low operating margins
- Are not highly dependent on the historically low price of a key raw material, like gasoline or flour, to remain profitable

industry, but you should gain a sense of whether the industry you have chosen to enter is a good one or a poor one for start-ups.

Information that addresses each of these issues is available via industry reports published by IBISWorld, Mintel, BizMiner, and similar fee-based databases that are typically free if accessed through a university or large public library's website. These resources are listed in the Internet Resource Table in Appendix 3.3. Steve Blank, one of the creators of Lean Startup, maintains an excellent database of market research tools under the heading "Startup Tools" on his blog (https://steveblank.com/tools-and-blogs-for-entrepreneurs). The First Screen, which is the feasibility analysis template included in Appendix 3.2, includes a section that draws attention to the most important issues to focus on regarding industry attractiveness during the feasibility analysis stage of investigating a business idea.

There are exceptions to the conventional wisdom provided above. Although industries that fit the characteristics shown in Table 3.4 are normally the best place for start-ups to locate, older industries that haven't seen much innovation represent opportunities for disruption. Examples include Warby Parker in the eyewear industry, Casper in mattresses, Uber in personal transportation, and ZenDesk in customer support.

Target Market Attractiveness

We noted previously that a target market is a segment within a larger market that represents a narrower group of customers with similar needs.[7] Most start-ups simply don't have the resources needed to participate in a broad market, at least initially. Instead, by focusing on a smaller target market, a firm can usually avoid head-to-head competition with industry leaders and can focus on serving a specialized market very well. It is also not realistic, in most cases, for a start-up to introduce a totally original product idea into a completely new market. In most instances, it is just too expensive to be a pioneer in each area. Most successful start-ups either introduce a new product into an existing market (like Wonder Workshop introducing new toys into the existing toy market) or introduce a new market to an existing product (like Etrainer is introducing web-based, real-time fitness instruction, which is a new market for an existing product offered by personal trainers).

The challenge in identifying an attractive target market is to find a market that is large enough for the proposed business but yet is small enough to avoid attracting larger competitors, at least until the entrepreneurial venture can get off to a successful start. Tommy John, a maker of men's undershirts, is an example of a company that has targeted a market that meets these criteria. Tommy John began in 2008 by making custom-fitted men's undershirts, and has now expanded to men's briefs, socks, and other apparel. The undershirts are sold under the brand name Second Skin, based on the idea that they fit so well they feel like a "second skin" when worn. Tommy John started by selling through a single retailer and eventually persuaded Neiman Marcus to give its undershirts a try. Today, Tommy John undershirts are sold in Neiman Marcus stores nationwide and are making their way into other retailers as well. Although Tommy John operates in the worldwide market for men's undershirts, it has carved out a specialized target or niche market for itself and is gaining momentum. One key to its success is that it has remained laser-focused on a clearly defined target market. The number one question the company gets is "when will it start producing women's undergarments?" So far it has resisted, preferring to remain focused on its Second Skin line of men's undershirts.[8]

While it is generally easy to find good information to assess the attractiveness of an entire industry, discerning the attractiveness of a small target market within an industry is tougher, particularly if the start-up is pioneering the target market. Often, under these circumstances, information from more than one industry and/or market must be collected and synthesized to make an informed judgment. For example, say you were developing new, innovative sunglasses for snowboarders, consistent with the illustration provided earlier. The question for a product like this is what market to assess? Obviously, a combination of markets must be studied, including the market for sunglasses and the market for snowboarding. It would be important to not only know how well sunglasses are selling but whether the market for snowboarding accessories (and the number of people who participate in snowboarding) is on the rise or decline. If the market for sunglasses is on an upward trajectory but the market for snowboarding accessories is on a sharp decline, the target market you would be pursuing would be much less attractive than if both markets were on the rise.

Organizational Feasibility Analysis

LEARNING OBJECTIVE

4. Explain what an organizational feasibility analysis is and its purpose and discuss the two primary issues to consider when completing this analysis.

An **organizational feasibility analysis** is conducted to determine whether a proposed business has sufficient management expertise, organizational competence, and resources to successfully launch.[9] There are two primary issues to consider in this area: management prowess and resource sufficiency.

Management Prowess

A proposed business should evaluate the prowess, or ability, of its initial management team, whether it is a sole entrepreneur or a larger group.[10] This task requires the individuals starting the firm to be honest and candid in their self-assessments. Two of the most important factors in this area are the passion the solo entrepreneur or the management team has for the business idea and the extent to which the management team or solo entrepreneur understands the markets in which the firm will participate.[11] There are no practical substitutes for strengths in these areas.[12]

A collection of additional factors help define management prowess. Managers with extensive professional and social networks have an advantage in that they are able to reach out to colleagues and friends to help them plug experience or knowledge gaps. In addition, a potential new venture should have an idea of the type of new-venture team that it can assemble.

A **new-venture team** is the group of founders, key employees, and advisers that either manage or help manage a new business in its start-up years. If the founder or founders of a new venture have identified several individuals they believe will join the firm after it is launched and these individuals are highly capable, that knowledge lends credibility to the organizational feasibility of the potential venture. The same rationale applies for highly capable people a new venture believes would be willing to join its board of directors or board of advisers.

One thing that many potential business founders find while assessing management prowess is that they may benefit from finding one or more partners to help them launch their business. Tips for finding an appropriate business partner are provided in the nearby “Partnering for Success” feature. Another group of people to reach out to in the feasibility analysis stage is potential mentors, as discussed in the “Partnering for Success” feature in Chapter 1. A good mentor will offer meaningful advice and help you work through challenges.

Resource Sufficiency

The second area of organizational feasibility analysis is to determine whether the proposed venture has or is capable of obtaining sufficient resources to move forward. The focus in organizational feasibility analysis is on nonfinancial

PARTNERING FOR SUCCESS

Finding the Right Business Partner

One thing that becomes clear to many potential business founders while conducting organizational feasibility analysis is that they need one or more partners to help launch their business. You might be a computer programmer who has a great idea for a cooking website, for example, but have no experience in marketing or sales. In this instance, you may need to find a partner with marketing and sales experience to successfully launch and run the firm. There are five key criteria to look for in a business partner. You want to get this right because picking the wrong partner or partners can lead to a lot of heartaches and business challenges.

1. **Know the skills and experiences you need.** Make an honest assessment of the skills and experience you bring to the business and the gaps that remain. Pick someone who fills the gaps. For example, if you are an experienced computer programmer you probably don't want to partner with another experienced computer programmer. Pick someone who brings other competencies that you need to the venture, such as marketing or finance.
2. **Make sure your personalities and work habits are compatible.** While you don't need someone who is just like you, you do need to be comfortable with the person you'll be in business with. For example, if you'd rather work 16 hours a day if that is what it takes to finish a project on time, and your partner would rather quit after 8 hours a day and try to renegotiate the due date for the project, that difference in work styles will invariably cause conflict. Similarly, if you like to wear a coat and tie when meeting with clients and your partner thinks wearing blue jeans is fine, obvious disagreements could surface.
3. **Make sure you and your partner have common goals and aspirations.** Be sure that you and your partner are shooting for the same target. For example, if your goal is to build a billion-dollar company but your partner would be perfectly satisfied growing the company to $10 million in sales and then selling out, obvious problems could ensue.
4. **Look in the right places.** If you don't have someone already in mind, it is important to know where to look for a potential partner. Generic networking events, like Chamber of Commerce mixers, are usually ineffective for finding a business partner. Instead, if you are looking for an engineer, contact engineering trade associations for leads or attend engineering trade fairs. Social networking sites for professionals, such as LinkedIn, can be an effective way to make contacts. Most cities have start-up networking events. There are also websites and events specifically designed to help bring people together to start companies. Examples include Startup Weekend (http://startupweekend.org), Founder2Be (www.Founder2be.com), and CoFoundersLab (www.cofounderslab.com).
5. **Hire a lawyer.** When you have identified a potential partner and you are confident that the first four criteria we have discussed have been satisfied, you should hire a lawyer to sit down with the two (or more) of you to help hammer out the details. You should decide what each partner will contribute to the business, how the equity in the business will be split, what form of business ownership to select, what each partner's role in the company will be, and so forth. It's important to hire someone who is not loyal to any specific partner (even if it's you). Hire someone who is impartial and everyone feels good about.

Questions for Critical Thinking

1. Think about your personality and work habits. What type of person (in terms of personality and work habits) do you think you'd work well with and what type of person do you think you'd be in constant conflict with?
2. Do you think it's a good idea or a bad idea to form a business partnership with a close friend? How could you go about discerning if a good friend would make a good business partner?
3. Provide some suggestions, other than those mentioned in the feature, for places (online or offline) for finding a business partner.
4. Spend some time looking at LinkedIn. How could you use LinkedIn to help find a business partner?

resources. The objective is to identify the most important nonfinancial resources and assess their availability. An example is a start-up that will require employees with specialized skills. If a firm launches in a community that does not have a labor pool that includes people with the skill sets the firm needs, a serious resource sufficiency problem exists.

Another key resource sufficiency issue is the ability to obtain intellectual property protection on key aspects of the business. This issue doesn't apply to all start-ups; but, it is critical for companies that have invented a new product or are introducing a new business process that adds value to the way a product is manufactured or a service is delivered. One quick test a start-up can administer is to see if a patent has already been filed for its product or business process idea. Google Patents (www.google.com/patents) is a user-friendly way to search for patents. Although it isn't a substitute for utilizing a patent attorney, this approach can give a start-up a quick assessment of whether someone has beaten them to the punch regarding a particular product or business process idea. An excellent resource for doing a quick trademark search is Trademarkia (www.trademarkia.com). We discuss all forms of intellectual property, including patents and trademarks, in Chapter 12. Some prospective businesses are also subject to regulatory issues that must be investigated and discerned. For example, to this day, Uber is legally prohibited from operating in some jurisdictions because the manner in which it operates violates local codes.

To test resource sufficiency, a firm should list the 6 to 12 most critical nonfinancial resources that it will need to move its business idea forward and determine if those resources are available. Table 3.5 provides a list of the types of nonfinancial resources that are critical to many start-ups' success.

Financial Feasibility Analysis

LEARNING OBJECTVE

5. Describe what a financial feasibility analysis is, explain its importance, and discuss the most critical issues to consider when completing this analysis.

A **financial feasibility analysis** is the final component of a comprehensive feasibility analysis. For feasibility analysis, a preliminary financial assessment is usually sufficient; indeed, additional rigor at this point is typically not required because the specifics of the business will inevitably evolve, making it impractical to spend a lot of time early on preparing detailed financial forecasts.

The most important issues to consider at this stage are total start-up cash needed, financial performance of similar businesses, and the overall financial attractiveness of the proposed venture.

If a proposed new venture moves beyond the feasibility analysis stage, complete pro forma (or projected) financial statements that demonstrate the firm's financial viability for the first one to three years of its existence must be completed. In Chapter 8, we will provide you with specific instructions for preparing these statements.

Total Start-Up Cash Needed

This first issue refers to the total cash needed to prepare the business to make its first sale. An actual budget should be prepared that lists all the anticipated capital purchases and operating expenses needed to get the business up and running. After determining a total figure, an explanation of where the money

TABLE 3.5 Types of Nonfinancial Resources That Are Critical to Many Start-Ups' Success

- Affordable office space
- Lab space, manufacturing space, or space to launch a service business
- Contract manufacturers or service providers
- Key management employees (now and in the future)
- Key support personnel (now and in the future)
- Key equipment needed to operate the business (computers, machinery, delivery vehicles)
- Ability to obtain intellectual property protection on key aspects of the business
- Support of local governments and state government if applicable for business launch
- Ability to form favorable business partnerships


Pressmaster/Shutterstock

This entrepreneur is working on the start-up budget for a social media platform he is developing. Financial feasibility analysis is a vital part of the feasibility analysis process.

will come from should be provided. Avoid cursory explanations such as "I plan to bring investors on board," or "I'll borrow the money." Although you may ultimately involve investors or lenders in your business, a more thoughtful account is required of how you will provide for your initial cash needs. We cover funding and financing in detail in Chapter 10.

If the money will come from friends and family or is to be raised through other means, such as credit cards or a home equity line of credit, a reasonable plan should be stipulated to repay the money. Showing how a new venture's start-up costs will be covered and repaid is an important issue. Many new ventures look promising as ongoing concerns but have no way of raising the money to get started or are never able to recover from the initial costs involved. When projecting start-up expenses, it is better to overestimate rather than underestimate the costs involved. Murphy's Law is prevalent in the start-up world—things will go wrong! It is a rare start-up that doesn't experience some unexpected expenses during the start-up phase.

There are worksheets posted online that help entrepreneurs determine the start-up costs to launch their respective businesses. Start-up cost worksheets are available via SCORE (www.score.org) and the U.S. Small Business Administration (www.sba.gov).

Financial Performance of Similar Businesses

The second component of financial feasibility analysis is estimating a proposed start-up's potential financial performance by comparing it to similar, already established businesses. Obviously, this effort results in approximate rather than exact numbers. There are several ways of doing this, all of which involve a little gumshoe labor.

First, substantial archival data, which offers detailed financial reports on thousands of individual firms, is available online. The easiest data to obtain is on publicly traded firms through Hoovers or a similar source. These firms are typically too large, however, for meaningful comparisons to proposed new ventures. The challenge is to find the financial performance of small, more comparable firms. Samples of websites that are helpful in this regard are provided in the Internet Resource table in Appendix 3.3. IBISWorld, BizMiner, and Find-TheCompany provide data on the average sales and profitability for the firms in the industries they track. ReferenceUSA provides revenue estimates for many private firms, but fewer libraries subscribe to its service. (This resource is more commonly available at large city libraries.) On the expense side, a very useful website is BizStats.com, where an entrepreneur can type in the projected revenue of his or her firm, by industry classification (not all industries are covered), and receive a mock income statement in return that shows the average profitability and expense percentages of U.S. businesses in the same category. IBISWorld also normally provides a chart of the average expenses (as a percentage of sales) for major items such as wages, rent, office and administrative expenses, and utilities for firms in the industries they follow. Another source to help estimate a firm's sales and net profit is BizMiner (www.bizminer.com). BizMiner provides a printout of the average sales and profitability for firms in the industries it follows and provides more detail than similar reports. It is a fee-based site but is free if accessed through a university library that subscribes to the service.[13]

There are additional ways to obtain financial data on smaller firms. If a start-up entrepreneur identifies a business that is similar to the one to be started, and the business isn't likely to be a direct competitor, it is perfectly acceptable to ask the owner or manager of the business to share sales and income data. Even if the owner or manager is only willing to talk in general terms (e.g., our annual sales are in the $3 million range, and we're netting around 9 percent of sales), that information is certainly better than nothing. Simple Internet, ProQuest, and LexisNexis Academic searches are also helpful. If you're interested in the sports apparel industry, simply typing "sports apparel industry sales" and "sports apparel industry profitability" will invariably result in links to stories about sports apparel companies that mention their sales and profitability.

Simple observation and legwork is a final way to obtain sales data for similar businesses. For example, if you were proposing to open a new smoothie shop, you could gauge the type of sales to expect by estimating the number of people who patronize similar smoothie shops in your area, along with the average purchase per visit. A very basic way to do this is to frequent these stores and count the number of customers who come in and out of the stores during various times of the day.

Overall Financial Attractiveness of the Proposed Venture

A number of other factors are associated with evaluating the financial attractiveness of a proposed venture. These evaluations are based primarily on a new venture's projected sales and rate of return (or profitability), as just discussed. At the feasibility analysis stage, the projected return is a judgment call. A more precise estimation can be computed by preparing pro forma (or projected) financial statements, including one- to three-year pro forma statements of cash flow, income statements, and balance sheets (along with accompanying financial ratios). This work can be done if time and circumstances allow, but is typically done at the business plan stage rather than the feasibility analysis stage of a new venture's development.

To gain perspective, a start-up's projected rate of return should be weighed against the following factors to assess whether the venture is financially feasible:

- The amount of capital invested
- The risks assumed in launching the business
- The existing alternatives for the money being invested
- The existing alternatives for the entrepreneur's time and efforts

As promising as they seem on the surface, some opportunities simply may not be worth it financially. For example, it makes no economic sense for a group of entrepreneurs to invest $10 million in a capital-intense, risky start-up that offers a relatively low return (say around 3 percent) on the capital the entrepreneurs are investing. The adequacy of returns also depends on the alternatives the individuals involved have. For example, an individual who is thinking about leaving a $150,000-per-year job to start a new firm requires a higher rate of return than the person thinking about leaving a $50,000-per-year job.[14]

Other factors used to weigh the overall financial attractiveness of a new business are listed in Table 3.6.

In summary, the importance of feasibility analysis can be illustrated through an example of a product that was introduced to the market and quickly failed. The illustration, which focuses on the Keurig Kold, an in-home soda maker that was pulled off the market nine months after it debuted, is provided in the nearby "What Went Wrong?" feature.

A Feasibility Analysis Template

LEARNING OBJECTIVE

6. Describe a feasibility analysis template and explain why it is important for entrepreneurs to use this template.

First Screen, shown in Appendix 3.2, is a template entrepreneurial firms use to complete a feasibility analysis. It is called First Screen because a feasibility analysis is an entrepreneur's (or a group of entrepreneurs') initial pass at determining the feasibility of a business idea. If a business idea cuts muster at this stage, the next step is to complete a business plan.

The mechanics for filling out the First Screen worksheet are straightforward. It maps the four areas of feasibility analysis described in the chapter, accentuating the most important points in each area. The final section of the worksheet, "Overall Potential," includes a section that allows for suggested revisions to a business idea to improve its potential or feasibility. For example, a business might start out planning to manufacture its own product, but through the process of completing First Screen, learn that the capital needed to set up a manufacturing facility is prohibitive in terms of both the money that would need to be raised and the extended time to break even for the business. As a result, two of five items in Part 5, "Initial Capital Investment" and "Time to Break Even," might be rated "low potential." This doesn't need to be the end of the story, however. In the column labeled "Suggestions for Improving the Potential," the founders of the business might write, "Consider contract manufacturing or outsourcing as an alternative to manufacturing the product ourselves." The value of the First Screen worksheet is that it draws attention to issues such as this one and forces the founders to think about alternatives. If this particular suggestion is realistic and is determined to be a better way to proceed, a revised version of First Screen might rate the two factors referred to previously, "Initial Capital Requirements" and "Time to Break Even," as "high potential" rather than "low potential" because of the change in the business concept that was

TABLE 3.6 Financial Feasibility

- Steady and rapid growth in sales during the first five to seven years in a clearly defined market niche
- High percentage of recurring revenue—meaning that once a firm wins a client, the client will provide recurring sources of revenue
- Ability to forecast income and expenses with a reasonable degree of certainty
- Internally generated funds to finance and sustain growth
- Availability of an exit opportunity (such as an acquisition or an initial public offering) for investors to convert equity into cash

WHAT WENT WRONG?

How Feasible Was the Keurig At-Home Soda Machine to Begin With?

Keurig Green Mountain is a specialty coffee company. It sources, makes, and sells coffee, hot cocoa, teas, and other beverages under various brands in portion packs for its Keurig brewing system. The Keurig brewing machines are very popular. A coffee-drinker buys a Green Mountain portion pack. You simply pop a pod into the slot, press the 8 oz.-size button, and place your mug under where the machine dispenses the coffee.

In 2015, Keurig decided to launch an at-home soda machine. The idea was to create a product for soda that was similar to the Keurig coffee machine. The Keurig Kold (which was its name) would allow people to quickly make single servings of soda in their homes. Keurig had high hopes for the Keurig Kold. The company even suggested that it might outsell its coffee makers, which are estimated to be in about 17 percent of U.S. households.

As it turned out, the Kold was a miserable failure. Nine months after it debuted, it was pulled from the market. What went wrong? Several things, which makes one wonder what type of feasibility analysis, if any, was conducted before the machine was offered for sale. Consider the following facts as causes of "what went wrong?"

1. It was too expensive. The machine debuted at $369. In comparison, the cheapest SodaStream model, which also allows people to make single serve sodas at home, costs $79. Every 8-ounce soda made by the Kold costs about 50 cents. By comparison, a 12-pack of branded-soda products, such as Coke, Dr. Pepper, or Pepsi Cola, can usually be bought at Walmart and other discount stores for about $4.50. That's $37\frac{1}{2}$ cents for each 12-ounce drink.
2. It was too big, loud, bulky, and inconvenient. As soon as the Kold came out, buyers complained that it was too big and took up too much counter space. If you are interested, go to Google Images and type in Keurig Kold to judge for yourself. It was loud. It also had to be plugged in to work, meaning that one couldn't conveniently take it on a picnic or use it for an outdoor barbeque unless electricity was readily available.
3. The pods only came in one size. The Kold made a single 8-ounce serving of soda from disposable pods of syrup. There was no way to increase the drinks' size. Most cans of soda are 12 ounces. Soda fountains in restaurants or convenience stores often offer much larger sizes.
4. Soda consumption is on the decline. The Kold rolled out at the same time when Americans are cutting back on soda consumption for nutritional and health reasons.
5. Who "brews" soda at home? Kold was asking people to change their behavior—something that is hard to do even if every other aspect of a product is perfect. People have always made coffee at home. The Keurig coffee machine provided a more convenient and efficient way for people to do something that was already being done. But people have never made soft drinks at home. The Kold's challenge was to not only make a soda maker, but to sell people on the idea of making soda at home.

Although Keurig is a large company, the failure of the Keurig Kold provides an important reminder for start-ups and young firms. It is vital for a company to determine if a product or business is feasible before, rather than after, it is introduced to the marketplace. And this just doesn't pertain to product feasibility analysis. All four phases of feasibility analysis that we've discussed in this chapter are important and vital.

Questions for Critical Thinking

1. Of the five facts that contributed to Kold's failure, which one do you think was the most damaging? Explain your answer.
2. Describe the feasibility analysis that Keurig Kold should have conducted prior to the Kold's debut. Do you think Keurig would have produced the same product if they had followed your recommendations? In what ways do you think the product would have been different?
3. Why is it so difficult to change people's behavior? How would you have gone about convincing people that making soda in their home is a good idea?
4. Write a 200-word essay on what a start-up can learn about feasibility analysis from the Keurig Kold failure.

Sources: H. Peterson. "Why Keurig's At-Home Soda Machine Was Always Going to Fail?" Slate.com, available at http://www.slate.com/blogs/business_insider/2016/06/07/keurig_s_kold_an_at_home_soda_machine_was_doomed_to_fail.html (posted June 7, 2016, accessed February 10, 2017); A. Steele. "The One Simple Reason That Keurig Kold Failed: No One Makes Soda at Home," Zacks, https://www.zacks.com/stock/news/219798/the-one-simple-reason-that-keurig-kold-failed-no-one-makes-soda-at-home (posted June 7, 2016, accessed February 10, 2017).

made. Business ideas at the feasibility analysis stage should always be seen as fluid and subject to change. Little is lost if several versions of First Screen are completed for the same business idea; however, there is much more to be lost if a start-up gets halfway through writing a business plan and concludes that the business isn't feasible, or actually launches a business without having at least most of the kinks worked out.

Although completing First Screen does take some research and analysis, it is not meant to be a lengthy process. It is also not meant to be a shot in the dark. The best ideas are ones that emerge from analysis that is based on facts and good information, rather than speculation and guesses, as emphasized throughout the chapter. Appendix 3.3 contains the Internet Resource Table that may be particularly helpful in completing a First Screen analysis. It is well worth your time to learn how to use these resources—they are rich in terms of their content and analysis.

It is important to be completely candid when completing First Screen for your business idea. No business scores "high potential" on every item. There is also no definitive way of discerning, after the worksheet is completed, if an idea is feasible. First Screen, like the feasibility analysis itself, is meant to convey an overall impression or sense of the feasibility of a business idea. Copies of the First Screen Worksheet, in both MS word and PDF, are available from your instructor.

Chapter Summary

LO1. Feasibility analysis is the process of determining whether a business idea is viable. It is a preliminary evaluation of a business idea, conducted for the purpose of determining whether the idea is worth pursuing. The proper time to conduct a feasibility analysis is early in thinking through the prospects for a new business idea. It follows opportunity recognition but comes before the development of a business model and a business plan.

LO2. A product/service feasibility analysis is an assessment of the overall appeal of the product or service being proposed. The two components of product/service feasibility analysis are product desirability and product demand. A concept statement, which is a preliminary description of a product idea, is developed during this particular aspect of the feasibility analysis process to see if the proposed product or service makes sense to potential customers and if it has any fatal flaws that require immediate attention. Using online tools such as Google AdWords and Landing Pages and conducting library, Internet, and gumshoe research are techniques entrepreneurs use to assess the likely demand for a product or service.

LO3. An industry/market feasibility analysis is an assessment of the overall appeal of the market for the product or service being proposed. For feasibility analysis, there are two primary issues that a business should consider in this area: industry attractiveness and target market attractiveness. A target market is a segment within a larger market that represents a narrower group of customers with similar needs. Most start-ups simply don't have the resources needed to participate in a broad market, at least initially. Instead, by focusing on a smaller target market, a firm can usually avoid head-to-head competition with industry leaders and can focus on serving a specialized market very well. An attractive industry has several desirable characteristics for a new venture, including those of being (a) "young" rather than old or very well established, (b) in the early rather than the late stage of the product life cycle, and (c) fragmented (where a large number of firms are competing but no single firm has a dominant market position) rather than highly concentrated (where a few large firms dominate competition).

LO4. An organizational feasibility analysis is conducted to determine whether a proposed business has sufficient management expertise, organizational competence, and resources to successfully launch its business. There are two primary issues to consider in this area: management prowess and resource sufficiency. With respect to management prowess, the intention is to determine the ability of the proposed venture's initial management team. In terms of analysis, resource sufficiency is concerned with determining if the proposed venture would have the resources required to compete successfully.

LO5. A financial feasibility analysis is a preliminary financial analysis of whether a business idea is worth pursuing. The most important areas to consider are the total start-up cash needed, financial performance of similar businesses, and the overall financial attractiveness of the proposed business.

LO6. First Screen is a template for completing a feasibility analysis. It is called First Screen because a feasibility analysis is an entrepreneur's (or group of entrepreneurs') initial pass at determining the feasibility of a business idea.

Key Terms

concept statement, **111**
concept test, **111**
confirmation bias, **116**
feasibility analysis, **109**
financial feasibility analysis, **124**
industry, **118**
industry/target market feasibility, **118**
landing page, **117**
new-venture team, **122**
organizational feasibility analysis, **122**
primary research, **110**
product/market fit, **112**
product/service feasibility analysis, **110**
prototype, **119**
secondary research, **110**
target market, **118**

MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

3-1. How would you describe the four areas that a properly executed feasibility analysis explores?
3-2. What is a product/service feasibility analysis?
3-3. What is the difference between primary research and secondary research?
3-4. What is a concept test?
3-5. What are the two ways that entrepreneurs assess the likely product demand for the proposed product or service they are analyzing?
3-6. What is gumshoe research in the context of product/service feasibility analysis?
3-7. What is an industry/target market feasibility analysis?
3-8. Why do we need to have face-to-face conversations with potential customers?
3-9. What is the purpose of an industry feasibility analysis and what must be considered?
3-10. Why do most start-ups focus on relatively small target markets to begin with rather than larger markets with more substantial demand?
✪ 3-11. What are some of the ways to determine the attractiveness of a small target market within a larger industry?
3-12. What is an organizational feasibility analysis?
3-13. What are the two primary issues to consider when conducting an organizational feasibility analysis?
3-14. What is a new-venture team?
3-15. What is a financial feasibility analysis?
3-16. What are the three separate components of financial feasibility analysis?
3-17. What are some of the techniques a start-up can use to estimate its potential financial performance by comparing it to similar, already established businesses?
✪ 3-18. What are the nonfinancial resources that are essential for start-ups to succeed?
3-19. Why is the feasibility analysis template called First Screen, and what is included in the final part of the analysis?

Application Questions

3-20. Jackson Reed, a friend of yours, just told you an interesting story. He was at his parents' house over the weekend. While there, his father saw the entrepreneurship textbook that is being used in one of the classes Jackson is taking this semester. He looked through the book and spent a bit of time studying the chapter on feasibility analysis. After doing so, he said to Jackson, "When you were growing up, I launched and sold three successful businesses and never once completed a feasibility analysis. What do you think the authors of the text would say about that?" What would you suggest that Jackson say in response to his father's question?

3-21. In a recent entrepreneurship class, Steven Milton has been given an assignment to conduct a product/service feasibility analysis. He is to propose a product or service that might be useful to students on campus, and the analysis should include an assessment of its overall appeal. Steven should include the following questions in his analysis to determine its appeal: Does the product/service make sense? Does it solve a problem or fill a gap in the market? Is now a good time to introduce the product/service? Are there any flaws? As Steven's friend, help him to propose a suitable product/service to the intended target market and conduct a feasibility analysis based on his proposal.

3-22. If you were one of the recipients of New Venture Fitness Drinks' concept statement, as presented earlier in the chapter, what type of feedback would you have given the company about the viability of its product idea?

3-23. Linda Toombs, who has considerable experience in the home security industry, is planning to launch a new line of home security alarms that she believes would be superior to other products in the market. Linda knows how to develop a concept statement and administer a buying intentions survey but is less clear about the type of library and Internet research that might help her assess the demand for her product. If Linda asked you about this, what advice would you give to her about how to conduct successful library and Internet searches?

3-24. Marie Finn is planning to start a business in home cleaning services. List the potential methods of market feasibility analysis that Marie should conduct for her new venture.

3-25. If you were interested in opening a musical instruments store near the college or university you are attending in order to sell guitars, drums, and other types of musical instruments, what online resources would you draw on to conduct secondary research regarding the industry/target market feasibility of your business idea?

3-26. You bumped into your ex-colleague Allen Smith at a nearby supermarket. You struck up a conversation, and he spoke enthusiastically about his upcoming business. He is in the middle of plans to open a fitness center in your neighborhood. Throughout your conversation with him, you noticed that he did not mention a proper financial feasibility analysis. It seemed that he was blindly forging ahead with no proper planning, especially on financial matters. As a friend, advise him on the most critical financial issues he should consider when completing this analysis.

3-27. If you were considering the possibility of launching a website that you've developed in order to sell sports apparel for petite women, what are some specific actions you could take to collect feedback regarding the usability of your website?

3-28. What are some of the red flags that would suggest that the overall financial attractiveness of a proposed new venture is poor? Which of the red flags you identified would suggest that realistically, a proposed venture isn't feasible?

3-29. The owner of a small restaurant has been looking at new ideas to attract addition table bookings. She has created a landing page on the restaurant's website with some basic copy and a link for visitors to type in their email address. Each person that emails is sent a copy of the menu and the owner's cell phone number to make a booking. After a month, the owner has had 349 customers input their email address and has received 63 bookings. She is delighted with the response with so little effort and cost. How would you advise her to increase her exposure to potential customers?

YOU BE THE VC 3.1 Company: Eat Clean ME

• Web: eatcleanme.com • Facebook: Eat Clean ME

Business Idea: Develop a custom-made wellness and healthy food–ordering platform that brings together a city's healthy food choices under one app and delivers the food at the customers' homes and offices.

Pitch: Remaining healthy and fit is a growing concern and a rising trend among consumers in the Middle East. Today's health- and fitness-conscious consumers spend a lot of time examining their food and their nutritional values. However, developing and maintaining good eating habits is challenging considering the busy lives that many people lead today. Fixing a healthy meal is not only time-consuming but also requires all the effort that goes into grocery shopping, preparing, storing, and cleaning. Going out to eat healthy can be time consuming as well—finding dairy-free, sugar-free, gluten-free, and low-calorie options can be a challenging task.

So how about an app-based platform that brings a variety of healthy food options to consumers' doorsteps? Eat Clean ME (Middle East) is an app-based platform that offers both convenience and healthy eating to residents of the city of Dubai, in the United Arab Emirates. The city has a large expat working population who are young, have high disposable incomes, and are becoming increasingly fitness- and health-conscious. Its local population is also well informed and aspires to adopt more global values of fitness.

Eat Clean ME offers more than 500 healthy menu options from the across the city and allows users to customize their experience by specifying their dietary and nutritional preferences. The app asks for the user's location and lists the healthy food choices available in the area nearby. Menu options are displayed to users along with descriptions of nutritional values like Kcal, proteins, carbohydrates, and fat content, along with prices, payment options, and estimated delivery time. Eat Clean ME also follows the local practice of offering its the users the option of paying by cash or card on delivery. The app is supported by a call center that deals with customers' queries and allows them to track their food deliveries. Eat Clean ME also offers its consumers a healthy handbook that contains useful nutrition information, increasing their awareness of topics in dieting and nutrition. The platform also has a blog where dieticians and nutritionists give advice and information on how to incorporate good eating habits and follow a healthy lifestyle. Eat Clean ME's proposition is attractive: Be more informed about what you are eating, be in control of your food choices, order from your office or home, get food delivered, and choose from a large variety of offerings.[15]

3-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answer would satisfy you?

3-31. If you had to make your decision on just the information provided in the pitch and on the company website, would you fund this company? Why or why not?

YOU BE THE VC 3.2 Company: CADI Scientific—SmartSense

• Web: www.cadi.com.sg • Facebook: CADI Scientific • Twitter: @cadismartsense

Business Idea: Produce and sell the first wireless patient-monitoring system, enhancing patient care by continuously measuring vital medical data, and transmitting the information to health practitioners.

Pitch: Monitoring a sick patient can be a delicate balancing act. They need uninterrupted sleep to aid their recovery, but medical staff must also regularly check vital signs such as temperature and blood pressure. The two needs are not always good bedfellows.

Four entrepreneurial scientists have come up with a solution—a wireless gadget called SmartSense, which is now being used in hospitals in Singapore, Bangkok, Taipei, and the Middle East. The 1.2-inch wide device is taped to a patient's body to continuously measure vital signs. Radio frequency technology then transfers the data wirelessly via ceiling-mounted transmitters to computers in the nurses' station.

The inspiration for the idea came out of a coffee-break conversation between CADI Scientific founder Zenton Goh and a colleague who had a sick child and said that he and his wife were waking the infant every two hours through the night to take her temperature. Goh then thought of an automated wireless sensing system that would monitor a baby's body temperature and let both parent and child enjoy uninterrupted sleep. That idea evolved into SmartSense.

Nurses can now dispense with the task of manually checking temperatures and blood pressure every few hours, and patients get uninterrupted rest. SmartSense also cuts down on any possibility of human error in the checks. Doctors can check the data on-the-go too via Wi-Fi-enabled digital assistants or on PCs anywhere in the hospital.

Another bonus to introducing this system in crowded wards is that it is now very easy to quickly spot clusters of patients developing a fever at the same time. As incidences of hospital-acquired infections grow, this is an increasingly important early warning signal. Since then, consumer versions of SmartSense, such as an Infrared Ear and Forehead Thermometer, have been produced to allow people to monitor temperature and blood pressure at home.

3-32. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

3-33. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this firm? Why or why not?

CASE 3.1

"Something Borrowed"—How Feasibility Analysis Shaped Rent the Runway into the Business It Is Today

• *Web: www.renttherunway.com* • *Facebook: RentTheRunway* • *Twitter: @RenttheRunway*

Bruce R. Barringer, *Oklahoma State University*

R. Duane Ireland, *Texas A&M University*

Introduction

In 2007, Jennifer Hyman and Jennifer Fleiss met at Harvard Business School. They were in the same cohort and quickly became friends. Both were interested in entrepreneurship and frequently met for lunch to talk about business ideas. Prior to coming to Harvard, Hyman had worked for Starwood Hotels where she was given the chance to start a business inside the company. She started a wedding business and launched the first bridal registry for honeymoons. She figured since people were waiting longer to get married, they no longer needed china and pots and pans as wedding gifts. So why not let the wedding guests help contribute to the honeymoon trip? Fleiss was an internal strategy consultant at Morgan Stanley and Lehman Brothers and also founded an essay editing service for college applicants.

The idea for Rent the Runway originated in November 2008, during Hyman and Fleiss' second year at Harvard. On a trip home to New York City, Hyman visited her sister, Becky. Becky, who made about $60,000 per year as a buyer for Bloomingdales, had just bought a $2,000 Marchesa red gown to wear to a wedding. Hyman was looking in Becky's closet which was full of designer clothes. She started teasing her sister asking why she didn't just wear something she already owned. Becky's response was that those dresses were dead to her. She'd worn them, been photographed in them, and the photos were up on Facebook. She felt she needed something new for the wedding. Hyman thought what if women like Becky could just rent clothes for special occasions rather than buying them? Hyman later learned that the average woman has 28 occasions per year where she dresses in something special. The occasions include weddings, New Year's Eve parties, dates, sorority parties, job interviews, class reunions, graduations, and so forth.

On arriving back in Boston after her weekend trip, Hyman had lunch with Fleiss and told her about her idea. Fleiss said she thought the idea sounded fun, and the two started brainstorming about who to talk to about it. To find out if the idea had legs, they felt they needed to validate both the supplier side (the provider of designer dresses) and the consumer side (the women who would rent the dresses).

Feasibility Analysis

The Designers. They decided to start on the supplier side, the designers of women's designer clothing. One such designer suggested they talk to Diane von Furstenberg, a well-known fashion designer. Hyman sent her an e-mail stating that she was a student at Harvard,

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had a business idea, and would like to get her feedback. Hyman got a response—in 28 point hot pink bubble font—agreeing to meet the next day. Hyman and Fleiss drove to New York City for the meeting. The original idea for Rent the Runway was a little different from where it ended up. The initial idea was to create a platform that would allow Hyman and Fleiss to rent the existing inventory of top designers, at 10 percent of the retail cost, rather than owning the inventory themselves. The pitch to women would be, "why buy designer clothes when you can rent them for 10 percent of the price?" Ms. von Furstenberg hated the idea. She said it could ruin her brand and cannibalize her retail sales. She was gracious, however, and spent time talking through the designer clothing industry with the two young women. By the end of the conversation, Hyman and Fleiss had learned two things they didn't know previously. First, most women who buy designer clothes are in their 50s and 60s. Younger women shy away because of the cost and the availability of attractive clothes at lower price points. Second, designer fashion was concentrated in major metropolitan areas, such as New York City, Los Angeles, and San Francisco. There wasn't sufficient demand in smaller cities and rural areas for designers to maintain stores. The combination of these insights created an "aha" moment for Hyman and Fleiss. There was a customer acquisition problem in the designer fashion industry. What if they could open the market to younger women and bring geographical diversity to the industry? Von Furstenberg told them if they could make her clothes relevant to younger women, she might work with them.

During the summer months of 2009, Hyman and Fleiss met with additional designers, now pitching the idea as a way to bring younger women and geographical diversity to the women's designer clothing industry rather than saving women money. The reason that getting buy-in from the designers was so important is that Hyman and Fleiss knew they needed them for their business to work. They couldn't go to retail stores and buy their inventory—that would be too expensive and they couldn't control the supply. Instead, they needed to buy at wholesale and work with designers to curate their purchases. Many of the meetings were rough, with designers expressing the same concerns that Ms. von Furstenberg had. They started to make headway, however, and several agreed to sign on if Hyman and Fleiss launched the business.

Jumping ahead a bit, after Rent the Runway launched, Hyman and Fleiss still had a lot of convincing to do. Many of the top designers still hadn't come on board. So when they started renting dresses, they put a place on their website where women could upload photos of themselves at events wearing Rent the Runway clothing. One out of every four customers posted a photo. So they started to accumulate tens of thousands of photos of young women celebrating their lives. Hyman later said in an interview that she thinks that the photos were the clincher in getting designers to feel comfortable working with Rent the Runway. They could see for themselves the demographic to whom the service was appealing.

The Customers. After meeting with designers, the next step was to validate their idea with customers. They ran three tests, with the first one conducted at Harvard. They bought 100 dresses and borrowed another 50. Hyman and Fleiss like to joke that a lot of the dresses they bought were in their sizes so if the business didn't work out at least they'd have fantastic wardrobes. They put up pop-up stores with dresses that women could rent. They tried to simulate what their finished business might look like, so they provided the women envelopes to return the dresses by mail.

They let the women try on the dresses. The idea was to answer several questions—"Would women rent dresses?" "What designers will they rent?" "How much would they pay?" "What kinds of occasions would they rent them for?" "Can you return a dress through the mail?" "Will the rented dresses come back destroyed?" They gleaned insight into each of these questions through the test. They also had their second "aha" moment. They observed the women before and after they tried on the dresses. They noticed one woman in particular, who tried on a Tory Burch Celebrity Dress. Her whole demeanor changed after she put on the dress. She

Rent the Runway rents stylish dresses and accessories suitable for many occasions. The company has an excellent assortment of black tie dresses like the one this woman is wearing.

Megan Betteridge/Shutterstock

looked more inspired and confident. Hyman and Fleiss thought, "This is our business. We're not only renting clothes. We're providing young women confidence and determination." This experience caused Hyman and Fleiss to again rethink their positioning. Rent the Runway wouldn't be about saving women money. It would be about providing women incredible moments with fashion.

The second test was at Yale University. During the test, women could see the dresses but could not try them on. About 75 percent rented. For the third test, Hyman and Fleiss sent PDF files to between 1,000 and 2,000 friends, family, and others they knew. The women could see photos of the dresses but couldn't view them or try them on. A much smaller percentage rented, but the response was significant enough that Hyman and Fleiss felt encouraged.

Rent the Runway Becomes a Business

Rent the Runway launched on November 9, 2009, as an e-commerce company. Hyman and Fleiss were able to raise a seed round of just under $2 million for their initial inventory and start-up costs. Initially, the site was an invitation-only website. Membership was free, but you had to be invited or be recommended by a friend to join. In two weeks, Rent the Runway had 100,000 members. There were three keys to gaining so many members so quickly. First, Hyman and Fleiss had built buzz through the feasibility analysis process, by talking to many designers and others in the women's designer fashion industry. Second, they had built an e-mail list of 40,000 people, which included friends, family, friends of friends, and anyone they could think of. They e-mailed them as soon as Rent the Runway launched and invited them to join. They also invited them to invite friends to join. Third, they got incredibly lucky. The day they launched they were featured on the front cover of the business section of *The New York Times*. Someone in their network had recommended them to the paper and they ran the story. More publicity followed which built the momentum.

Rent the Runway launched with an approach that remains largely the same today, although you don't need to be invited anymore to be a member. Customers can rent one of Rent the Runway's designer dresses for 10 percent of the retail price. Each dress includes a back-up size at no additional cost to ensure fit. You can filter pieces by size, color, category, occasion, and even age range.

Customers can get a second dress with their order for a smaller fee. Rent the Runway provides customers with a pre-paid, pre-addressed package to return the dress. Rental prices include the dry cleaning and restocking of the item.

"Listening" to Customers

The practice of listening and testing didn't stop after Rent the Runway launched. In the early days, the company focused heavily on customer feedback and focus groups to refine their processes and offerings. That approach has become an ongoing practice. For example, the company calls its customer service reps its "Customer Insights Team." The team interacts with customers about how a particular dress fits or the most appropriate accessories for a particular garment, but it also collects insights about how the company should innovate its business model. For example, the Customer Insights Team received so many questions early on about accessories, such as "What type of necklace would work the best with this dress?" or "Which earrings would go well with this item?" that the company started renting accessories on its site much earlier than anticipated.

Lessons Learned

Since Rent the Runway launched, Hyman and Fleiss have completed many interviews; this is where much of the information for this case came from. They frequently talk about three or four lessons learned from their experiences. First, they feel as though their complementary strengths have benefited their business. Hyman is the creative person and the visionary while Fleiss is the executor. Although they were friends, they didn't select each other by chance. They were in several classes together in college, allowing them to observe each other's work ethic and how each responded to case questions and where each added value. Second, they don't believe that not having fashion industry experience was a detriment to their business. In fact, they believe their inexperience allowed them to see the industry through fresh sets of eyes. Finally, they're big believers in testing and vetting ideas before trying them. See the nearby quote from Fleiss. The way Hyman and Fleiss vetted Rent the Runway prior to launch and the manner in which the company is now managed is fully consistent with this sentiment.

Jennifer Fleiss on Feasibility Analysis

"A big mistake that many entrepreneurs make is being hesitant to share information about their concept with others. Jenn (Hyman) and I did the exact opposite. We shared our idea with as many designers, women, and investors as we possibly could and utilized their feedback to tweak our original idea." *Inc*., "Best Advice I Ever Got: Jennifer Fleiss," September 10, 2012.

Opportunities Ahead

Although the essence of Rent the Runway's original vision remains the same, the company has made some changes. The company now has several physical locations—New York City, Washington, D.C., Chicago, Los Angeles and Las Vegas—along with its e-commerce business.

In March 2016 the company launched Unlimited, which, for $139 per month, allows customers to have three Rent the Runway items at any given time. The items can be kept for as long as the customer wants or swapped out for new selections. Rent the Runway has also broadened its product line. It now rents a full line of accessories, including jewelry and handbags, and sells essentials including lingerie, tights, shapewear, and cosmetics. As of October 2016, Rent the Runway had over six million members, 975 employees, and over 400 designer partners.

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The company doesn't have plans to branch into men's clothing, preferring instead to remain focused on women's designer apparel. In March of 2017, cofounder Jennifer Fleiss stepped down from her executive role in Rent the Runway. She remains a member of the firm's board of directors and intends to pursue other earlier-stage entrepreneurial ventures. Now running the company herself, Jennifer Hyman is preparing the firm for an eventual IPO event.

Discussion Questions

3-34. Make a list of the ways in which Hyman and Fleiss vetted their business idea prior to launch. How long was it between the initial idea for Rent the Runway and when the business launched? What does the amount of time between the two events tell you about Hyman and Fleiss' feasibility analysis process?

3-35. To what degree would Rent the Runway be a different company today if Hyman and Fleiss had not conducted a feasibility analysis? Do you think the business would be as successful as is currently the case?

3-36. Identify at least two "take aways" from the Rent the Runway story not mentioned in the Lessons Learned portion of the case.

3-37. What can young entrepreneurs with business ideas learn from Hyman and Fleiss' experiences?

Sources: Rent the Runway Homepage, www.renttherunway.com (accessed February 8, 2017); N. D'Souza-Wolfe. "Rent-a-Work Wardrobe, *The Wall Street Journal*, May 21, 2016, D2; Girlboss Radio, "Jenn Hyman, Co-Founder & CEO of Rent the Runway, available at https://www.girlboss.com/girlboss/2016/5/31/girlboss-radio-jenn-hyman-co-founder-ceo-rent-the-runway (posted April 14, 2016, accessed February 8, 2016); *Inc*. "Best Advice I Ever Got: Jennifer Fleiss. *Inc*., September 10, 2012; "Open Q&A about Rent the Runway CEO of Rent the Runway Jennifer Hyman, available at https://www.youtube.com/watch?v=xjmSDeK4_x4 Draper TV (posted June 26, 2015, accessed February 8, 2017); Wikipedia, Rent the Runway (accessed February 8, 2017).

CASE 3.2

Embrace Infant Warmer: Sometimes a Business Start Is a Matter of Life and Death

• *Web: https://embraceglobal.org* • *Facebook: Embrace* • *Twitter: @embracewarmer*

Bruce R. Barringer, *Oklahoma State University*

R. Duane Ireland, *Texas A&M University*

Introduction

When Rahul Panicker, Jane Chen, and Linus Liang enrolled in Design for Extreme Affordability, a course taught in the Design School at Stanford University, little did they know that the class would change their lives. And little did they know that, a short three years later, premature babies born in rural India, who often don't survive because of hypothermia, would have a new chance at life because of a product they designed.

The Design for Extreme Affordability class draws students from across the Stanford campus. The goal of the class is to develop solutions for formidable, real-world problems. The project Panicker, Chen, and Liang were assigned was to develop a low-cost infant incubator for use in developing countries. This was a topic that the three knew nothing about. They were electrical engineering, MBA, and computer science students, respectively. To get started, they did some simple Google searches. They learned that 15 million pre-term and underweight babies are born annually in developing countries. Three million babies die in the first 28 days of their life—that's six babies every minute. The biggest cause of death is hypothermia. Premature babies don't have enough fat to regulate their body temperature. As a result, they can literally freeze to death in a room that is at room temperature. Nearly half of the world's low-birth-weight babies are born in India. Hospitals have incubators that provide consistent, life-saving heat to premature babies. But incubators cost up to $20,000 apiece, require a constant supply of electricity, and are difficult to operate.

The obvious solution was to drive down the cost of incubators. The team could systematically reduce the cost of traditional incubators by eliminating nonessential parts and using cheaper materials. Rather than moving forward, Liang got funding for a trip to Nepal to study incubators in developing countries. While visiting a hospital, he noticed something that was odd. Many of the incubators were empty. He then learned the sad truth. About 80 percent of the premature babies born in the developing world are born in rural villages. They aren't brought to a hospital and placed in an incubator. Even when they are, they're often taken home before the baby is ready to leave due to family needs back at the village.

Back at Stanford, the team grappled with what to do with the insight. The easier road ahead would be to redesign the traditional incubator in order to make them more affordable. But that wasn't the answer. The harder challenge was to find a solution for saving premature babies where they were born—in rural villages.

Early Prototypes

The team tackled the harder challenge: How to create a baby-warming device that doctors and parents in rural villages could use to save premature babies? The team set to work and started creating rough prototypes of an original design. The earliest prototypes were made using old sleeping bags, baby dolls, and blankets. The design was a portable infant warmer that looks like a tiny sleeping bag. The warmer opens in the front, allowing mothers to nurse their babies and maintain intimate contact. The bag contained a pouch of wax-like, phase-change material that keeps the baby warm for up to six hours at regular body temperatures. It required just 30 minutes of electricity to heat the pouch, an ideal situation for areas where the availability of electricity is spotty. To provide additional warmth, mothers would be instructed to hold their babies as much as possible against their skin. This activity prompted the team to call the product "Embrace."

The class ended and the team had a decision to make. All had promising prospects. In the end, the team members couldn't walk away. The lives of premature babies were at stake. They would move forward and continue to work on what was now known as the Embrace Infant Warmer.

Embrace Infant Warmer

The team, now joined by a fourth Stanford student, Naganand Murty, took the prototype to India to solicit customer feedback. They used rapid prototyping techniques to iterate on feedback and zero in on the attributes that are of highest relevance and value in a rural setting. Some of what they found out was surprising, and would have never been learned had they remained in California. For example, they found that women in India believe that Western medicine is very powerful, so they routinely cut back on the recommended dosages of Western medicines, just to be safe. That knowledge impacted early prototypes of the Embrace Infant Warmer. The early prototypes instructed mothers to set the temperature at 37 degrees Celsius. What they found was that the devices were being set at about 30 degrees. To solve the problem, they preprogrammed the ideal temperature into the device and just put an OK and Not OK switch on it. Commenting on the decision to go to India rather than remain at Stanford to flesh out the Embrace Infant Warmer, Chen told Helen Walters, who wrote an article on Embrace, "There are so many nuances that are critical to design and effective implementation, so many nuances that you don't understand unless you're there and living and breathing the culture every day."

Talking to potential customers raised other issues. For example, they learned that villagers wanted different pricing options—like an option to rent the device. Commenting on changes that were made as a result of feedback from rural villagers, Chen said in an *HBR* blog post, "Entrepreneurs often fall in love with their original product idea or business model and fail to listen to customers. We (meaning the Embrace team), on the other hand, have no qualms about modifying

Embrace Baby Warmer

Embrace

our product features and pricing again and again until we find a solution that delivers the highest value to our customers at the lowest cost for them."

Gaining Momentum

The initial prototypes of the Embrace Infant Warmer were a success, which emboldened the team to keep working. Additional field research took place, involving village mothers in every aspect of design, from the straps on the warmer to the instructions printed on its front. Spending time in homes in rural India produced additional insights. "Oftentimes the mother-in-law is the decision maker," Chen said in the same interview as the one cited above. As a result, they determined a way to involve these decision makers in the process of using the Embrace Infant Warmer. In December of 2010, Embrace was featured in a segment of the ABC News show *20/20.* The show contained images of a five-pound baby girl in India named Nisha, the first child to use the Embrace Infant Warmer in a clinical trial—and perhaps the first life saved by the device.

The Embrace Infant Warmer was formally launched in April 2011, after completing clinical trials. It went through more than 60 iterations before a final design was settled on. All manufacturing is done in Bangalore, India. Some of the parts are outsourced, but the final assembly and quality testing is done by the company. To ensure distribution, Embrace is partnering with multinational

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medical devices companies like GE Healthcare and with local NGOs. An organizational structure has also emerged. Embrace has both a nonprofit arm, which donates its baby warmers to those in need and runs educational programs, and a for-profit side, named Embrace Innovations, which sells the baby warmers to government entities and private clinics. It's a two-pronged approach that the founders hope will allow the company to prosper, grow, and save an increasing number of premature babies. In spring 2014, Beyoncé made a $125,000 donation, which allowed Embrace to enter several countries in sub-Saharan Africa. Just a few months later, Jen Chen, one of Embrace's cofounders and CEO, was invited to the White House for a Maker Faire, honoring Embrace as an example of the new manufacturing revolution.

Little Lotus

In November 2015, Embrace Innovations started Little Lotus (https://littlelotusbaby.com), a retail line of baby products for the U.S. market. Prior to Little Lotus, Embrace and Embrace Innovations had relied primarily on sales to the Indian government. While grateful for the sales, relying on government contracts is not a sustainable revenue model. Little Lotus is a new line of baby products, including swaddles and sleeping bags, that uses NASA-inspired technology to keep babies at the ideal temperature. The fabric absorbs body heat when the baby is too warm and supplies it when the baby is cold. The Little Lotus products are an intersection of technology, design, art, and social impact. On average, babies sleep an additional hour a day when using a Little Lotus product because of less temperature fluctuation. Following the one-for-one model pioneered by TOMS and Warby Parker, for every Little Lotus sold a portion of the proceeds goes to purchase an Embrace Baby Warmer for a mother in need. Little Lotus' products not only provide warmth and comfort to babies in the United States and elsewhere, but provide a new source of revenue and momentum for Embrace Innovations and the entire Embrace effort.

Embrace Today

As of the end of 2016, roughly five and a half years after launch, the Embrace Infant Warmer had been used to help save the lives of more than 150,000 babies across 10 countries. The company's goal is to impact the lives of 1 million babies. Panicker and Chen lead Embrace, while their Stanford classmates and cofounders have moved on. The company is private and doesn't disclose financial information, other than to say that its margins are sufficient to keep growing and try additional products. In addition to rural villages, the Embrace Infant Warmer is being used in hospitals and clinics, to move premature babies from location to location, and to use when a premature baby is born and all of the traditional incubators are in use.

In addition to continuing to improve the Embrace Infant Warmer, the company has aspirations to tackle some of the other factors that cause infant mortality. Other potentially fatal conditions include meningitis, pneumonia, infections such as sepsis, and diarrhea.

To learn more about Embrace and Embrace Innovations, in October 2016, Jen Chen was featured on eCorner, which is an excellent podcast produced by the Stanford Technology Ventures Program. eCorner podcasts are available at ecorner.stanford.edu/podcasts. Look for Season 12, Episode 4, recorded on October 26, 2016. The title of Chen's talk is "Embrace the Entrepreneurial Journey."

Discussion Questions

3-38. What target market does Embrace seek to serve and how attractive is that market?

3-39. What examples of primary research that Embrace's founders completed appear in the case?

3-40. What actions did Embrace's founders take to solicit feedback from prospective customers and what did they learn from these efforts?

3-41. If you were asked to conduct a financial feasibility analysis for Embrace, what issues would you consider to complete this analysis and why are those important?

Sources: Embrace Homepage, www.embraceglobal.com (accessed February 20, 2017); E. Weil, "Caring for Premature Babies, With a Little Help From Beyoncé, *The New York Times*, November 20, 2015; J. Chen. "Embrace the Entrepreneurial Journey," eCorner podcast, available at ecorner.stanford.edu/podcasts (posted October 26, 2016, accessed February 20, 2017); E. Lelon, "The Baby Saving Revolution: Obama and Beyoncé Embrace Founder, Jane Chen (You Will Too), Huffington Post Blog, available at https://www.huffingtonpost.com/elise-lelon/the-baby-saving-revolution-nonprofit_b_5570683.html (posted July 10, 2014, accessed February 10, 2017); T. Kelley and D. Kelley, *Creative Confidence*, New York: Random House Publishing, 2013.

ESSAY QUESTIONS

1. When conducting an industry/target market analysis, why is it critical for a firm to identify and evaluate its target market? Using the story about the Keurig Kold as discussed in the "What Went Wrong?" feature, write a paragraph or two to explain (1) how identifying a target market might have prevented the Kold from being such a failure and (2) what you believe might be a viable target market for this product.
2. Re-read the material in the chapter that describes the components of an organizational feasibility analysis. Given your understanding of CADI Scientific, the company featured in the "You be the VC 3.2" feature, develop a paragraph or two describing the management expertise and the type of new-venture team that you believe would contribute to this venture's efforts to be successful.

APPENDIX 3.1 Tips for Conducting Feasibility Analysis Interviews

General Rules-of-Thumb to Follow

- Always qualify the person you're talking to to make sure he or she is capable of giving good quality feedback.
- Never ask questions for which you should know the answer. For example, you shouldn't ask, "Do you have a college degree?" if the interviewee's bio is easy to find on his or her company's website and it provides his or her educational background.
- Never ask a question that starts with the word "would." Examples include, "If we built a product that solved X problem, would you use it?" "How much would you pay for something that did X?" or "Would you pay $1,000 extra for a 12-month guarantee?" These are hypothetical questions that tend to produce inaccurate data.
- Always prepare an interview script, but allow sufficient flexibility so the interviewee can take the discussion in an unexpected direction.
- Be mentally prepared to hear things you don't want to hear. If you don't, you might catch yourself trying to "sell" your idea rather than soliciting honest feedback.
- Ask open-ended questions. Minimize questions that have "yes" "no" answers, such as "Do you like 24 Hour Fitness?" Instead, ask a question along the lines of, "What do you look for in fitness centers?"
- At the end of the interview, ask the interviewee if there is someone else he or she believes you should talk to. This is one of the most effective ways of getting additional interviews.

Examples of Ineffective Feasibility Analysis Interview Questions

- "Do you like (something everyone likes) such as music, good food, good friends?"
- "Do you have a problem (insert a problem everyone has) such as finding enough time in your day to exercise or read?"
- "Do you want to lose weight, want more money, or want more free time?" (Who doesn't?)
- "Would you pay for an HR training program that would result in having happier employees?" This question assumes that your interviewees' employees aren't happy.
- "Tell me about the biggest problem you have in your business?" (Allows people to vent.)
- Leading questions—You shouldn't ask a question that will sway an interviewee to one side of an argument. An example would be, "How bad do you think our health care system is?" Instead, ask "What are your impressions of our health care system?"
- Loaded questions—You shouldn't ask a question such as, "Where do you enjoy drinking beer?" The question assumes the interviewee drinks beer. Not everyone does. If it is important for you to know the answer to this question, it is better to first ask, "Do you drink beer?"

Examples of Effective Feasibility Analysis Interview Questions

- "What does your typical day look like?" (This is a good warm-up question and can tell you a great deal about your interviewee's major pain points.)
- "What's the hardest part about (insert problem)?"
- "How are you currently solving (insert problem)?"
- "What don't you love about the solutions you've tried?"
- "What are some unmet needs you have?"
- "What is the hardest part of your day?"
- "What would you describe as your ideal solution to this problem?"
- "How likely would you be to tell your friends about this product" (or would you recommend our solution to others?)
- "Why?" This is by far the most powerful question you can ask, so ask it often. By asking "why" after someone gives you a response, you can often exact a more revealing response and get to the core of the issue.

APPENDIX 3.2 First Screen

Part 1: Strength of the Business Idea

For each item, circle the most appropriate answer and make note of the (−1), (0), or (+1) score.

	Low Potential (−1)	Moderate Potential (0)	High Potential (+1)
1. Extent to which the idea: • Takes advantage of an environmental trend • Solves a problem • Addresses an unfilled gap in the marketplace	Weak	Moderate	Strong
2. Timeliness of entry to market	Not timely	Moderately timely	Very timely
3. Extent to which the idea "adds value" for its buyer or end user	Low	Medium	High
4. Extent to which the customer is satisfied by competing products that are already available	Very satisfied	Moderately satisfied	Not very satisfied or ambivalent
5. Degree to which the idea requires customers to change their basic practices or behaviors	Substantial changes required	Moderate changes required	Small to no changes required

Part 2: Industry-Related Issues

	Low Potential (−1)	Moderate Potential (0)	High Potential (+1)
1. Number of competitors	Many	Few	None
2. Stage of industry life cycle	Maturity phase or decline phase	Growth phase	Emergence phase
3. Growth rate of industry	Little or no growth	Moderate growth	Strong growth
4. Importance of industry's products and/or services to customers	"Ambivalent"	"Would like to have"	"Must have"
5. Industry operating margins	Low	Moderate	High

Part 3: Target Market and Customer-Related Issues

	Low Potential (−1)	Moderate Potential (0)	High Potential (+1)
1. Identification of target market for the proposed new venture	Difficult to identify	May be able to identify	Identified
2. Ability to create "barriers to entry" for potential competitors	Unable to create	May or may not be able to create	Can create
3. Purchasing power of customers	Low	Moderate	High
4. Ease of making customers aware of the new product or service	Low	Moderate	High
5. Growth potential of target market	Low	Moderate	High

Part 4: Founder's- (or Founders'-) Related Issues

	Low Potential (−1)	Moderate Potential (0)	High Potential (+1)
1. Founder's or founders' experience in the industry	No experience	Moderate experience	Experienced
2. Founder's or founders' skills as they relate to the proposed new venture's product or service	No skills	Moderate skills	Skilled
3. Extent of the founder's or founders' professional and social networks in the relevant industry	None	Moderate	Extensive

	Low Potential (−1)	Moderate Potential (0)	High Potential (+1)
4. Extent to which the proposed new venture meets the founder's or founders' personal goals and aspirations	Weak	Moderate	Strong
5. Likelihood that a team can be put together to launch and grow the new venture	Unlikely	Moderately likely	Very likely

Part 5: Financial Issues

	Low Potential (−1)	Moderate Potential (0)	High Potential (+1)
1. Initial capital investment	High	Moderate	Low
2. Number of revenue drivers (ways in which the company makes money)	One	Two to three	More than three
3. Time to break even	More than two years	One to two years	Less than one year
4. Financial performance of similar businesses	Weak	Modest	Strong
5. Ability to fund initial product (or service) development and/or initial start-up expenses from personal funds or via bootstrapping	Low	Moderate	High

Overall Potential

Each part has five items. Scores will range from −5 to +5 for each part. The score is a guide—there is no established rule of thumb for the numerical score that equates to high potential, moderate potential, or low potential for each part. The ranking is a judgment call.

Score (−5 to +5)	Overall Potential of the Business Idea Based on Each Part	Suggestions for Improving the Potential
Part 1: Strength of Business Idea	High potential Moderate potential Low potential	
Part 2: Industry-Related Issues	High potential Moderate potential Low potential	
Part 3: Target Market and Customer Related Issues	High potential Moderate potential Low potential	
Part 4: Founder's (or Founders') Related Issues	High potential Moderate potential Low potential	
Part 5: Financial Issues	High potential Moderate potential Low potential	
Overall Assessment	High potential Moderate potential Low potential	

Summary

Briefly summarize your justification for your overall assessment:

APPENDIX 3.3 Internet Resource Table

Resources to Help Complete the First Screen Worksheet in Appendix 3.1

Source	Description	Applicable Parts of First Screen	Cost/Availability
American Factfinder (https://factfinder.census.gov)	An easy-to-use portal for obtaining census data. One quick way to retrieve data is to get a "Fact Sheet" on a geographic area (by city, county, or zip code), that provides population, median household income, demographic breakdown (age, gender, race), and other information.	Part 3	Free
BizMiner (www.bizminer.com)	Industry statistics, sample pro forma financial statements by industry (and size of business), business start activity and failure rates by industry, and similar information. Provides data on small private firms.	Parts 2, 3, and 5	Fee based (more affordable than most); typically free if accessed through a university library
BizStats (www.bizstats.com)	Has a variety of detailed financial data on various retail categories. On the site, a user can type in the projected income of a firm, by industry, and receive a mock income statement in return.	Parts 2 and 5	Free
City-Data.com (www.city-data.com)	Contains detailed information on cities, including median resident age, median household income, ethnic mix of residents, and aerial photos.	Part 3	Free
County Business Patterns (http://www.census.gov/programs-surveys/cbp.html)	Good resources for looking at business activity, including the number of competitors, at a city, county, or state level. For example, you can find the number of dry cleaners (or any other business) in a specific zip code or city.	Parts 2 and 3	Free
Crunchbase (www.crunchbase.com)	Good resources for analyzing the founder bios and investment histories of start-ups that have received funding.	Parts 3 and 5	Free
Factiva (https://www.dowjones.com/products/factiva/)	Robust search engine that aggregates content from more than 36,000 sources such as newspapers, magazines, journals, photos, and radio and television transcripts.	Parts 1, 2, 3, 4, and 5	Fee based; typically free if accessed through a university library website
FedStats (https://fedstats.sites.usa.gov/)	Provides easy access to information generated by over 100 federal agencies.	Parts 1, 2, 3, 4, and 5.	Free
FindTheCompany (www.findthecompany.com)	Features a search engine that provides information on most private and public companies in the United States.	Parts 2, 3, and 5	Free
D&B Hoovers (www.hoovers.com)	Brief histories and financial information on companies, industries, people, and products. Premium service provides access to detailed financial information and 10-K reports for publicly traded firms.	Parts 2, 3, and 5	Free; premium version available on a fee basis or typically for free if accessed through a university library
IBISWorld (www.ibisworld.com)	Detailed reports available on hundreds of industries, including industry statistics, trends, buyer behavior, and expected returns.	Parts 1, 2, 3, and 5	Fee based; typically free if accessed through a university library
LexisNexis Academic (www.lexisnexis.com)	Provides access to sales data for public and private firms, which can be searched in a number of useful ways. Helps start-ups estimate the financial performance of similar businesses. Go to "Business" and then "Company Financial."	Part 5	Fee based; typically free if accessed through a university library

Source	Description	Applicable Parts of First Screen	Cost/Availability
MagPortal.com (www.magportal.com)	Search engine and directory for finding online magazine articles. Helps start-ups by providing access to magazine articles about their product/service and industry of interest. This information may be helpful in all areas of feasibility analysis.	Parts 1, 2, 3, 4, and 5	Free
MakeMyPersona (www.makemypersona.com)	Interactive web-based tool that generates buyer personas for you after you answer a series of questions about your ideal customers.	Part 3	Free
Mergent Online (www.mergentonline.com)	Provides near instant access to financial data, including income statements, balance sheets, and cash flows, on more than 10,000 U.S. public corporations.	Parts 2 and 5	Fee based; typically free if accessed through a university library
Mintel (www.mintel.com)	Detailed reports available on hundreds of industries, including industry statistics, trends, buyer behavior, and expected returns.	Parts 1, 2, 3, and 5	Fee based; typically free if accessed through a university library
Nielsen MyBestSegments (www.claritas.com)	Provides tools to understand an area's demographic information and lifestyle habits.	Parts 2 and 3	Free
PewResearchCenter (www.pewresearch.org)	Provides substantial data, from economic conditions to political attitudes to social media usage that you can use to better understand your industry and target market.	Parts 2 and 3	Free
ProQuest (https://proquest.com)	Very robust search engine for searching publications such as *The Wall Street Journal* and *The New York Times*. Useful for all areas of feasibility analysis.	Parts 1, 2, 3, 4, and 5	Fee based; typically free if accessed through a university library
QuickFacts (https://census.gov/quickfacts)	A very quick way to access census bureau data, including population, median household income, census breakdowns by age and other demographic characteristics, and so on.	Parts 2 and 3	Free
ReferenceUSA (www.referenceusa.com)	Provides contact information, estimated annual sales, credit rating score, year established, news, and other information on both public and private companies. Contains more information on private firms than many similar sites. Helps start-ups estimate the financial performance of similar businesses.	Part 5	Fee based; typically free if accessed through a university library
Salary.com	Useful resources for determining salary ranges for positions (such as computer programming) in a specific city or zip code.	Part 5	Free
SimilarWeb (www.similarweb.com)	Allows users to assess the website traffic for any URL. Information can be helpful in assessing the attractiveness of a similar business idea.	Part 1	Free
Standard & Poor's NetAdvantage (www.netadvantage.standardpoors.com)	Detailed reports available on hundreds of industries, including industry statistics, trends, buyer behavior, and expected returns.	Parts 1, 2, 3, and 5	Free; premium version available on a fee basis or typically free if accessed through a university library
ThomasNet (www.thomasnet.com)	Search engine for sourcing components, equipment, raw materials, and customer manufacturing services. Helpful in determining how much it will cost to manufacture a product.	Part 5	Free

(*continued*)

Source	Description	Applicable Parts of First Screen	Cost/Availability
U.S. Small Business Administration (www.sba.com)	Describes loan availability, eligibility, sources of grants, etc. Helpful in determining the financial feasibility of a business idea.	Part 5	Free
Yahoo! Industry Center (http://biz.yahoo.com/ic)	Provides a directory of industries, along with a list of the companies in each industry, the latest industry-related news, and performance data on the top companies in an industry.	Parts 2, 3, and 5	Free

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Getting Personal with INDIEU

18Love Music, LLC (dba IndieU)/Photo Credit: Natalie Edell

Founder

NATALIE EDELL

BS, Radio, Television and Film,
Northwestern University, 2014

Dialogue *with* Natalie Edell

FAVORITE BAND ON MY SMARTPHONE MUSIC LIST
Lately it's been Norah Jones (she keeps me calm and collected)

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
Success doesn't come easy

FIRST ENTREPRENEURIAL EXPERIENCE
Managing artists my senior year of high school and signing one to a record deal

MY FAVORITE SMARTPHONE APP
Waze. I'm pretty bad at directions

MY BIGGEST WORRY AS AN ENTREPRENEUR
Are we allocating our funds in the correct way and will we have enough funds to take us to the next level?

BEST ADVICE I'VE RECEIVED
Make sure to have fun! You're lucky that you get to spend every day working on something that you're passionate about and working towards a vision that YOU have created. Not everyone gets the opportunity to do that

CHAPTER 4

Developing an *Effective* Business Model

OPENING PROFILE

INDIEU

Executing on an Established Business Model and Preparing for the Future

• Web: www.indieu.com • Facebook: IndieU • Twitter: @indieumusic

> MyLab Entrepreneurship
>
> **✪Improve Your Grade!**
>
> If your instructor is using MyLab Entrepreneurship, visit **www.pearson.com/mylab/entrepreneurship** for videos, simulations, and writing exercises.

If you are a college student and enjoy indie music, you might consider asking Natalie Edell to bring IndieU to your campus. IndieU is an innovative music platform that connects independent, unsigned musicians to colleges and college students. While the platform is still under development, the plan is that IndieU will showcase a large number of independent musicians on its website and students on local campuses will create events, such as concerts and private parties, where they can then book musicians to play. By creating an account on IndieU, students can promote the event to their local campus and sell tickets through the IndieU platform. The revenue from the ticket sales will be split between IndieU, the band, charities, and the event's organizers.

When asked where the idea for IndieU came from, Edell has quite a story to tell. She started playing tennis when she was 8, and her initial ambition was to be a professional tennis player. During her senior year in high school, she went to a Chris Brown, New Boyz concert. On a dare from friends, she approached Greg Johnson, the manager of the New Boyz, to ask if the New Boyz could perform at her 18th birthday party. After much persuasion, they eventually did, but more importantly, Edell landed an internship with Johnson and Genuine Music Group that summer. She worked with Johnson every day and gained a familiarity with the business side of music by doing so. She also got to work with the New Boyz as well as Grammy award-winning producers such as Organized Noize and DJ Khalil. During this time, she started dabbling in the music industry on her own, trying to connect musicians with labels. At the age of 18, she signed her first artist, Luke Christopher to Interscope Records.

Following these experiences, Edell headed to Northwestern University to study communications and play tennis. She also took entrepreneurship classes, and eventually was admitted to Northwestern's student business incubator. Her original business idea, named 18LoveMusic, came from the experiences she had signing a musician to Interscope Records. She saw that when musicians signed with labels, their success was far from certain. They still had to build a following, and now had to share their income with the label. So she set out to create an independent artist movement where musicians would have more of a voice in decisions and an organic way to build a following. The idea went through several iterations and eventually morphed into IndieU. During this

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Describe business models and discuss their importance.
2. Identify and describe the two general types of business models—standard and disruptive.
3. Explain the components of the Barringer/Ireland Business Model Template that entrepreneurs can use to develop a business model for their firm.

time, Edell bounced ideas off her dad, Jeffrey Edell, who quickly became her business partner and is now the Chairman of IndieU.

She had a subsequent internship at ICM Partners and spent four months at Virgin Records. At Virgin, Edell worked under Ron Fair, former Chief Creative Officer and Executive Vice President of Virgin Records. Mr. Fair's days were comprised of artist meetings, intercompany marketing meetings, and general meetings with songwriters, producers, musicians, agents, and others who want to work with Virgin Records. Edell sat in on the meetings and got a first-hand view of the music industry.

After graduating from Northwestern, Edell returned to Los Angeles, her hometown, to work on IndieU full time. Of paramount importance was developing an effective business model. The mission of IndieU is to help musicians build a following while at the same time engaging college students in their local music scenes. The key to accomplishing this is signing students to serve as local brand ambassadors. The local brand ambassadors work as volunteers staging events, creating written and video content for the IndieU platform, finding and encouraging local musicians to place their work on the IndieU website, promoting IndieU on campus, and so forth. Although the students are not paid for their work, what they do is enjoyable and represents a good résumé-building activity. The IndieU platform is the second key to the company's business model's success. It allows students, regardless of whether they are an IndieU ambassador or not, to create an account and connect with their campus. Once registered, a student will be able to stage an event and manage it through the IndieU platform. Students will also be able to follow their favorite bands, track their friends' musical interests, receive notifications when events are happening, create playlists, and stream/download thousands of songs from the IndieU website for free. The students who create the live events will in effect become student entrepreneurs who plan, organize, and execute the events and share in the profits. They will be aided by the services offered via the IndieU platform. IndieU will make money by taking a percentage of the ticket sales that are routed through the platform. IndieU also recently launched its interactive digital magazine that further informs students about their local music scene and it highlights and promotes up-and-coming musicians and upcoming events. Integral to IndieU's business model is the basic philosophy that what college students are looking for is "new" bands that are fresh and original rather than those that are hitting the top of the charts. This is the essence of IndieU's core competency and its unique value proposition—connecting college students with new indie artists and then putting it in the students' hands to stage unforgettable college experiences that showcase fresh new music.

IndieU is currently present on 20 college campuses, including Penn State, Indiana, Arizona State, Stanford, and the University of Michigan. More than 400 additional campuses are interested. Over 10,000 songs are currently available on the IndieU website, with more coming. IndieU is currently fundraising, and once its fundraising is complete its business model will be fully in place.

In this chapter, we introduce you to the concept of the business model. A **business model** is a firm's plan or recipe for how it creates, delivers, and captures value for its stakeholders.[1] Business models are foundational to a firm's ability to succeed, both in the short and long term, especially when it is the first one to introduce a new product or service to customers.[2] Dropbox, for example, has what is referred to as a freemium business model. It offers its customers a free account with a set amount of storage space; the firm earns money by selling premium accounts with more capacity. Dropbox could charge all of its users a monthly fee based on the amount of storage that they use, but that is not its business model. Its business model is based on the belief that by introducing users to its service through a free account, it will ultimately sign up more paid users.

The proper time to determine a company's business model is following the initial validation of the business idea and prior to fleshing out the details of how the firm will operate to provide its product or service to customers.[3] This sequence, which is depicted in Figure 4.1, nicely parallels the chapters in this book. Chapter 1 dealt with the decision to become an entrepreneur. Chapters 2–3 considered the initial validation of the business idea. This chapter deals with determining a business model, and Chapters 5–15 deal with the topics needed to implement a firm's business model and grow the firm.

In this chapter we first discuss business models and their importance. We then introduce and discuss a template for developing a business model. The template, called the Barringer/Ireland Business Model Template, consists of 4 categories and 12 items that make up a firm's business model. The template, which can be completed on an $8\frac{1}{2}$ by 11 sheet of paper or blown up and placed on the wall, provides a nice visual mechanism to help entrepreneurs and others think through and display the elements of a firm's business model.

A critical factor is that, similar to feasibility analysis, a firm's business model should not be completed in isolation. The founders of a firm should "get out of the building" and talk to potential customers as a firm's business model takes shape.[4] This is a facet of developing an effective business model that we stress throughout the chapter.

Business Models and Their Importance

LEARNING OBJECTIVE

1. Describe business models and discuss their importance.

As stated earlier, a firm's business model is its plan or recipe for how it creates, delivers, and captures value for its stakeholders. Glance ahead to Figure 4.2, the Barringer/Ireland Business Model Template. As you can see by looking at the template, a firm's business model represents the core aspects of its business. It also describes how the core aspects fit together and support one another. For example, three important elements of a firm's business model are its target market, its basis for differentiation, and its key assets. In IndieU's case, its target market is college students, it differentiates itself by connecting independent, unsigned musicians to colleges and college students, and its key assets include college students who work as volunteers as IndieU brand ambassadors. This example illustrates a nicely designed business model, at least as it pertains to the three elements just mentioned. Each element supports the others. It's also a business model that will be difficult to copy over time. As IndieU increases its number of volunteers on local campuses and its brand becomes more prevalent, it will become more difficult for a competitor to match what IndieU has accomplished.

To further illustrate what a business model is, the nearby "Savvy Entrepreneurial Firm" feature focuses on CoachUp, an interesting company, which brings athletes and coaches together for the purpose of helping athletes reach their full potential. The feature illustrates how CoachUp creates, delivers, and captures value for its stakeholders.

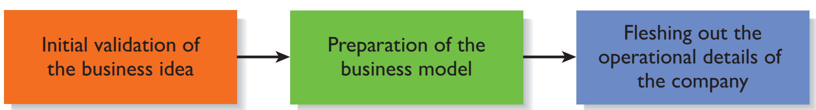

FIGURE 4.1
Proper Time to Determine a Company's Business Model

SAVVY ENTREPRENEURIAL FIRM

CoachUp: How One Company Creates, Delivers, and Captures Value for Its Stakeholders

• **Web: www.coachup.com** • **Facebook: CoachUp** • **Twitter: @CoachUp**

CoachUp is an interesting company. Founded in 2011, it is an online platform that connects athletes with private coaches. The company believes strongly that private coaching is the secret to reaching the next level in sports and life.

CoachUp was founded by Jordan Fliegel, who was an average high school basketball player until his father hired a private coach for him. The coach was Greg Kristof, the former head coach of the Brandeis University basketball team. The sessions with Kristof helped Fliegel make his high school basketball team, and he went on to play in college and in a professional league overseas. CoachUp's website matches athletes, in all major sports, with coaches who are willing to work with them. Thousands of athletes have connected with more than 13,000 coaches since the site was launched. CoachUp vets all coaches for necessary coaching experience. Coaches set their own rates on CoachUp, so prices vary. The cost of a one-hour session averages $40 to $60. CoachUp makes money by taking a percentage of the coaching fees charged through its site. Earnings are calculated based on how many sessions a coach has had with an athlete. The more sessions a coach has with an athlete, the higher the percentage of the fee the coach retains. For an active coach, CoachUp charges a commission of 5 percent to 10 percent of the coaching fee. For a less active coach, it is 10 percent to 20 percent. Each coach also pays a $9.99 annual membership fee. The company offers a 100-percent-money-back guarantee on all sessions.

CoachUp has established partnerships with the National High School Basketball Association, the Positive Coaching Alliance, and the Sports Legacy Institute. The company has raised money from angel investors and venture capital firms.

CoachUp accomplishes all it does via its business model. As noted in this chapter, a business model is a firm's plan or recipe for how it creates, delivers, and captures value for its stakeholders. Here is how CoachUp accomplishes each of these key elements:

- CoachUp *creates value* by providing athletes access to private coaches. In most cases, the athletes would have had no way of connecting with the coach otherwise. In some instances, the goal is to help the athlete build self-esteem or make a high school team. In other instances, the objective is to help the athlete win a college athletic scholarship or even make a pro team. The value of a college athletic scholarship can easily be tens of thousands of dollars. Even more money is at stake if an athlete makes a pro team. Coaches benefit through the satisfaction that comes from helping athletes reach their goals, and via the opportunity to build their coaching practices and earn extra income.
- CoachUp *delivers value* by providing an easy-to-navigate platform that makes the matches between the athletes and the coaches. To initiate a match, an athlete fills out a form that asks for the athlete's training goals. CoachUp then recommends three coaches, but the athlete has the option to look through all the profiles and sort the results by distance, price, and reviews to identify the coach who represents the best match. After each training session, the athlete receives actionable feedback. All coaches have extensive coaching experience and are required to pass rigorous background checks. CoachUp charges athletes for coaching sessions and deposits the coaches' share directly into their bank accounts. One million dollars in liability insurance coverage is provided for all sessions booked through the CoachUp platform.
- CoachUp *captures value* for its stakeholders via the profits that it realizes on making the matches. Its core value is that private coaching helps boost the performance and life skills of athletes and provides extraordinarily rewarding experiences for coaches. It captures intangible value by seeing its core value played out in successful coaching sessions each and every day.

The attractiveness of CoachUp's business model is that as more athletes and coaches participate in the program, word-of-mouth will increase demand for the company's services. It will also be able to continually add sports. CoachUp is also a business model that would be difficult to copy. It has raised $9.4 million in funding, has 13,000 coaches on its platform, and tens of thousands of athletes have used its service.

Questions for Critical Thinking

1. Do you think CoachUp's business model is sound? If you could make any changes to the firm's business model, what would you suggest?
2. To what degree does CoachUp's business model reflect the attributes of a sound business idea as described in Chapter 2?
3. Read the "What Went Wrong?" feature for this chapter. The feature focuses on peer-to-peer business models, and makes the point that the peer-to-peer approach works in some instances and in some instances it doesn't. Why do you think CoachUp's peer-to-peer business model is working while others haven't?
4. Do some additional research on CoachUp. Complete the Barringer/Ireland Business Model Template for the company.

Sources: CoachUp Homepage, www.coachup.com (accessed February 11, 2017); CoachUp, Wikipedia, https://en.wikipedia.org/wiki/CoachUp (accessed February 11, 2017).

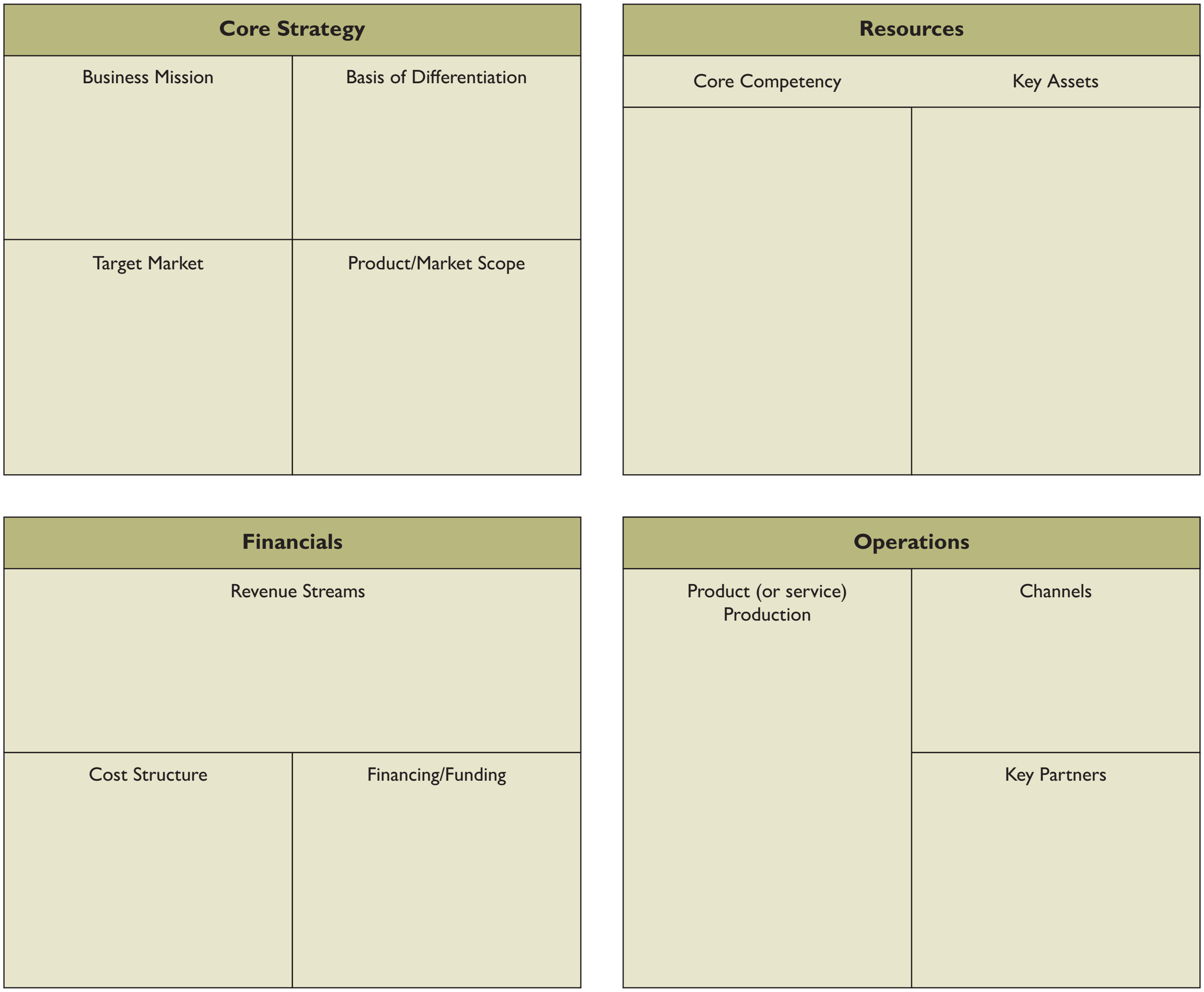

FIGURE 4.2
Barringer/Ireland Business Model Template

General Categories of Business Models

LEARNING OBJECTIVE

2. Identify and describe the two general types of business models—standard and disruptive.

There are two general categories of business models: standard business models and disruptive business models.[5] Next, we provide details about each model.

Standard Business Models

The first category is standard business models. This type of model is used commonly by existing firms as well as by those launching an entrepreneurial venture. **Standard business models** depict existing plans or recipes firms can use to determine how they will create, deliver, and capture value for their stakeholders. There are a number of standard or common business models. An abbreviated list is shown in Table 4.1. Most of the standard business models, with the exception of the freemium model, have been in place for some time. In fact, many of the business models utilized by online firms were originally developed by offline firms, and simply transferred to the Internet. For example, Amazon did not invent a new business model. It took the mail order business model, pioneered years ago by Sears' Roebuck and Company, and moved it online. Similarly, eBay did not invent the auction business model—that has been in

TABLE 4.1 Standard Business Models

Name	Description	Examples of Entrepreneurial Firms (or Types of Firm) Utilizing This Model
Advertising Business Model	Business model based on providing advertisers access to highly targeted customer niches.	Google, Facebook, Pinterest
Auction Business Model	Currently synonymous with eBay, the auction business model has been around since 500 BC. The idea is to provide a platform for individuals and businesses to sell items in an auction format.	eBay, uBid.com
Bricks and Clicks Business Model	A business model in which a company integrates both offline (bricks) and online (clicks) presences.	Apple, Barnes & Noble, J. Crew
Franchise Business Model	A business model in which a firm that has a successful product or service (franchisor) licenses its trademark and method of doing business to other businesses (franchisees).	24 Hour Fitness, Panera Bread, iLoveKickboxing.com
Freemium Business Model	A business model in which a firm provides a basic version of its service for free, and makes money by selling a premium version of the service.	Dropbox, Evernote, MailChimp
Low-Cost Business Model	A well-established business model that relies on driving down costs and making money by servicing a large number of customers.	Southwest Airlines, Warby Parker, Costco
Manufacturer/Retailer Business Model	A business model in which a manufacturer both produces and sells (online, offline, or both) a product.	Apple, Fitbit, Tesla Motors
Peer-to-Peer Business Model	A model in which a business acts as a matchmaker between individuals with a service to offer and others who want the service.	Airbnb, Uber, Task Rabbit
Razor and Blades Business Model	This model involves the sales of dependent goods for different prices—one good (a razor) is sold at a discount, with the dependent good (blades) sold at a considerably higher margin.	Game Consoles and Games, Mobile Phones and Air Time, Printers and Ink Cartridges
Subscription Business Model	A business model in which the customer pays a monthly, quarterly, or yearly subscription fee to have access to a product or service.	Birchbox, Blue Apron, Netflix
Traditional Retailer Business Model	A business model calling for a firm to sell its products or services, made by others, directly to consumers at a markup from the original price. Can be sold online or offline.	Amazon, Whole Foods Markets, Zappos

existence for centuries. It moved the auction format online. What Amazon.com and eBay did do, however, which is common among successful start-ups, is adopt a standard business model and build upon it in one or more meaningful ways to produce a new way of creating value. Birchbox, for example, adopted the subscription business model and then built upon it in novel ways. This firm provides its subscribers a monthly assortment of cosmetic and skin care samples in hopes of enticing them to buy full-sized versions of the same products. Its cost structure is low because it operates via the Internet and many of the samples that it distributes are provided for free by companies that want to get their products in front of Birchbox's unique clientele. The other elements of Birchbox's business model are supportive of its basic premise. The multifaceted "value" that Birchbox's business model creates is that it presents products to women (and now men as well) that they wouldn't have otherwise tried. Through this model, Birchbox creates two revenue streams for itself, the subscription service and online sales, and it creates additional sales for the companies that provide the samples that Birchbox disseminates to its subscribers.You can read more about Birchbox in Case 6.1.

It is important to understand that there is no perfect business model.[6] Each of the standard models has inherent strengths and weaknesses. For example, the strength of the subscription business model is recurring revenue. Birchbox has over one million subscribers who pay $10 per month (or $99 if they pay once a year). As a result, if Birchbox maintains its subscriber base, it would know that it had a minimum of $10 million in revenue each month. The disadvantage of the subscription business model is "churn." **Churn** refers to the number of subscribers that a subscription-based business loses each month. If Birchbox loses 10 percent of its subscribers each month, it will need to recruit 100,000 new subscribers each month just to stay even. This is why companies that feature a subscription-based business model normally offer a high level of customer service. They want to retain as high a percentage of their subscribers as they can to lower churn and avoid the expenses involved with replacing existing customers.

It is important to note that a firm's business model takes it beyond its own boundaries. IndieU's business model, for example, is based on the idea that college students will voluntarily give their time to contribute content about the music scene at their local university to be featured on IndieU's website. The challenge associated with getting something like this to work is to provide sufficient incentive for partners to participate. In IndieU's case, the students contribute because they are passionate about music, want to obtain work-related experience, and want to build their résumés. Apparently, IndieU is providing these students a rich enough experience that it's worth their time to participate. Many companies feature the participation of others as an integral part of their business models. An example is Apple, and in particular the Apple App Store. As of February of 2017, more than 2 million apps were available through the Apple App Store, created by tens of thousands of developers. It's a win-win situation for both Apple and the developers. The developers get access to a platform to sell their apps, while Apple shares in the revenue that's generated. Positive scenarios like this often allow businesses to not only strengthen but to expand their business models.

Regardless of the business model a start-up is rolling out, one thing that new companies should guard themselves against is thinking that one particular business model is a "homerun" regardless of circumstances.[7] In this sense, the issues discussed in Chapters 1–3 still apply, meaning, for example, that the strength of the opportunity must be assessed and the feasibility of the idea must be validated. The "What Went Wrong?" feature nearby draws attention to this point. Even though the peer-to-peer business model is currently hot, with homeruns such as Airbnb and Uber, utilizing the peer-to-peer business model is not sufficient to guarantee firm success.

Disruptive Business Models

The second category of business models is disruptive business models. **Disruptive business models**, which are rare, are models that do not fit the profile of a standard business model, and are impactful enough that they disrupt or change the way business is conducted in an industry or an important niche within an industry.[8] In Table 4.2, we describe actual disruptive business models that were used by four different companies.

There are three types of disruptive business models. The first type is called new market disruption. A **new market disruption** addresses a market that previously wasn't served. An example is Google and its AdWords program. AdWords allows an advertiser to buy keywords on Google's home page, which triggers text-based ads to the side of (and sometimes above) the search results when the keyword is used. So, if you type the words "organic snacks" into the Google search bar, you will see ads paid for by companies that have organic snacks to

WHAT WENT WRONG?

Peer-to-Peer Business Models: Good for Some, Not So Good for Others

Peer-to-Peer business models are hot. Airbnb, Uber, and Lyft, three of the most successful firms in the peer-to-peer business model space, are growing and are worth billions of dollars. Peer-to-peer businesses act as matchmakers between individuals with a service to offer and others who want the service. Airbnb, for example, matches people who are looking for a place to stay (for a day or two or longer) with people who have an extra room they're willing to rent. Lyft and Uber match people who need a ride with people who are willing to provide them.

Despite the promise of the peer-to-peer business model, several high-profile, peer-to-peer businesses have failed. The failures include BlackJet, a service that matched the owners of private jets with people who wanted a seat on a private jet for a trip; Ridejoy, a carpooling service; and Neighborrow.com, a service that allowed people to list household items for rent, such as vacuum cleaners, tools, and food mixers. So, what went wrong? On the surface, BlackJet, Ridejoy, and Neighborrow.com seem very similar to Airbnb, Uber, and Lyft in that they matched people wanting a particular service with someone willing to offer it. Let's see what happened to these three entrepreneurial ventures.

BlackJet's basic premise was that once a person joined the service, she or he could book a seat on a private jet within minutes for a ride to a desired location. The idea was that BlackJet would sign up a large number of owners of private jets, who would let BlackJet know when they were making a trip. If a seat was open on the jet, it would be made available to a BlackJet member who was looking for a ride to the same destination. For those seeking rides, BlackJet charged a $2,500 yearly membership fee and up to $4,000 per ride. As it turned out, there just weren't enough people willing to pay that stiff of a fee for the service. In addition, a private jet ride isn't something people need frequently, so BlackJet wasn't an option that was foremost on people's minds. Further compounding BlackJet's challenge, there are readily available substitutes for BlackJet's service. Anyone can book a first-class seat on an airline and ride in relative luxury, without having to pay a yearly membership fee. BlackJet closed in late 2013, later revived its service, but closed for good in mid-2016.

Ridejoy was a carpooling service that focused on connecting people who wanted to share rides for long distances, such as Los Angeles to San Francisco. Lyft and Uber, mentioned earlier, focus on short rides. Ridejoy experienced early success. During its first year, 2011, its user base grew about 30 percent a month, with more than 25,000 drivers signed up and an estimated 10,000 rides completed. But it didn't grow fast enough to satisfy its investors. In addition, it had competition from free alternatives, such as carpooling forums on college websites. Also, some riders started cutting Ridejoy out once they got to know one another. Instead of paying Ridejoy its 10 percent transaction fee for a trip from Portland to San Francisco, for example, the car owner and riders would just exchange cash instead of paying by credit card on Ridejoy's website or mobile app. Ridejoy shut down in the summer of 2013, returning about half of its funding to its investors.

Neighborrow.com would let people list household items for rent, such as vacuum cleaners, cameras, tools, and electronics. The idea was that if you only use a power saw or a high-end camera once or twice a year, why buy one if your next-door neighbor has exactly what you need and would be willing to rent it to you for a modest fee? The site got plenty of publicity when it launched, including a story in *USA Today* and a spot on NBC's early morning program, the *Today* show. It also had thousands of people sign up and list their items. The problem: very few people actually used the service. What the company eventually found is that people don't like borrowing things from neighbors. In addition, borrowing an item such as a power drill isn't typically an urgent need, so people didn't tend to think "Oh, I could get that through Neighborrow.com." Although they may have read about the company in *USA Today* or seen it featured on television, they soon forgot about the service. Neighborrow.com folded in 2011, after a five-year run.

Questions for Critical Thinking

1. Prior to launching their firms, how could BlackJet, Ridejoy, and Neighborrow.com have better anticipated the issues that ultimately caused them to fail?
2. In regard to putting together an effective business model, what can other peer-to-peer business model start-ups learn from the failures of BlackJet, Ridejoy, and Neighborrow.com?
3. Spend some time looking at Lyft, one of the successful peer-to-peer business model companies mentioned in this feature. Why do you think Lyft has been successful while BlackJet, Ridejoy, and Neighborrow.com failed?
4. What role do you think the industry that a start-up is in plays in its success or failure as a peer-to-peer business? Are some industries more receptive to peer-to-peer business model start-ups than others? Explain your answers.

Sources: D. Primack, "Celeb-backed BlackJet Is Grounded. Again," *Fortune*, May 5, 2016; S. E. Needleman and A. Loten, "Startups Want to Be the Next Airbnb, Uber," *The Wall Street Journal*, May 8, 2014, B4; D. Kander, "Lessons from Failure: Borrowing Tools from Your Neighbors," Entrepreneurship.org, available at https://www.entrepreneurship.org/resource-center/lessons-from-failure-borrowing-tools-from-your-neighbors.aspx (accessed February 12, 2017).

TABLE 4.2 Four Disruptive Business Models

Company	Disruptive Business Model and Description	Standard Business Model That Was Disrupted
Dell	Direct-to-consumer computer sales model, which allowed consumers to customize their computers Introduced the notion of buying a computer first over the phone and then via the web. The customer would configure the computer and pay for it before the computer was assembled. Delivery via UPS or FedEx.	Computers that were assembled, shipped to a store, and then sat on shelves until someone bought them. No customization was possible because the computer was assembled before the customer bought it.
Google	AdWords (online advertising product) Introduced text advertising, which appears to the right or the top of organic search results, that when clicked takes the searcher to an advertiser's website or landing page. The text ads could be bought for as little as $1. Google's initial customers were small businesses who couldn't afford Yahoo's service.	Traditional banner advertising, provided by companies such as Yahoo. Some services required a minimum $10,000 ad buy for a company to advertise on the Internet.
Salesforce.com	SaaS (Software as a Service) provider of customer relationships management (CRM) software First company to offer CRM software as a SaaS product, making CRM affordable to small companies for the first time. By moving CRM to the cloud, it also enabled salespeople to access their CRM service anywhere they had an Internet connection.	Traditional installed CRM software, which required large licensing fees, provided by vendors such as Siebel Systems and PeopleSoft.
Uber	Quickly connects riders with the owners of private cars who are willing to provide rides First company to provide riders with an app that connects them with the owners of private cars who are willing to provide rides. Advantages include: cleaner cars, avoiding the frustration of trying to hail a cab, direct billing via Uber so no money changes hands between the passenger and driver, and Uber knowing the location of the nearest driver so pickup time is often reduced.	Local taxis and town-car services.

sell. The ads are usually paid for on a pay-per-click basis. The cost of keywords varies depending on the popularity of the word. Prior to the advent of AdWords, online advertising was cost prohibitive for small businesses. At one time Yahoo, for example, required advertisers to spend at least $5,000 creating a compelling banner ad and $10,000 for a minimum ad buy. AdWords changed that. Its customers could set up a budget and spend as little as $1 per day (depending on the keywords they purchased). Thus, AdWords was a new market-disruptive business model in that it provided a way for small businesses, in large numbers, to advertise online.

The second type of disruptive business model is referred to as a **low-end market disruption**. This is a type of disruption that was elegantly written about by Harvard professor Clayton Christensen in the book *The Innovator's Dilemma*.[9] Low-end disruption is possible when the firms in an industry continue to improve products or services to the point where they are actually better than a sizable portion of their clientele's needs or desires. This "performance oversupply" creates a vacuum that provides an opportunity for simple, typically low-cost business models to exist. Examples here include Southwest Airlines in the United States and Ryanair in Europe. Southwest created its point-to-point, low-cost, no-frills business model as an alternative to higher-end service offerings provided by legacy carriers such as United and American. By actually offering what some would conclude is inferior service relative to its competitors, Southwest was able to attract a large clientele that still wanted a safe and comfortable ride, but were willing to trade off amenities for a lower fare. Low-end disruptive business models are also introduced to offer a simpler, cheaper, or more convenient way to perform an everyday task. If a start-up goes this route, the advantages must be compelling and the company must strike a nerve for disruption to take place. An example of a firm that has done this is Uber, a 2009 start-up that connects people needing a ride with the owners of private cars willing to provide rides. Uber, which is the subject of Case 14.2, provides a compelling set of features—cars are ordered by sending a text message or via an app, customers can track their reserved car's location, payment is made through the app so no cash trades hands between the passenger and the driver, and Uber maintains strict quality standards for the cars and drivers that participate in its service. Uber not only offers a cheaper and more convenient way to perform an everyday task (getting a ride), but has also struck a nerve.[10] The taxi industry scores low on most measures of customer satisfaction, so consumers were eager to try something new. Not surprisingly, the taxi industry is responding to the new type of competition it is experiencing by trying to upgrade its service by offering cleaner vehicles with friendly drivers and so forth. Uber also appeals to technologically savvy people, who see a big advantage in using an app to order a ride as opposed to the often frustrating process of hailing a cab.

The Barringer/Ireland Business Model Template

LEARNING OBJECTIVE

3. Explain the components of the Barringer/Ireland Business Model Template that entrepreneurs can use to develop a business model for their firm.

Although not everyone agrees precisely on the components of a business model, many agree that a successful business model has a common set of attributes. These attributes are often laid out in a visual framework or template so it is easy to see the individual parts and their interrelationships. One widely-used framework is the Business Model Canvas, popularized by Alexander Osterwalder and Yves Pigneur in their book, *Business Model Generation*.[11] The Business Model Canvas consists of nine basic parts that show the logic of how a firm intends to create, deliver, and capture value for its stakeholders. You can view the Business Model Canvas via a simple Google search.

The business model framework used here, the Barringer/Ireland Business Model Template, is shown in Figure 4.2 on page 125. It is slightly more comprehensive than the Business Model Canvas in that it consists of 4 major categories and 12 individual parts. The 12 parts make up a firm's business model. The job of the entrepreneur, or team of entrepreneurs, is to configure their firm's business model in a manner that produces a viable and exciting business. The Barringer/Ireland Business Model Template is a tool that allows an entrepreneur to describe, project, revise, and pivot a business model until all 12 parts are decided upon. Appendix 4.1 contains an expanded version of the Barringer/Ireland Template. The 12 parts are spread out, which provides space for ideas to be recorded, scratched out, and recorded again as ideas morph and change. Feel free to copy and use the template to help formulate the business model for an individual firm.

Next, we discuss each of the 4 categories and the 12 individual elements of a firm's business model. We will refer frequently to Figure 4.2 throughout the discussion.

Core Strategy

The first component of a business model is core strategy. A **core strategy** describes how the firm plans to compete relative to its competitors.[12] The business mission, basis of differentiation, target market, and product/market scope are the primary elements of a core strategy.

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Many entrepreneurs enlarge their business model templates and place them on a whiteboard. This practice provides a means to step back and look at how all the parts of a prospective business model fit together.

Business Mission. A business' **mission or mission statement** describes why it exists and what its business model is supposed to accomplish.[13] If carefully written and used properly, a mission statement can articulate a business' overarching priorities and act as its financial and moral compass. In this sense, a mission statement is an anchor around which decisions are made. A firm's mission is the first box that should be completed in the business model template. A well-written mission statement is something that a business can continually reference as it makes important decisions in other elements of its business model.

At a very broad, 50,000-foot level, a mission statement indicates how a firm intends to create value for stakeholders. For example, Zynga's mission is "Connecting the world through games." Zynga is a producer of social games, such as FarmVille and Texas HoldEm Poker, which can be played through its website and social networking platforms such as Facebook and Google+. Zynga's mission statement provides direction for how the other elements of the firm's business model should be configured. The company will focus on games, as opposed to other business pursuits, and its games will be social, meaning that they will be designed to be played with other people. The remaining 11 parts of Zynga's business model should support these basic premises.

There are several rules of thumb for writing mission statements. A business' mission statement should:

- Define its "reason for being"
- Describe what makes the company different
- Be risky and challenging but achievable
- Use a tone that represents the company's culture and values
- Convey passion and stick in the mind of the reader
- Be honest and not claim to be something that the company "isn't"

Basis of Differentiation. It is important that a business clearly articulate the points that differentiate its product or service from competitors.[14] This is akin to what some authors refer to as a company's value proposition. A company's **basis of differentiation** is what causes consumers to pick one company's products over another's.[15] It is what solves a problem or satisfies a customer need.

When completing the basis for differentiation portion of the Barringer/Ireland Business Model Template, it is best to limit the description to two to three points. Also, make sure that the value of the points is easy to see and understand. For example, ZUCA (www.zuca.com) is a backpack on rollers. It was designed by Laura Udall as an alternative to traditional backpacks when her fourth-grade daughter complained daily that her back hurt from carrying her backpack. The ZUCA has two distinct points of differentiation: It relieves back pain by putting backpacks on rollers and it is sturdy enough for either a child or adult to sit on. The company's website frequently features photos of kids sitting on the ZUCA seat, which anyone could imagine might be handy for kids waiting for the school bus. These are points of differentiation that are easy to grasp and remember. They are the reasons that some parents will choose ZUCA's product and solution over others.

Making certain that your points of differentiation refer to benefits rather than features is another important point to remember when determining a firm's basis of differentiation. Points of differentiation that focus on features, such as the technical merits of a product, are less compelling than those that focus on benefits, which is what a product can do. For example, when Laura Udall introduced the ZUCA, she could have focused on the features of the product and listed its points of differentiation as follows: (1) is pulled like a suitcase rather than worn on the back, (2) includes a sturdy aluminum frame, and (3) is available in six colors. While features are nice, they typically don't entice someone to buy a product. A better approach for Udall would have been to focus on the benefits of the product: (1) relieves back pain by putting backpacks on rollers, (2) is sturdy enough for either an adult or child to sit on, and (3) strikes the ideal balance between functionality and "cool" for kids. This set of points focuses on benefits. It tells parents how buying the product will enhance their child's life.

Target Market. The identification of the target market in which the firm will compete is extremely important.[16] As explained in Chapter 3, a **target market** is a segment within a larger market that represents a narrower group of customers with similar interests. This is the case with Snapchat, a firm targeting individuals who want to send messages that disappear within 10 seconds to 24 hours of their receipt.[17] Most new businesses do not start by selling to broad markets. Instead, most start by identifying an emerging or underserved niche within a larger market.[18]

A firm's target market should be made explicit on the business model template. IndieU's target market is college students and unsigned, independent musicians. Zynga's target market is online game enthusiasts. A target market can be based on any relevant variable, as long as it identifies for a firm the group of like-minded customers to whom it will try to appeal. For example, Hayley Barna and Katia Beauchamp, the founders of Birchbox, wrote the following about their company's target market:

> From the start, we've always said that our target market isn't a specific demographic, but instead a psychographic—we believe that Birchbox appeals to women of all ages and backgrounds as long as they are excited to try new things and learn through discovery.[19]

This type of awareness of a firm's intended market, and the people who are the most likely to respond positively to a firm's product or service, is helpful in fleshing out all the elements of a firm's business model. For example, targeting women of all ages and backgrounds who are excited to try new things and learn through discovery requires a certain set of core competencies (we define core competencies in the next major section dealing with resources). It requires identifying and hiring people who have the ability to build anticipation and can locate partners and suppliers that have exciting new products that appeal to all age groups. If Barna and Beauchamp had instead identified Birchbox's target market as females ages 16–31, and left the "try new things and learn through discovery" part out, a different set of core competencies may have been needed for the firm's overall business model to work. The same philosophy applies across the business model template. The target market a firm selects affects everything it does, from the key assets it acquires to the financing or funding it will need to the partnerships it forms.

Product/Market Scope. Product/market scope is the fourth element of core strategy. A company's **product/market scope** defines the products and markets on which it will concentrate. Most firms start narrow and pursue adjacent product and market opportunities as the company grows and becomes financially secure. As explained earlier, new firms typically do not have the resources to produce multiple products and pursue multiple markets simultaneously.

An example is Dropbox, the online data storage company. When Dropbox was pitching its business idea, a challenge it had was that it was solving a problem that most people didn't know they had. There were ways for people to transfer files from one device to another, such as USB memory sticks, e-mailing files to yourself, and so forth. Dropbox's solution was much more elegant. Its service allows users to create a special folder on each of their devices for the purpose of syncing and storing data across devices. Dropbox completely solved the problem of working on a file on one device, such as an office computer, and then not having it available on another device, such as a laptop at home. When Dropbox launched in 2008, it had a single product—its online data storage service. The initial market it pursued was tech-savvy people in the Silicon Valley. Since then, Dropbox's market has expanded to all computer and Internet users; the firm now has 500 million customers. But for the first three years of its existence, it stuck to its initial product, preferring to continually improve the quality of its online data storage service rather than developing new services. It wasn't until 2012 that Dropbox added a second product line through the acquisition of Snapjoy, which provides a service for aggregating, archiving, and viewing all digital photographs taken with cameras, smartphones, and popular photo applications. In 2013, Dropbox added a third and fourth product line by acquiring Mailbox, an e-mail processing service for mobile devices and Carousel, a digital gallery that will allow users to share their entire life's memories. In 2014, the company added its fifth and sixth product line via the acquisition of Hackpad, a real-time collaborative text editor and Bubbli, a 3D Photo Sharing App. In 2015, Dropbox added its seventh product line, Dropbox for Business, an enterprise cloud storage business. In 2015, it also announced the shutdown of both Mailbox and Carousel, demonstrating that the firm continuously evaluates the degree of success it is achieving in each of its chosen products and in each of its chosen markets. Thus, in terms of product/market scope, Dropbox's experiences are as follows:

- Launch—Single product/Silicon Valley tech-savvy users
- 1–2 years into existence—Single product/Growing number of Silicon Valley tech-savvy users and people they told about the service
- 3 years into existence—Single product/All computer and Internet users
- 4 years into existence—Two products/All computer and Internet users
- 5 years into existence—Four products/All computer and Internet users

- 6 years into existence—Six products/All computer and Internet users
- 7 years into existence—Seven products to start the year—eventually cut back to five/All computer and Internet users.

In completing the Barringer/Ireland Business Model Template, a company should be very clear about its initial product/market scope and project 3–5 years into the future in terms of anticipated expansion. A bullet-point format, as shown for Dropbox above, is acceptable. Similar to all aspects of a company's business model, its product/market scope will affect other elements of the model.

Resources

The second component of a business model is resources. **Resources** are the inputs a firm uses to produce, sell, distribute, and service a product or service.[20] At a basic level, a firm must have a sufficient amount of resources to enable its business model to work.[21] For example, a firm may need a patent (a key asset) to protect its basis of differentiation. Similarly, a business may need expertise in certain areas (core competencies) to understand the needs of its target market. At a deeper level, a firm's most important resources, both tangible and intangible, must be both difficult to imitate and hard to find a substitute for in order for the company's business model to be competitive over the long term. A tangible resource that fits this criterion is Uber's network of 327,000 active drivers. It would take a tremendous effort for a competitor to amass a similar number of drivers. In addition, there is no practical substitute or viable alternative for the number of rides that 327,000 drivers can complete. An example of an intangible resource that fits the criterion is Zappos' reputation for customer service. Zappos is consistently viewed very favorably for its ability to deliver a high level of customer service that is both difficult to imitate and for which a substitute is difficult to find.

Resources are developed and accumulated over a period of time.[22] As a result, when completing the Barringer/Ireland Business Model Template, the current resources a company possesses should be the resources that are noted, but aspirational resources should be kept in mind. For example, it took time for Uber to recruit 327,000 drivers. The company may have had 100 drivers if and when it completed its first business model template. As a result, the proper notation under the Key Assets portion of the Barringer/Ireland Business Model Template would have been "100 drivers" (with the goal of adding 5,000 drivers a month) or whatever the exact number might have been.

Core Competencies. A **core competency** is a specific factor or capability that supports a firm's business model and sets it apart from its rivals.[23] A core competency can take on various forms, such as technical know-how, an efficient process, a trusting relationship with customers, expertise in product design, and so forth. It may also include factors such as passion for a business idea and a high level of employee morale. A firm's core competencies largely determine what it can do. For example, many firms that sell physical products do not manufacture their own products because manufacturing is not a core competency. Instead, their core competencies may be in areas such as product design and marketing. The key idea is that to be competitive a business must be particularly good at certain things, and those certain things must be supportive of all elements of its business model. For example, Netflix is particularly good at supply chain management, which was essential during the years that Netflix's business model was geared primarily towards delivering DVDs to customers via the mail. Without a core competency in supply chain management, Netflix's entire business model would not have worked.

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Start-ups vary in terms of their core competencies. Here, a member of a start-up team is designing a new product. The start-up's core competency is product design.

Most start-ups will list two to three core competencies on the business model template. Consistent with the information provided above, a core competency is compelling if it not only supports a firm's initiatives, but is also difficult for competitors to imitate and substitute. Few start-ups have core competencies in more than two to three areas. For example, IndieU has three core competencies:

- Connecting independent, unsigned musicians to colleges and college students
- Recruiting and managing a volunteer network
- Recruiting independent, unsigned musicians to place songs on the firm's website

Similar to the Netflix and supply chain management example, IndieU's entire business model would be untenable absent these three core competencies. In IndieU's case, an added advantage is that its core competencies are, at varying levels, difficult to imitate and substitutes are hard to find for them.

Key Assets. **Key assets** are the assets that a firm owns that enable its business model to work.[24] The assets can be physical, financial, intellectual, or human. Physical assets include physical space, equipment, vehicles, and distribution networks. Intellectual assets include resources such as patents, trademarks, copyrights, and trade secrets, along with a company's brand and its reputation. Financial assets include cash, lines of credit, and commitments from investors. Human assets include a company's founder or founders, its key employees, and its advisors.

Firms vary regarding the key assets they prioritize and accumulate. All companies require financial assets to varying degrees. Retailers such as Whole Foods Markets and Amazon.com rely heavily on physical assets—Whole Foods because of its stores and Amazon because of its warehouses and distribution network. Companies such as Airbnb rely almost exclusively on intellectual assets. However, the relationship between Whole Foods and Amazon will change if Amazon's intention of acquiring Whole Foods, which was announced in the summer of 2017, is fulfilled. Airbnb does not own the rooms that guests book through its website. It simply provides a technology-based platform that connects people wanting rooms with people willing to provide them. As a result, Airbnb's key assets are an app, its brand, and the relationships it has with its customers, building owners, and the communities in which it operates. Many companies rely heavily on human assets. The success of Zynga's business model, for example, relies heavily on its ability to attract and retain a group of game producers and programmers who are creative enough and proficient enough to continually conceive and develop online games that are engaging and social.

Obviously, different key resources are needed depending on the business model that a firm conceives. In filling out the Barringer/Ireland Business Model Template, a firm should list the three to four key assets that it possesses that support its business model as a whole. In some cases, the ongoing success of a firm's business model hinges largely on a single key resource. For example, Zynga has historically maintained an agreement with Facebook that provided Zynga a privileged position on Facebook's platform. That agreement recently ended, which weakened Zynga's business model and dimmed its future prospects.

Financials

The third component of a business model focuses on a firm's financials. This is the only section of a firm's business model that describes how it earns money—thus, it is extremely important. For most businesses, the manner in which it makes money is one of the most fundamental aspects around which its business model is built.[25] Revenue streams, cost structure, and financing/funding are the primary aspects of the financials' component.

Revenue Streams. A firm's **revenue streams** describe the ways in which it makes money.[26] Some businesses have a single revenue stream, while others have several. For example, most restaurants have a single revenue stream. Their customers order a meal and pay for it when they're finished eating. But some restaurants have several revenue streams. They may operate a restaurant, offer a catering service, and sell products at their counter, such as bottled barbeque sauce in the case of a barbeque restaurant. The nature of the way businesses make money also varies. Some businesses make money via one-time customer payments, while others receive recurring revenue by selling a subscription service. Some businesses are very creative in the ways in which they make money. For example, many providers of online games offer the basic game for free, and generate most of their revenue from a small number of users who purchase premium products such as time-saving shortcuts, special weapons, and other features to enhance play.

The most common revenue streams are shown in Table 4.3. As noted above, many businesses have more than one revenue stream, primarily to leverage the value they are creating for their customers. For example, Birchbox historically has had two revenue streams—its subscription service and its online store. For $10 a month, its subscribers receive four to five product samples. If a customer wants to buy a full-sized version of one of the samples, it is available via Birchbox's online store. Recently, the company established its own bricks-and-mortar store in New York City's SoHo District. This means that Birchbox now has three revenue streams, which makes perfectly good sense for this firm. Think of it this way–the product samples introduce subscribers to products that they might not have known about otherwise. If a subscriber likes a particular product and wants a full-sized version, it is available via Birchbox's website and now via Birchbox's physical store as well. These arrangements are good for the subscriber and for Birchbox in that they provide subscribers convenient ways to buy a product that he or she just sampled, and provides Birchbox with three revenue streams.

TABLE 4.3 Most Common Revenue Streams

Revenue Stream	Description
Advertising	Revenue generated from advertising a particular product or service in a newspaper, magazine, website, or in some other manner.
Commissions	Revenue generated by bringing two parties together to complete a sale. Etsy and eBay generate revenue in this manner. The money usually comes from taking a small percentage of the sale price.
Download Fee	Revenue generated by allowing a user to download a digital product, such as a smartphone app, an e-book, or a software product.
Licensing	Revenue generated from charging for the use of a protected intellectual property, such as a software product.
Matchmaking	Revenue generated by matching someone who wants temporary access to an asset or competency with someone who owns an asset or has a competency and is willing to make it available. This is how peer-to-peer networks work. Examples include Airbnb, TaskRabbit, and Uber.
Product Sale	Selling a physical good—such as a product in a retail store or on a website.
Renting/Leasing	Revenue generated by renting or leasing an asset such as a rental car, a copy machine, or a piece of specialized machinery.
Service Sale	Selling a service—such as a meal in a restaurant or a car repair.
Subscription Service	Selling a subscription—such as Netflix for DVDs or streaming of content, or Birchbox for lifestyle samples.

The number and nature of a business's revenue streams has a direct impact on the other elements of its business model. All for-profit businesses need at least one revenue stream to fund their operations. Whether additional revenue streams add or subtract value depends on the nature of the business and the other elements of its business model. It makes sense for Birchbox to have three revenue streams, as explained above. It also makes sense for a retail store, such as a bicycle shop, to not only sell bicycles (Revenue Stream #1), but to sell bicycle accessories (Revenue Stream #2), offer bicycle repair services (Revenue Stream #3), and sponsor local bicycle races (Revenue Stream #4). In contrast, the seller of a smartphone app may charge a one-time download fee (Revenue Stream #1) and offer product upgrades (Revenue Stream #2). But the seller may stop short of selling online advertising (Potential Revenue Stream #3), fearing that online advertising would detract from the experience of playing the game and lead to poorer user reviews and ultimately fewer downloads.

In filling out the Barringer/Ireland Business Model Template, you should clearly identify your revenue streams. Placing them in bullet-point format is preferable.

Cost Structure. A business' **cost structure** describes the most important costs incurred to support its business model.[27] It costs money to establish a basis of differentiation, develop core competencies, acquire or develop key assets, form partnerships, and so on. Generally, the goal for part of a firm's business model template is threefold: identify whether the business is a cost-driven or value-driven business, identify the nature of the business' costs, and identify the business' major cost categories.

Initially, it is important to determine the role of costs in a business. Businesses can be categorized as cost-driven or value-driven. Cost-driven businesses focus on minimizing costs wherever possible. An example is Warby Parker, a firm selling prescription glasses for $95, which is well below the price charged by retail stores such as Pearle Vision and LensCrafters. To do this, Warby Parker's entire business model is based on cost containment. Its glasses are designed in-house, manufactured overseas, and sold via the web, eliminating many of the costs associated with traditional glasses manufacturing and retailing. Instead of concentrating on driving costs lower and lower relative to rivals' cost structures, value-driven business models focus on offering a high-quality product (or experience) and personalized service. Optometrists routinely sell prescription glasses in the $400 to $800 price range. The additional value they provide is a wide selection, personalized service selecting and fitting the glasses, and free follow-on services if the glasses need to be adjusted or repaired.

Next, it's important to identify the nature of a business' costs. Most businesses have a mainly fixed-cost or variable-cost structure. **Fixed costs** are costs that remain the same despite the volume of goods or services provided. **Variable costs** vary proportionally with the volume of goods or services produced. The reason that it's important to know this is that it affects the other elements of a firm's business model. Developing smartphone apps, for example, involves large fixed costs (the coding and development of the app) and small variable costs (the incremental costs associated with each additional app that is sold). As a result, a large amount of money will be needed up front, to fund the initial development, but not so much downstream, to fund the ongoing sales of the app. In contrast, a business such as a sub sandwich shop may have low fixed costs and high variable costs. The initial cost to set up the business may be modest, particularly if it is located in a leased facility, but the cost of labor and ingredients needed to prepare and serve the sandwiches may be high relative to the prices charged. This type of business may need a smaller up-front investment but may require a line of credit to fund its ongoing operations. Other elements of the business model may also be affected. For example, a business with substantial fixed costs, such as an airline, has typically made a major investment in key assets. A service-based company, such as Blue Apron (the prepared meal delivery service mentioned in Chapter 3), may have few key assets but may have core competencies and a partnership network that allows it to source ingredients, design meals, and reliably deliver the meals to its customers.

The third element of cost structure is to identify the business' major cost categories. At the business model stage, it is not necessary to establish a budget or prepare pro-forma financial projections. It is necessary, however, to have a sense of a firm's major categories of costs. For example, Facebook's major categories of costs are data center costs, marketing and sales, research and development, and general and administrative. This type of breakdown helps a business understand where its major costs will be incurred. It will also provide anyone looking at the business model template a sense of the major cost items that a company's business model relies on.

Financing/Funding. Finally, many business models rely on a certain amount of financing or funding to bring their business model to life. For example, Birchbox's business model may have looked elegant on paper, but the firm needed an infusion of investment dollars to get up and running. Most businesses incur costs prior to the time they generate revenue. Think of a business such as Faraday Bikes. Prior to earning revenue, the company had to design its product, arrange for manufacturing, purchase inventory, acquire customers, and ship its product to its customers. This sequence, which is common, typically necessitates an infusion of up-front capital for the business to be feasible. Absent the capital, the entire business model is untenable.

Some entrepreneurs are able to draw from personal resources to fund their business. In other cases, the business may be simple enough that it is funded from its own profits from day one. In many cases, however, an initial infusion of funding or financing is required, as described earlier. In these cases, the business model template should indicate the approximate amount of funding that will be needed and from where the money is most likely to come.

Similar to cost structure, at the business model stage, projections do not need to be completed to determine the exact amount of money that is needed. An approximation is sufficient. There are three categories of costs to consider: capital costs, one-time expenses, and provisions for ramp-up expenses. In regard to capital costs, this category includes real estate, buildings, equipment, vehicles, furniture, fixtures, and similar capital purchases. These costs vary considerably depending on the business. A restaurant or retail store may have substantial capital costs, while a service business may have little or no capital costs. The second category includes one-time expenses such as legal expenses to launch the business, website design, procurement of initial inventory, and similar one-time expenses and fees. All businesses incur at least some of these expenses. Finally, a business must allow for ramp-up expenses. Many businesses require a ramp-up period in which they lose money until they are fully up to speed and reach profitability. For example, it usually takes a new fitness center several months to reach its membership goals and achieve profitability. It's important to have cash set aside to make it through this period.

Operations

The final quadrant in a firm's business model template on operations. **Operations** are both integral to a firm's overall business model and represent the day-to-day heartbeat of a firm. The primary elements of operations are: product (or service) production, channels, and key partners.

Product (or Service) Production. This section focuses on how a firm's products and/or services are produced. If a firm sells physical products, the products can be manufactured or produced in-house, by a contract manufacturer, or via an outsource provider. This decision has a major impact on all aspects of a firm's business model. If it opts to produce in-house, it will need to develop core competencies in manufacturing and procure key assets related to the production process. It will also require substantial up-front investment. If a firm that produces a physical product opts to use a contract manufacturer or an outsource provider, then a critical aspect of its business model is its ability to locate a suitable contract manufacturer or outsource provider. This is not a trivial activity. It is often difficult to find a contract manufacturer or outsource provider that will take a chance on a start-up. As a result, in the Barringer/Ireland Business Model Template, it is not sufficient to complete this box by simply saying "Manufacturing will be completed by a contract manufacturer." The exact name of the manufacturer is not necessary, but a general sense of the part of the world in which the manufacturer is located and the type of arrangement that will be forged with the manufacturer is needed.

If a firm is providing a service rather than a physical product, a brief description of how the service will be produced should be provided. For example, Rover.com, the subject of Case 2.2, is a service that matches people who need their dogs watched while they are out of town with individuals who are willing to watch and care for dogs. The business model template needs to briefly report how this works. The explanation does not need to be lengthy, but it needs to be substantive. For example, an acceptable description for Rover.com is as follows:

> Rover.com will connect dog owners and dog sitters via a website. The dog sitters will be screened to ensure a quality experience. Customer support will be provided 24/7 to troubleshoot any problems that occur. Pet insurance is provided that covers any medical bills that a dog has while in the care of a Rover.com sitter.

This brief statement provides a great deal of information about how Rover.com works and how the elements of its business model need to be configured. This is information that isn't provided in another box in the business model template.

RossHelen/Shutterstock

For firms that sell a physical product, how the product is made must sync with other parts of its business model. This entrepreneur makes and sells specialty cheeses. The product is made in-house to ensure that the company's "basis of differentiation" of high quality is maintained.

Channels. A company's **channels** describe how it delivers its product or service to its customers.[28] Businesses sell direct, through intermediaries, or through a combination of both.

Many businesses sell direct, through a storefront and/or online. For example, Warby Parker sells its eyewear via its website and in a small number of company-owned stores. It does not sell via intermediaries, such as distributors and wholesalers. In contrast, Faraday Bikes sells direct, via its website, and also through bicycle stores throughout the country. It utilizes distributors and wholesalers to get its bikes into stores. Some companies sell strictly through intermediaries. For example, some of the manufacturers that sell via Zappos and Amazon do not maintain a storefront or sell via a website of their own. They strictly rely on broadly trafficked sites such as Zappos and Amazon to sell their products.

The same holds true for firms that sell services. Hotels, for example, sell their services (typically rooms) directly through their websites and telephone reservation services, and also through intermediaries such as travel agents, tour operators, airlines, and so forth. For example, if you were planning a trip to Orlando, FL you could book your flight, rental car, and hotel through Travelocity, Expedia, or many other similar services. In this instance, Travelocity and the others act as intermediaries for the service providers.

A firm's selection of channels affects other aspects of its business model. Warby Parker maintains a simple channels strategy, selling strictly through its website and a small number of company-owned stores. Its price point is low enough that it must capture 100 percent of its margins for itself for its business model to work. In contrast, GoPro sells its cameras through its website, via online outlets such as Amazon and BestBuy.com, and through hundreds of retail stores in the United States and abroad. It utilizes intermediaries, such as wholesalers and distributors, to help it find new outlets. GoPro has a value-driven cost structure, so it can afford to share some of its margins with channel partners. The advantage of GoPro's approach is wide dissemination of its products both online and in retail outlets.

Some firms employ a sales force that calls on potential customers to try to close sales. This is an expensive strategy but necessary in some instances. For example, if a firm is selling a new piece of medical equipment that needs to be demonstrated to be sold, fielding a sales force may be the only realistic option.

Key Partners. The final element of a firm's business model is key partners. Start-ups, in particular, typically do not have sufficient resources (or funding) to perform all the tasks needed to make their business models work, so they rely on partners to perform key roles. In most cases, a business does not want to do everything itself because the majority of tasks needed to build a product or deliver a service are outside a business' core competencies or areas of expertise.

The first partnerships that many businesses forge are with suppliers. A **supplier** (or vendor) is a company that provides parts or services to another company. Almost all firms have suppliers who play vital roles in the functioning of their business models. Traditionally, firms maintained an arm's-length relationship with their suppliers and viewed them almost as adversaries. Producers needing a component part would negotiate with several suppliers to find the best price. Today, firms are moving away from this approach and are developing more cooperative relationships with suppliers. More and more, managers are focusing on supply chain management, which is the coordination of the flow of all information, money, and material that moves through a product's supply chain. The more efficiently an organization can manage its supply chain, the more effectively its entire business model will work.

Along with suppliers, firms partner with other companies to make their business models work. The most common types of business relationships, which include strategic alliances and joint ventures, are shown in Table 4.4. The advantages of participating in partnerships include: gaining access to a particular resource, risk and cost sharing, speed to market, and learning.[29] An example is a partnership between Zynga, the online games company, and Hasbro, a long-time maker of board games. In 2012, the two companies formed a partnership, which resulted in the production of Zynga-themed adaptations of classic Hasbro games. Hasbro now makes a board game called FarmVille Hungry Hungry Herd, which is an adaptation of Zynga's popular FarmVille online game. The partnership is good for both Zynga and Hasbro. It provides Zynga a new source of revenue and entry into a new industry, board games, and it provides Hasbro a fresh new game to sell to its customers.[30] Partnerships also

TABLE 4.4 The Most Common Types of Business Partnerships

Partnership Form	Description
Joint venture	An entity created by two or more firms pooling a portion of their resources to create a separate, jointly-owned organization
Network	A hub-and-wheel configuration with a local firm at the hub organizing the interdependencies of a complex array of firms
Consortia	A group of organizations with similar needs that band together to create a new entity to address those needs
Strategic alliance	An arrangement between two or more firms that establishes an exchange relationship but has no joint ownership involved
Trade associations	Organizations (typically nonprofit) that are formed by firms in the same industry to collect and disseminate trade information, offer legal and technical advice, furnish industry-related training, and provide a platform for collective lobbying

Source: B. Barringer and J. S. Harrison, "Walking a Tightrope: Creating Value Through Interorganizational Relationships," *Journal of Management* 26, no. 3 (2000): 367–403.

PARTNERING FOR SUCCESS

Upwork and Guru: Platforms That Facilitate the Forming of Partnerships with Freelancers

Upwork: *• Web: www.upwork.com • Facebook: upwork • Twitter @Upwork*
Guru: *• Web: www.guru.com • Facebook: Guru.com • Twitter: @Guru_com*

A freelancer is an independent contractor who has skills in a certain area, such as website design, search engine optimization (SEO), or marketing. Start-ups hire freelancers for two reasons. First, they fill gaps that companies have in their expertise. For example, a business may need to develop a social media strategy, but lack capabilities in that area. There are freelancers who are social media specialists, who can quickly and effectively help a business design a social media strategy. Second, freelancers can be hired on an "as needed" basis, so they are typically cheaper than hiring a part-time employee. In addition, if a business hires a freelancer for a project and it doesn't work out, a decision can be made to not hire the same person again. It is more difficult to separate from a part-time or full-time employee.

There are a growing number of web-based platforms that make it easy to identify and hire experienced freelancers. Upwork (www.upwork.com) and Guru (www.guru.com) are popular examples. These platforms are services that allow freelancers to identify themselves and allow anyone needing a freelancer to browse through the listings to find a good fit. For example, Guru lists freelancers by category, which includes Web, Software & IT, Design, Art & Multimedia, Writing & Translation, Sales & Marketing, and several others. Both platforms allow freelancers to post profiles that provide information about their areas of expertise and feedback from previous clients. Upwork's profiles include the freelancer's photo and brief bio, the number of jobs the person has arranged through the Upwork platform, the job success rate, and the history of past jobs, including comments from previous clients. For example, at the time this feature was written a freelancer named Jennifer F. had completed 45 jobs through Upwork with a 97 percent job success percentage. One of her clients wrote, "Jenny has been one of the best freelancers we have ever worked with. She is a social media pro, works fast and efficient, and is always available to answer our questions or discuss ideas and projects." This type of feedback provides future clients assurance that Jennifer F. might be worth a try for a similar project. Jennifer charges $25 per hour. If she's able to help a company design a high impact social media campaign that cost may be well worth it. She'll also only charge for the number of hours it takes her to complete a job.

Over time, companies often become comfortable with individual freelancers, and the relationship becomes more of a partnership than an arms-length arrangement. The platforms make money by taking a percentage of the money that the freelancers are paid. Upwork's freelancers pay a "sliding service fee" based on total billings with each client: 20 percent for the first $500 billed to the client across all contracts, 10 percent for total billings with the client between $500.01 and $10,000, and 5 percent for total billings with the client that exceed $10,000. Clients pay a 2.75 percent per payment processing fee. Guru's freelancers pay between 4.95 percent and 9.95 percent; these percentages are deducted from their earnings. Guru's clients also pay a 2.5 percent per payment processing fee. There are protections built into the services to prevent freelancers from taking money and not completing a job. Both Upwork and Guru are expanding the number of fields for which they provide expertise and new providers are entering the market. Companies can now find qualified freelancers to reliably plug almost any skill gap they have.

Questions for Critical Thinking

1. Imagine that you are the founder of a company and need help setting up QuickBooks for your company. QuickBooks is an accounting and bookkeeping platform for small businesses. Search Upwork and Guru for QuickBooks freelancers. Select the one that you think represents the best combination of expertise, experience, and cost. Summarize the key attributes of the person you selected.
2. To what degree is it appropriate or inappropriate to hire freelancers to fulfill some of the core competencies of a business?
3. Make a bullet-point list of the advantages of hiring freelancers to do short-term projects for a start-up.
4. In what ways do you believe that a freelancer could become a partner of a company rather than an arms-length independent contractor?

Sources: Upwork Homepage, www.upwork.com (accessed February 12, 2017); Guru Homepage, www.guru.com (accessed February 12, 2017).

have potential disadvantages.[31] The disadvantages include loss of proprietary information, management complexities, and partial loss of decision autonomy.[32]

When completing the Barringer/Ireland Business Model Template, you should identify your primary supplier partnerships and other partnerships. Normally, a start-up begins with a fairly small number of partnerships, which grows over time.

One trend in partnering, utilized by all types of businesses, is to use freelancers to do jobs that are outside a firm's core competencies. A freelancer is an independent contractor who has skills in a certain area, such as software development or website design. There are several web platforms that are making it increasingly easy to identify and find qualified freelancers. These platforms are highlighted in the nearby "Partnering for Success" feature.

Chapter Summary

LO1. A business model is a firm's recipe for how it intends to create, deliver, and capture value for stakeholders. In essence, a business model deals with the core aspects of how a firm will conduct business and try to succeed in the marketplace. The quality of the business model a firm develops, as well as the quality of how that model is executed, affect the firm's performance in both the short and long term. How well the different parts or elements of a business model fit together and are mutually supportive affects its quality. The best business models are developed and executed in ways that are difficult for competitors to understand and imitate. Moreover, the greater the difference between a firm's business model and those of its competitors, and assuming that the model has been effectively developed, the stronger the likelihood a firm will be competitively successful. Thus, an entrepreneurial firm wants to develop a business model that clearly specifies how the firm intends to be uniquely different from its competitors and create value for stakeholders as a result.

LO2. There are several types of business models. However, it is important for an entrepreneur to understand that no particular type of business model is inherently superior to any other model. The "best" business model is the one that allows a firm to effectively describe the value it intends to create for stakeholders and appropriately details the actions it will take to create that value. Standard and disruptive business models are two well recognized categories of business models. We say "categories" because there are several types of standard models (see Table 4.1) and two types of disruptive models (discussed here). Standard business models depict or reveal plans or recipes firms can use to determine how they will create, deliver, and capture value for stakeholders. Many of the standard models have been in existence for many years. When selecting a standard business model, an entrepreneurial venture believes that it can integrate the elements of that model uniquely as a means of creating value while competing against rivals. Disruptive business models, which are rare, are ones that do not fit the profile of a standard business model and are impactful enough that they disrupt or change the way business is conducted in an industry or in an important segment or niche of an industry. A new market disruption and a low-end market disruption are the two types of disruptive models. A new market disruption finds a firm using a business model through which it is able to address a market that wasn't previously served (think of Google as an example). A low-end market disruption is possible when firms already competing in an industry are providing customers with products or services that exceed their expectations or desires. This "performance oversupply" creates an opportunity for an entrepreneurial venture to enter an industry for the purpose of providing customers with the product or service functionality that more closely approximates what they want. Low-cost business models are often used to create a low-end market disruption (think of Southwest Airlines in the United States and Ryanair in Europe as examples).

LO3. Comprehensive in scope, the Barringer/Ireland Business Model Template features

4 major categories and 12 individual parts (see Figure 4.2). As a tool, entrepreneurs can use this business model template to describe, project, revise, and pivot its intended actions until they are convinced that the model's elements are integrated in a way that will yield a viable business firm. Core strategy, which describes how the firm plans to compete, is the first of the four major categories. The firm's mission, basis of differentiation, target market, and product/market scope are the parts of the core strategy category. Resources, the second category, are the inputs a firm intends to use to sell, distribute, and service its product or service. Core competency, which is a specific factor or capability that supports a firm's business model and differentiates it from competitors and key assets, or the assets a firm owns that enable its business model to work, are the critical resources a firm needs to execute as called for by its chosen core strategy. The third category, financials, is concerned with how the firm intends to earn money. Revenue streams, which deal with the exact ways a firm earns revenue, cost structure, which includes the most important costs (both fixed and variable costs) the firm will incur to support the execution of its business model, and funding/financing (dealing with how the firm will support or cover its costs) are the parts of the financials category. Operations is the fourth and final category featured in the Barringer/Ireland Business Model Template. The product (or service) production part of this category details the firm's intended production methods. The channels part specifies how products or services will be delivered to customers, while the key partners' part identifies others with whom the firm intends to collaborate as a means of supporting its operations.

Key Terms

basis of differentiation, **158**
business model, **148**
channels, **166**
churn, **153**
core competency, **160**
core strategy, **156**
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MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

4-1. What is a business model?
4-2. How does a freemium business model work?
4-3. What is the best time for a firm to develop its business model?
4-4. What is a standard business model and what is a disruptive business model?
4-5. What are the four major categories that comprise the Barringer/Ireland Business Model Template?
4-6. How are a firm's core strategy and its mission related to each other as parts of a business template?
4-7. What is the difference between a new market disruption and a low-end market disruption?
4-8. Why do most entrepreneurial firms initially choose to compete within a narrow target market?

4-9. What is "churn," and how does it affect a firm?
4-10. Why are the resources a firm possesses a critical part of its business model?
4-11. What is a core competency?
4-12. How many core competencies do most start-ups have?
4-13. What is a business's cost structure?
✪ 4-14. What are the differences between a firm's physical assets and its intellectual assets?
4-15. What is a revenue stream and why is it so important to a firm's short- and long-term success?
4-16. What are the most common revenue streams for certain business firms?
4-17. What are the primary elements of the Operations component of the Barringer/Ireland Business Model Template?
4-18. Who are "key partners" and why are they important to the success of an entrepreneurial venture?
4-19. What are the different ways a firm may choose to deliver its product or service to its customers?
✪ 4-20. Who are "freelancers" and why are these individuals potentially attractive as partners for an entrepreneurial venture?

Application Questions

4-21. Hans Bliss knows that he needs to establish partnerships to perform all the tasks needed to make his business model work. Unfortunately, apart from his partnership with his supplier, he is not sure of the types of partnerships that he could gain from. What are the types of partnerships that Hans can consider for future needs?
4-22. A gym in the suburbs of a major city has an average of 7,000 members. Each month, some 5–8 percent of members fail to renew. How might a business like this reduce its churn and see sustained growth over a period of time?
4-23. Spend some time looking at CADI Scientific, the focus of the "You Be the VC 3.2" feature. What are five actions this firm could have taken when completing its feasibility analysis that would have been particularly helpful in supporting its business model?
4-24. Twitter (http://twitter.com) is a free networking and micro-blogging service that allows its users to send and read other users' updates, called "tweets." This business model continues to be criticized for not being viable in the long-term. Spend some time studying how Twitter does business. How does the company earn money? Does it or does it not have a business model with long-term potential? If it does not have a viable long-term business model in your view, what changes to its business model should Twitter make to increase its competitiveness?
4-25. Debra McGahan, a close friend of yours, mentioned to you that to complete a project in one of the courses she is taking this semester, she needs to describe a firm that is using an effective business model. Your immediate response is to recall that you just read this chapter and learned about CoachUp's successful business model while reading the "Savvy Entrepreneurial Firm" feature. Describe CoachUp's business model to Debra for the purpose of explaining to her how this particular model allows CoachUp to create value for the firm's stakeholders.
4-26. Resources and core competencies are both important parts of the Barringer/Ireland Business Model Template. What are the differences between resources and core competencies and why must an entrepreneurial firm have both resources and core competencies in order to develop an effective business model?
4-27. What are some examples of instances in which location is an important part of a firm's business model?
4-28. Steven Gerald plans to start a 24-hour laundry mart. What are the basic resources he needs? Help Steven out by creating a list of the necessary resources.
4-29. Basis of differentiation is part of the Barringer/Ireland Business Model Template. This term was defined in the chapter as "what causes consumers to pick one company's products over another's." What is Apple's basis of differentiation?

YOU BE THE VC 4.1 COMPANY: DoorDash

• Web: www.doordash.com • Facebook: DoorDash • Twitter: @doordash

Business Idea: Launch an on-demand restaurant delivery service that empowers small business owners to offer delivery of their food items in an affordable and convenient manner.

Pitch: DoorDash is an on-demand restaurant delivery service. After identifying the most popular restaurants in a city that offer takeout, the company then strikes deals with the restaurants that allow DoorDash to connect the people ordering takeout with DoorDash drivers. In some cases, the relationship between DoorDash and a participating restaurant is simple. In these instances, DoorDash acts as an in-between for people wanting home delivery and DoorDash drivers who, like Uber drivers, are independent contractors. In other cases, it's more formal, and DoorDash provides additional operational efficiency services and data analytics. DoorDash has established these types of partnerships with thousands of restaurants across the country, from small independently-owned cafes to restaurant chains such as Taco Bell and Dunkin' Donuts.

For a consumer, here's how DoorDash's service works. A consumer goes to DoorDash's web or mobile app and either accesses their account or types in their zip code. A dashboard pops up that provides a list of all the nearby restaurants that offer takeout (stratified by restaurant type, such as American, Thai, Italian, Sushi, etc.), a takeout menu for each restaurant with prices, an estimate of how long it will take to deliver a meal, and the delivery price. Most orders are delivered in less than 45 minutes. For each restaurant, the app also provides a "Delight" score. The delight score, which is generated from customer feedback, is an indication of the total experience of ordering from that restaurant, from food quality to speed of delivery, to price. Once an order is placed, it is paid for by credit card, a Dasher (which is what DoorDash calls its drivers) goes to the restaurant and picks up the order, and then delivers it to the customer's address. Tips are allowed.

You might wonder how DoorDash earns money. It does so in three ways. First, a service fee is assessed with each order. Second, it collects the delivery fee which is paid directly to the driver. Third, added fees are collected from the restaurants to whom DoorDash provides additional operational efficiency services and data analytics. DoorDash launched in San Francisco and has expanded to other major metropolitan areas such as Los Angeles, Boston, Chicago, New York City, and several other markets. It plans to continue to add cities.

Because they are independent contractors, Dashers make their own schedule, and work as much or as little as they want. Many restaurants have seen an increase in sales, new customers, and improved operations as a result of DoorDash making home delivery an option. DoorDash sees itself as a logistics company rather than a meal delivery service, and views restaurants as its initial service offering. In the future, DoorDash plans to offer other types of home delivery services.

4-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

4-31. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 4.2 COMPANY: Secret Recipe Cakes and Café

• Web: www.secretrecipe.com.my • Facebook: Secret Recipe Malaysia • Twitter: @SecretRecipe_My

Business Idea: A café chain that integrates both local and international flavors for food enthusiasts all over the world.

Pitch: Secret Recipe Cakes and Café is no stranger to food enthusiasts, especially in Malaysia. It has been a household name since its establishment in 1997. With quality cakes, fusion food, and distinctive service as its core strategy, Secret Recipe has already developed a winning recipe for success. It is one of the leading and largest café chains in the country, with more than 150 outlets in Malaysia serving a variety of dishes and desserts that appeal to a wide range of customers. Serving more than 20 types of fusion food, 40 different types of cake creations, and an assortment of pastries, designer ice creams, and beverages, Secret Recipe has won the hearts of many Malaysians and has successfully established its brand name in the region.

The Secret Recipe business formula has also been successfully replicated internationally, with more outlets located in various countries including Thailand, Singapore, Indonesia, the Philippines, China, Pakistan, and Brunei. Over 20 years, Secret Recipe has expanded to a network of more than 440 cafés.

Building a sustainable business with a strong brand was not an easy task for Secret Recipe. To be different, it had to identify features of its brand that could extend beyond one store or one country. Differentiation, innovation, adaptability, research and development, consistency, identity, and brand promise were the key ingredients that have allowed Secret Recipe to enjoy worldwide success.

Secret Recipe has won several awards, including the Homegrown Franchise of the Year, International Franchisor of the Year, Franchise of the Year Best Sales Growth Award, and Best Brand Food & Beverage Café Award. Moreover, Secret Recipe has also grabbed several international awards, such as the Best Cake Award for Eastern China 2017. In 2013, Secret Recipe won two Platinum Awards in the "Best in Marketing" and "Best Brand" categories at The Star Business Awards in Malaysia.

Secret Recipe is not only a café that offers a wide variety of cakes, but it also offers a flexible menu with different items available in different countries. However, to identify Secret Recipe as a truly Malaysian brand, the overseas outlets also offer Malaysian all-time favorites like *nasi lemak* (rice with spicy gravy) and *mee goreng* (fried noodles). Secret Recipe will continue striving to surpass its own accomplishments and aims to be recognized as a leader in the industry both locally and globally.

4-32. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

4-33. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 4.1

Etsy: Breaking Down a Business Model

• ***Web: www.etsy.com*** • ***Facebook: Etsy*** • ***Twitter: @Etsy***

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Etsy is an e-commerce website that focuses on handmade or vintage items and unique factory-manufactured products. These items cover a wide range of product types, including jewelry, furniture, housewares, kitchen gadgets, clothing, knick-knacks, and art. The site resembles an open craft fair, where sellers (mostly small merchants and local artisans) set up Etsy stores and sell their products to buyers, who are people who want unique, mostly handmade products from small/local producers. Etsy launched in 2005. As of late 2017, Etsy had 54 million users registered as members, including 19.8 million active buyers and 1.7 million active sellers.

History

The idea for Etsy originated in a woodworking shop. Rob Kalin, who earned a college degree in the classics, bypassed the traditional job market to focus on his woodworking talents. He created a unique product, a computer encased in wood, but couldn't find a marketplace to sell it. So he, along with Chris Maguire, Jared Tarbell, and Haim Schoppik, launched Etsy, an online marketplace for crafts where hobbyists and artisans could connect with people interested in buying handmade goods.

From the beginning, Etsy championed the idea of community. The company saw itself as an advocate of small merchants and artisans. It also took steps to engage its community and empower its sellers. Every Monday evening Etsy sponsored craft night, where 50 to 80 people came to its office in Brooklyn to make crafts. The company also sponsored employee craft nights where its employees would hone their craft-making talents. At the same time, Kalin started holding virtual town hall meetings with Etsy sellers to provide tips to them on how to increase their sales. All this was done in part to build community, but there was a broader purpose. Kalin and his team knew that Etsy's financial success hinged on how much commerce flowed through its site.

Since it launched in 2005, Etsy has grown steadily. It currently employs 685 people in the

(*continued*)

DreamBig/Shutterstock

Etsy's platform is designed to help people sell handmade items. This photo contains a collection of headbands and other hair accessories made by an Etsy seller.

United States and abroad and facilitates transactions in nearly 200 countries. Etsy remained a private company for 10 years. It went public on April 16, 2015, and trades on the NASDAQ under the ticker symbol ETSY. The company was valued at $1.8 billion at the time of its IPO. In 2016, Etsy generated $2.7 billion in sales.

How Etsy Works

To sell on Etsy, a seller registers and creates an online Etsy store. Creating a store is free. Each item in the store costs 20 cents to list. The prices in the store are determined by the seller. Etsy takes a 3.5 percent commission on each sale. An example of an Etsy store is AHeirloom, which can be seen at https://www.etsy.com/shop/AHeirloom. AHeirloom sells handmade wood items. One of its most popular items is kitchen cutting boards that come in the shape of states. At the time this case was written, AHeirloom had 287 items listed, ranging in price from $8 to $155. When a sale is made, AHeirloom collects the money and delivers the item to the buyer. Etsy bills AHeirloom and its other sellers once a month for its listing and commission fees.

To buy on Etsy, a customer can either use the search bar on Etsy's home page to search for an item or can browse through a list of categories that includes Home & Living, Jewelry, Clothing, Toys & Games, Craft Supplies & Tools, and Weddings. A select number of items are also featured each day on Etsy's homepage. When a buyer enters an Etsy online store, he or she can read reviews from past buyers and see how the seller stacks up on a five-star scale. AHeirloom, for example, has over 4,973 reviews and nearly a perfect five-star rating.

Business Model Breakdown

At the heart of Etsy's success is its business model. A business model is a firm's plan or recipe for how it creates, delivers, and captures value for its stakeholders. The Barringer/Ireland Business Model Template, completed for what Etsy looks like today, is shown nearby. The following is a breakdown of each of the four major categories of Etsy's business model. What is particularly instructive is the way the model fits together. As you read through the description of each category, notice how it affects the other categories and Etsy's business model as a whole.

Core Strategy

Etsy's mission is ambitious. It wants to "re-imagine commerce in ways that build a more fulfilling and lasting world." To do this, Etsy has built its business around the neighborhood feel. Its focus is on constructing a way to shop that is meaningful to both sellers and buyers. To illustrate this point, Etsy CEO Chad Dickerson said, "Etsy, technologically and culturally, is a platform that provides meaning to people, and an opportunity to validate their art, their craft." To further articulate Etsy's core values Dickerson said, "At the end of each transaction you get something real from a real person. There is existential satisfaction to that." In addition to this set of values, Etsy is an advocate for small merchants and artisans. These are two categories of businesses that have been hurt by mass production and the advent of the big-box store. Etsy is helping bring back these businesses by providing them a platform to sell their products to a sizeable audience of buyers.

Etsy's basis of differentiation flows from its mission to focus on handmade goods, the number of buyers

Core Strategy	
Business Mission • Re-imagine commerce in ways that build a more fulfilling and lasting world	**Basis of Differentiation** • Focus on handmade goods • Largest number of registered buyers and sellers of handmade goods in the world • Sense of community associated with its site
Target Customer(s) • Buyers—A global clientele that wants unique, hand-made products from small/local producers • Sellers—Small merchants, home-based businesses and local artisans who want to sell their goods online	**Product/Market scope** • Handmade goods • Manufactured goods that meet strict guidelines • Global audience of both buyers and sellers

Resources	
Core Competencies • Developing and maintaining a vibrant community of buyers and sellers • Development of tools and educational materials to empower sellers • Generating word-of-mouth awareness of their business	**Key Assets** • Intuitive and easy-to-navigate web-based platform • Etsy's community of both buyers and sellers • Continual inflow of high-quality handmade products • Is a Certified B Corporation

Financials	
Revenue Streams • Sales commissions—3.5% on each item sold via the Etsy website • 20 cent listing fee for each item listed • Seller services—advertising platform, payment processing, website hosting	
Cost Structure • Cost-driven business • High fixed/low variable costs • Major categories of costs: Web-based platform development; staff salaries and general administrative; seller education initiatives	**Financing/Funding** • $97.3 million in angel and venture capital funding and $237 million in IPO • Funding from operations

Operations	
Product (or Service) Production • Etsy's secure platform allows small merchants and artisans that have products to sell to connect with people interested in buying hand-made goods • Etsy's platform was built and is maintained by an in-house staff of IT professionals	**Channels** • Etsy website • Etsy Wholesale—a platform that connects Etsy sellers with brick-and-mortar stores • Temporary holiday storefronts **Key Partners** • Third-party developers • Local organizations and businesses • Community and business alliances

Etsy: Barringer/Ireland Business Model Template

and sellers on its site, and the sense of community that it has created. Although its website is easy to navigate, that's not what differentiates Etsy from its rivals in that many online businesses have websites that are easy to navigate. What differentiates Etsy are the factors mentioned above. It's instructive to note that Etsy's points of differentiation are made possible by its core competencies and key assets. From the beginning, Etsy has excelled at helping its sellers increase sales via web-based tools, educational materials, and offline events. It also set its business up in a way that encourages its sellers to build awareness of Etsy in general. Each seller has its own Etsy store. As sellers promote their Etsy stores, they introduce people to Etsy more broadly, which is a key factor that has enabled Etsy to grow so quickly.

Etsy has two target markets—its sellers and its buyers. Its sellers are the producers of handmade goods. Its buyers are people drawn to the site because they want something unique, something that has a story. They want something that they enjoy telling other people about. It's a different motivation for buying than shopping at Walmart or on Amazon.com. This is what Etsy means by "re-imagining" commerce. Etsy's product/market scope has expanded since its inception. While the majority of items are still handmade, on October 1, 2013, Etsy announced that it would allow factory-made goods on its site. This move, according to the company, was necessary to allow its most successful sellers to expand their businesses and keep them from leaving the site. There are restrictions. The seller must meet a set of labor and ecological criteria. Some controversy was caused by the decision to allow manufactured goods, but Etsy's numbers continue to grow.

Resources

Etsy has three core competencies—the development of tools and educational materials to empower sellers, the growth of a vibrant community of buyers and sellers, and the ability to generate word-of-mouth awareness of its business. A key to Etsy's success has been a recognition that its sellers, which it affectionately calls Etsians, must be successful for the site to work. As a result, from the beginning Etsy has focused on developing tools, educational materials, and offline events to assist its sellers. For example, each year Etsy sponsors an event called the Etsy Success Symposium, which is a physical and online gathering of Etsy sellers for the purpose of helping one another increase sales. Etsy produces a number of publications, including the Etsy Seller's

(continued)

Handbook and the Etsy Success Newsletter, both geared toward helping Etsy newbies and veterans boost their clientele. Etsy Labs organizes community events for Etsy sellers, facilitates online workshops, and assembles Etsy teams, which are groups of sellers that organize around a particular location or craft. These efforts have enabled Etsy to build and maintain a vibrant community of buyers and sellers.

As mentioned earlier, Etsy's website is constructed in a way that has led to a core competency in generating word-of-mouth awareness of its business. As sellers promote their Etsy stores, they promote Etsy more broadly. Etsy has also been a leader in social media. It currently has close to 2.8 million Facebook likes and 2.7 million Twitter followers. The combination of an easy-to-navigate website and an aggressive social media presence has been instrumental in Etsy's growth.

In regard to key assets, Etsy's platform is intuitive and easy to navigate. Its community of buyers and sellers continues to grow. Its sellers populate its site with a continual influx of fresh new products, which keeps its buyers coming back. Etsy takes deliberate steps to add to its key assets in ways that support its mission and provide people another reason to engage in its site. For example, in early 2012, Etsy became a Certified B Corporation. B Corporations are a new type of company that uses the power of business to solve social and environmental problems.

Financials

Etsy has three revenue streams. The first is the 20 cent listing fee for each item listed on the site. While 20 cents doesn't sound like much, there are more than 40 million unique listings on the site. Second, Etsy charges a 3.5 percent commission on each item sold. Third, the company earns money from seller services such as its advertising platform, payment processing, and website hosting (for sellers who sell products via their own website in addition to their Etsy store). This mix of revenue streams makes sense given Etsy's core strategy and its resources. The larger and more engaged a community it builds, the more revenue it will earn from listing fees and commissions.

Etsy's cost structure is based on cost containment and a high fixed/low variable cost model. Etsy has high infrastructure costs, driven by the network capacity and data storage necessary to service 54 million registered members, 19.8 million active buyers, 1.7 million sellers, and over $2.7 billion in annual sales. It also has a staff of 685 that manages the site and maintains the Etsy community. To support its core strategy, the firm has people with job titles that don't exist in most businesses, such as Head of Seller Education. Etsy's variable costs are low. It costs Etsy very little to add another buyer or seller to its site.

Notable is the amount of funding that Etsy has raised—$97 million prior to the initial public offering (IPO) and $237 million in the IPO. The funding has been used to flesh out the company's infrastructure, add employees, invest in strategies for expansion, and fund seller education initiatives.

Operations

Etsy's website was built and is maintained by an in-house staff of IT professionals. The site has a homespun rather than a highly polished look. This is intentional, although some critics have urged Etsy to up its game some in terms of site design and functionality. As mentioned earlier, Etsy is strictly a platform that brings buyers and sellers together. While a seller's Etsy store resides on Etsy's website, all of the logistics involved with the sales process are handled by the seller. This includes stocking the store, processing orders, collecting payment, and shipping the merchandise. This arrangement relieves Etsy of the cost and responsibility of providing for those functions.

In terms of channels, the majority of sales flow through Etsy's website, via one-to-one transactions between individual buyers and Etsy sellers. In 2015, Etsy launched Etsy Wholesale, a platform that connects Etsy sellers with brick-and-mortar stores. The program allows retailers to shop in a restricted section of the website that features sellers Etsy has screened to make sure they are able to handle large orders. As of late 2015, more than 2,500 sellers and 6,500 local boutiques had signed up for the service. While most of the stores that have signed up are small shops, a few large retailers, like Nordstrom and Whole Foods, are also participating in the program. For a seller, opting into the program requires a $100 one-time fee and a 3.5 percent commission on all items sold through the brick-and-mortar stores. Etsy also has tried some special promotional events, such as setting up temporary physical storefronts in New York City during the Christmas season to feature products made by Etsy sellers.

Etsy has several key partners, or groups of partners, which improve its operations and help expand sales. In terms of operations, by publishing its API (Application Programming Interface), Etsy has enabled third-party developers to create tools that help Etsy sellers more efficiently manage their inventory and track their shipments. Etsy works with a number of organizations and businesses to support crafts and homemade products. An example is Etsy's involvement in New York's annual Renegade Craft Fair, which is an event that features and champions the work of artisans and small merchants.

Etsy is also branching into areas that enable it to support small businesses and entrepreneurship in more general ways. For example, in 2013, Etsy announced plans to collaborate with local communities to teach entrepreneurship skills to residents. By doing this, Etsy is helping seed the next generation of Etsy sellers. All of these efforts are consistent with Etsy's mission of re-imagining commerce and acquainting as many people as possible with Etsy and the marketplace it facilitates.

Challenges Ahead

Etsy's primary challenge will be to maintain the integrity of its business model while trying to grow. The complexity of this challenge is starting to show.

Many Etsy sellers, for example, were not happy with the company's decision to allow the sale of manufactured goods, which is now being done by several thousand Etsy sellers. Etsy Wholesale, which has helped Etsy sellers get their goods into retail stores, is at the same time a positive and a challenge. While the initiative has increased sales, Etsy's most powerful argument when it comes to persuading big retailers to carry products from its most prolific sellers is that the products are "homemade." But Etsy risks weakening that homemade brand by helping sellers find more efficient ways to make their products to scale their businesses. Sellers complain about rising fees, which may be an artifact of Etsy's need to produce sufficient profits to satisfy stockholders. Its initial listing fee was 10 cents per item, and it's now 20 cents. Some also complain about the lack of traditional marketing and would like to see Etsy take a more active role in driving traffic to its site. Recall that Etsy takes the opposite approach. It relies on its sellers to promote their Etsy stores, and benefits when the customers of individual sellers learn about Etsy more broadly.

Etsy also faces increased competition. Its biggest domestic competitors are Amazon, eBay, and Craigslist. In 2016, Amazon launched Amazon Handmade, which is a new store on Amazon for invited artisans to sell their handcrafted goods. It's hard to know if Amazon's entry will help or hurt Etsy. If it cannibalizes Etsy's sales, then that's a negative. If it increases awareness and interest in homemade goods and industry sales increase nationwide, then that's a positive. There are also several companies that have created Etsy-like platforms in foreign countries, like DaWanda in Germany and ezebee.com in Switzerland. These companies are now competing with Etsy in global markets.

Discussion Questions

4-34. How does Etsy create, deliver, and capture value for its shareholders?

4-35. Is Etsy's business model a standard or a disruptive business model? Explain your answer.

4-36. How is Etsy's business model different from eBay's business model for the makers of handmade goods?

4-37. In your judgment, what is the most serious challenge facing Etsy? To what extent does the challenge threaten Etsy's business model? How should Etsy confront the challenge?

Sources: Etsy Homepage, available at www.etsy.com (accessed February 12, 2017); S. Kessler, "Etsy Wants to Bring Its Handmade Wares to a Brick-and-Mortar Chain Store Near You," *Fast Company*, May 7, 2015; P. Armstrong, "What You Don't Know About Etsy (And Its 2017 Strategy)," *Forbes*, Dec 15, 2016; "Etsy," Wikipedia, www.wikipedia.com (accessed February 12, 2017); "The 'Etsy Economy' and Changing the Way We Shop," *Entrepreneur*, March 22, 2013.

CASE 4.2

TOMS' One-for-One Business Model: Is it Sustainable for the Future?

• *Web: www.toms.com* • *Facebook: TOMS* • *Twitter: @TOMS*

Bruce R. Barringer,
Oklahoma State University

R. Duane Ireland,
Texas A&M University

Introduction

In 2005, Blake Mycoskie, a serial entrepreneur, needed a break. After starting 5 companies in 12 years, he traveled to Argentina looking for some time to relax. He met some expatriates who were doing social work in villages on the outskirts of Buenos Aires and asked if he could tag along. In one village in particular, he noticed that most of the children didn't have shoes. He stopped a few of the kids to look at their feet and saw cuts, abrasions, and infections. He knew the villagers were poor and couldn't afford to buy their children shoes and wondered what he could do to help. He also knew there was an inexpensive shoe in Argentina called the alpargata. What would be the best way to provide poor Argentinean children alpargata shoes?

Mycoskie thought about starting a charity but felt the charity model wouldn't work. He envisioned himself asking his family and friends for contributions, and knew they would contribute once, or twice, or maybe even several times. But it would be hard to continue to ask. What he needed was an approach that would sustain itself by selling a product that people needed to buy anyway. The approach Mycoskie came up with he later dubbed "one-for-one." He would create a for-profit business to sell alpargata shoes, and for every pair sold he'd donate a pair to a child in need.

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Mycoskie returned to the United States and set up shop in Santa Monica, California. He started TOMS with no shoe industry experience. The company was originally called Shoes for Tomorrow but was quickly shortened to TOMS. To get started, Mycoskie went from one retail store to another with his unique business idea. A few Los Angeles boutiques agreed to sell the shoes. His first break came when the *Los Angeles Times* ran an article about his business. To Mycoskie's surprise, the article spurred $88,000 in orders in a single weekend.

Fast forward to today. TOMS is now an international brand. Its one-for-one model has been expanded to include shoes, eyewear, coffee, and bags. As of early 2017, TOMS had given away 60 million pairs of shoes in 75 countries, had helped restore sight for 400,000 people in 13 countries, and has helped provide over 335,000 weeks of safe water in 6 countries. The one-to-one model has been tweaked some, but the intention is the same. TOMS still gives away a pair of shoes for every pair it sells. Eyewear was added in 2011. Rather than donating a pair of glasses for every pair its sells, TOMS donates an equivalent amount of money that is used for sight-saving measures, such as eye surgery, medical treatment, or a new pair of prescription glasses. Coffee was added in 2014, under the "TOMS Roasting Company" brand. For every bag of coffee that's sold, TOMS Roasting Company works with its Giving Partners to provide 140 liters of safe water (a one-week supply) to a person in need.

In 2015, the TOMS Bag Collection was founded. The Bag Collection includes different types of bags for women, including backpacks, tote bags, travel bags, cross-body bags, and clutches. The mission of the Bag Collection is to help provide training for skilled birth attendants and distribute birth kits containing items that help a woman deliver her baby safely. As of 2016, TOMS has supported safe birth services for over 25,000 mothers. Many of TOMS' initiatives have ripple effects. For example, by supporting the creation of sustainable water systems, TOMS is able to provide entire communities with access to safe water, which leads to improved health, increased economic productivity, job creation, and access to education.

TOMS' Business Model

TOMS is known for pioneering the one-to-one business model. As explained in this chapter, a firm's business model is a plan or recipe for how it creates, captures, and delivers value to its stakeholders. TOMS' business model is unique in that it combines the goals of a for-profit company with the ambitions of a philanthropic organization. TOMS' business model template is shown nearby. The following is a brief overview of each of the major sections of the business model template.

Core Strategy

TOMS' mission is "One-for-One." The mission is made possible by the way TOMS is structured. TOMS has two parts. TOMS is a for-profit company that manages the overall operations and logistics. Friends of TOMS is a nonprofit organization that assembles volunteers, delivers the shoes, and coordinates the eyewear/sight restoration and coffee/clean water initiatives.

An important decision Mycoskie and his team made early on, when TOMS was strictly a shoe company, was that the cost of providing shoes to children in need would be built into the shoes' selling price. The same approach now applies to eyewear and coffee. As a result, as long as TOMS sells its products, it can fulfill its philanthropic mission. It does not need to rely on donations, as most charities and nonprofits do, to sustain itself.

TOMS' strategy is built on selling practical products. Shoes, eyewear, coffee, and bags are products that are sold widely. Its shoes are pricey ($55 to $89 for a pair of simple slip-ons), but people know that when they buy TOMS shoes they are paying for a pair that will be donated to a child in need. TOMS relies heavily on volunteers, interns, and partners to do much of its work. Many of the people who volunteer and work with TOMS are motivated by the company's mission, which changes lives. In some countries, shoes are required in order to attend school. Owning a pair of shoes provides a child a chance to be educated and to have a better life. TOMS is not reluctant to share these types of realities, which deeply resonate with volunteers and customers. TOMS has almost as many interns, for example, working in its facilities as employees. Friends of TOMS works with nonprofits and NGOs to distribute its products. It does this in part because local organizations, already embedded in a country, know the needs better than TOMS does and can direct the company. An example is TOMS' partnership with the Seva Foundation to implement its eyewear/restore sight program. The Seva Foundation runs sight programs in Tibet, Nepal, Bangladesh, and throughout sub-Saharan Africa. It is uniquely equipped to help TOMS make the best use of its dollars.

Resources

TOMS has been diligent in the execution of its one-to-one model. Its products are appealing, its philanthropic efforts are making a difference, and it involves a lot of people in what it does. These factors have enabled TOMS to build a strong brand. Its core strategy is also working. It has remained sustainable without needing donations. TOMS has also excelled at creating excitement and passion in others for what it is doing. It does a lot to elicit this. For example, every two weeks a group of TOMS' volunteers travels to Argentina or another part of the world to make a "shoe drop," which is the term that TOMS uses for distributing shoes. Anyone can apply for the trip, and for many it is a life-changing experience. Every shoe TOMS gives away is placed on a child's foot by a TOMS volunteer. Volunteers pay their own travel expenses, but the trips are organized by TOMS.

TOMS also listens. It has both proponents and critics who are vocal in their feedback. Rather than ignoring the feedback, TOMS reacts, which encourages additional feedback. For example, one source of

Core Strategy

Business Mission
- "One for One"

Basis of Differentiation
- Strong brand
- Business structure: TOMS (for profit) and its collaboration with Friends of TOMS (non profit subsidiary)
- Products (shoes, eyewear, coffee, and bags) that resonate with consumers
- TOMS volunteers
- Ability to change lives

Target Customer(s)
- Consumers who resonate with TOMS one-for-one approach and the company's combined for-profit/philanthropic persona

Product/Market Scope
- Shoes, eyewear, coffee, and bags
- Branded products (t-shirts, caps)
- TOMS products are sold worldwide. Combined, its shoes, eyewear, coffee, and training for skills birth attendants and birth kits have been distributed to over 75 countries

Resources

Core Competencies
- Pioneered the one-for-one business model; diligence in execution has created a strong brand
- Creation and management of for-profit/philanthropic business strategy that is sustainable
- Ability to create passion and excitement about what TOMS is doing in others (nonprofit partners, TOMS volunteers, Interns, Campus Clubs, etc.)
- Willingness to learn (i.e., responding to critics who point out how TOMS could be doing things better by adopting the best suggestions)

Key Assets
- Blake Mycoskie
- Corporate culture
- Relationships with nonprofits that help TOMS distribute products to children and people in need
- TOMS volunteers
- Interns (that work in TOMS facilities)
- Campus clubs
- One Day Without Shoes campaign
- World Sight Day

Financials

Revenue Streams
- Product sales, which include shoes, eyewear, coffee, and bags
- TOMS branded products (t-shirts, sweatshirts, caps, and TOMS flags)
- All sales trigger a commensurate gift to people in need.

Cost Structure
- Cost-driven business
- Low fixed/high variable costs
- Major categories of costs: Product manufacturer, distribution of products to people in need, salaries and general administrative

Financing/Funding
- Initial capital infusion of $500,000 from founder Blake Mycoskie
- $625 million purchase of a 50 percent interest by Bain Capital
- Profits from business operations
- TOMS customers/supporters volunteer their time to get products to adults and children in need and to spread the word about TOMS

Operations

Product (or Service) Production
- Products (shoes, eyewear, coffee, and bags) are made by contract manufacturers who are carefully selected and monitored
- Products are shipped directly to retailers or online outlets for sale to their customers (TOMS does not dropship)
- TOMS collaborates with nonprofits to distribute the shoes and eyewear and to provide clean water for those in need

Channels
- Online (TOMS.com, Zappos.com, etc.)
- Retailers (Nordstrom, Whole Foods, etc.)
- Products distributed to children and adults in need via Friends of TOMS, nonprofit partners, and TOMS volunteers

Key Partners
- Friends of TOMS
- Nonprofit partners
- TOMS volunteers
- Top brands, such as Ralph Lauren and Element Skateboard
- Affiliates (via the TOMS affiliate program)

TOMS: Barringer/Ireland Business Model Template

criticism that TOMS has faced is that when it gives a child a pair of shoes, it is a one-time event. The child will eventually grow out of the shoes and be right back to where he or she started. TOMS acknowledged this criticism as a valid point, and has responded by putting a program in place that tracks the children to whom shoes have been provided. It makes sure the children receive additional shoes when needed.

TOMS has a number of key assets. It has a healthy corporate culture, which draws people in. It has an entire apparatus to get people involved in its initiatives, including community groups, students, educators, and others. You can see TOMS' work in this area by accessing the TOMS Community website (www.tomscommunity.com). TOMS also frequently touts the work of its volunteers on its Twitter account, which is available at @TOMS. TOMS supports a network of students at colleges and universities across the United States who have formed TOMS' campus clubs. There are more than 280 such clubs in the United States and a dozen or so in Canada. Students who participate in TOMS' campus clubs participate in TOMS' awareness days, host TOMS-inspired events, spread the word about TOMS on their local campuses, and most importantly volunteer in their local communities.

TOMS also organizes events, which are heartfelt and draw attention to its products and causes. Two popular events are the One Day Without Shoes campaign and the World Sight Day. The One Day Without Shoes campaign was started in 2008 to raise public awareness of the importance of shoes. It asks ordinary people to go one day without shoes, just to see how it feels. The point is to instill in people what a difference a simple pair of shoes can make, particularly for children. The campaign grows every year. You can see highlights of the most recent year's campaign at www.toms.com/one-day-without-shoes. World Sight Day is a day dedicated to raising global awareness about blindness and visual impairment. You can learn more about World Sight Day at www.toms.com/world-sight-day.

Financials

TOMS' revenue comes from product sales. TOMS is a cost-driven business. It contains costs via its partnerships, volunteer network, and by avoiding traditional marketing. TOMS does very little traditional marketing, such as print media, radio, and television. Instead, it relies on word-of-mouth, social media, and prominent placements in retail stores by its retail partners. TOMS does not manufacture its products. Instead, it relies on contract manufacturers and growers (for its coffee) spread throughout the world. TOMS' approach to manufacturing has raised eyebrows because it produces products in China, where labor practices are suspect. TOMS aggressively polices its manufacturers and other suppliers. It maintains strict standards that everyone in its supply chain is obligated to adhere to, particularly when it comes to fairness to workers. TOMS' employees regularly visit its manufacturers to monitor compliance.

TOMS funds its operations from profits. It also benefits from the work of its volunteers.

Operations

To produce its products, TOMS manages a global supply chain. Its shoes are made in low-wage countries such as China, Argentina, and Ethiopia. Its eyewear is made in Italy. Its coffee beans are sourced from growers across the world and are roasted in the United States. Some of its most popular selections come from growers in Rwanda, Malawi, and Guatemala. In regard to distribution, TOMS delivers its products to its retail and online partners, who in turn sell to their customers.

TOMS does not dropship or sell on a consignment basis.

Manufacturing and selling is only the first step in TOMS' overall process. Its philanthropic efforts come next. To distribute its shoes, TOMS partners with nonprofits and NGOs in the countries in which it distributes products. These organizations are called "Giving Partners." The Giving Partners identify the children in need. The process of actually distributing the shoes is referred to as Shoe Drops. Friends of TOMS helps coordinate the Shoe Drops. TOMS' eyewear/restore sight and its coffee/clean water initiatives are executed in a similar manner. TOMS works with Friends of TOMS and local organizations to make the distributions.

In regard to channels, TOMS sells its products through both retail and online outlets. Over 500 retailers around the world now carry TOMS shoes. Its distribution network for eyewear and coffee is growing. A string of TOMS' café-stores are being rolled out. The café-stores sell TOMS coffee in a coffee house setting along with TOMS shoes, eyewear, and other products. As of early 2017, the company had eight stores. TOMS' business model would not be possible without key partners. Its most important partners are Friends of TOMS (its nonprofit subsidiary), the nonprofits and NGOs that distribute its products, and its volunteers. TOMS also has a robust affiliate program.

Criticisms of TOMS

For some, it may be hard to imagine that TOMS has critics, but it does. Its critics point out flaws in TOMS' approach, which some go as far as to say threaten the firm's future.

The criticism focuses on three main issues. First, critics argue that TOMS, along with similar organizations, makes people in poor countries dependent on the goodwill of others rather than creating opportunities for them to take care of themselves. Many social entrepreneurs believe that the best way to create sustainable change in an impoverished country is through education, job creation, and trade, rather than aid, which is what TOMS does. In fact, a mantra among some social entrepreneurs is "trade not aid." Microfinance, which provides loans to people in developing countries to start their own businesses, is based on these principles. The second criticism is that TOMS has manufacturing facilities in China and elsewhere where human rights violations have been documented. The third criticism is that by pouring a large number of free shoes into countries such as Argentina and Ethiopia, TOMS is inadvertently stymieing local entrepreneurship. The idea is that by providing shoes for free, TOMS takes potential business away from local companies, which provide not only shoes but jobs. In response to this criticism, TOMS says that about 40 percent of all shoes given away are made in the countries where they are distributed.

TOMS is aware of these criticisms, and in each case has responded in a proactive manner.

Is TOMS' Business Model Sustainable?

The question is, "Is TOMS' business model sustainable for the future?" The primary threats to its business model stem from the criticisms it receives, its reliance on people continuing to pay a premium for its products, and whether the one-for-one movement will continue to resonate with volunteers and nonprofit partners. Another threat is the nature of the products that TOMS sells. On the one hand, selling a physical product mitigates TOMS' risk because it does not have to rely on donations to fulfill its mission. On the other hand, TOMS has the dual challenge of managing a global supply chain while at the same time leading a worldwide philanthropic effort. The complexity of this challenge will grow as TOMS continues to scale its business. No company has attempted to scale a one-to-one business model to the extent that TOMS is contemplating.

Bain Capital apparently feels TOMS' business model is sustainable. In 2014, the private equity firm bought half of TOMS. Mycoskie owns the other half. At the time, TOMS was reportedly valued at around $625 million.

Patrick McMullan/Getty Images

Stylish TOMS shoe for sale in a store owned by one of TOMS' retail partners.

Discussion Questions

4-38. Given TOMS' mission and the way its business model is constructed, would you characterize TOMS' business model as a standard business model or a disruptive business model? What impact has TOMS' business model had on socially-minded organizations?

4-39. What revenue streams does TOMS have that support how the firm competes? How sustainable are these revenue streams?

4-40. What key assets does TOMS possess and how sustainable are those assets?

4-41. What are the major challenges TOMS faces as the firm continues implementing its business model as a means of reaching its mission? Which of these challenges is the most serious and why?

Sources: TOMS Homepage www.toms.com (accessed February 14, 2017); TOMS, Wikipedia, www.wikipedia.com (accessed February 14, 2017); M. Isaza, M. and L. Italie, "Blake Mycoskie on 10 Years of TOMS," Associated Press, May 6, 2016.

ESSAY QUESTIONS

1. After re-reading You Be the VC 4.2, refer to the Resources part of the Barringer/Ireland Business Model Template. Learn more about Secret Recipe by visiting the firm's website. Using all the information you have gathered about this firm, write a paragraph or two about their core competencies and key assets. Do these resources have the ability to support their desire to grow? Why or why not?

2. As explained in this chapter, selecting an entrepreneurial venture's target market is an important activity to complete successfully. Assume that you have decided to launch a clothing store in the town in which the university or college you are attending is located. What factors would you consider in selecting a target market for your clothing store and what target market would you select for this venture and why? Write a paragraph or two to describe your answer to this question.

APPENDIX 1 Barringer/Ireland Business Model Template

Company Name ______

Core Strategy	
Business Mission	Basis of Differentiation
Target Customer	Product/Market Scope

Resources	
Core Competency	Key Assets

Financials	
Revenue Streams	
Cost Structure	Financing/Funding

Operations	
Product (or Service) Production	Channels
	Key Partners

Barringer/Ireland Business Model Template

Key

Business Mission	A business' mission or mission statement describes why it exists and what its business model is supposed to accomplish.
Basis of Differentiation	A company's basis of differentiation is what separates it from its competitors. It is what causes consumers to pick one company's products or services over another's.
Target Market	A target market is a place within a larger market segment that represents a narrower group of customers with similar interests. This is the market in which the firm will compete.
Product/Market Scope	A company's product/market scope defines the products and markets on which it will concentrate.
Core Competencies	A core competency is a specific factor or capability that supports a firm's business model and sets it apart from its rivals.
Key Assets	Key assets are assets that a firm owns that enable its business model to work. The assets can be physical, financial, intellectual, or human.
Revenue Streams	A firm's revenue streams describe the ways in which it makes money. Some businesses have a single revenue stream, while others have several.
Cost Structure	A business' cost structure describes the most important costs incurred to support its business model.
Financing or Funding	This box describes how a business will finance its business model.
Product (or Service) Production	This section focuses on how a firm's product and/or service are produced.
Channels	A company's channels describe how it delivers its product or service to its customers.
Key Partners	This box describes the key partnerships that a firm's business model relies on.

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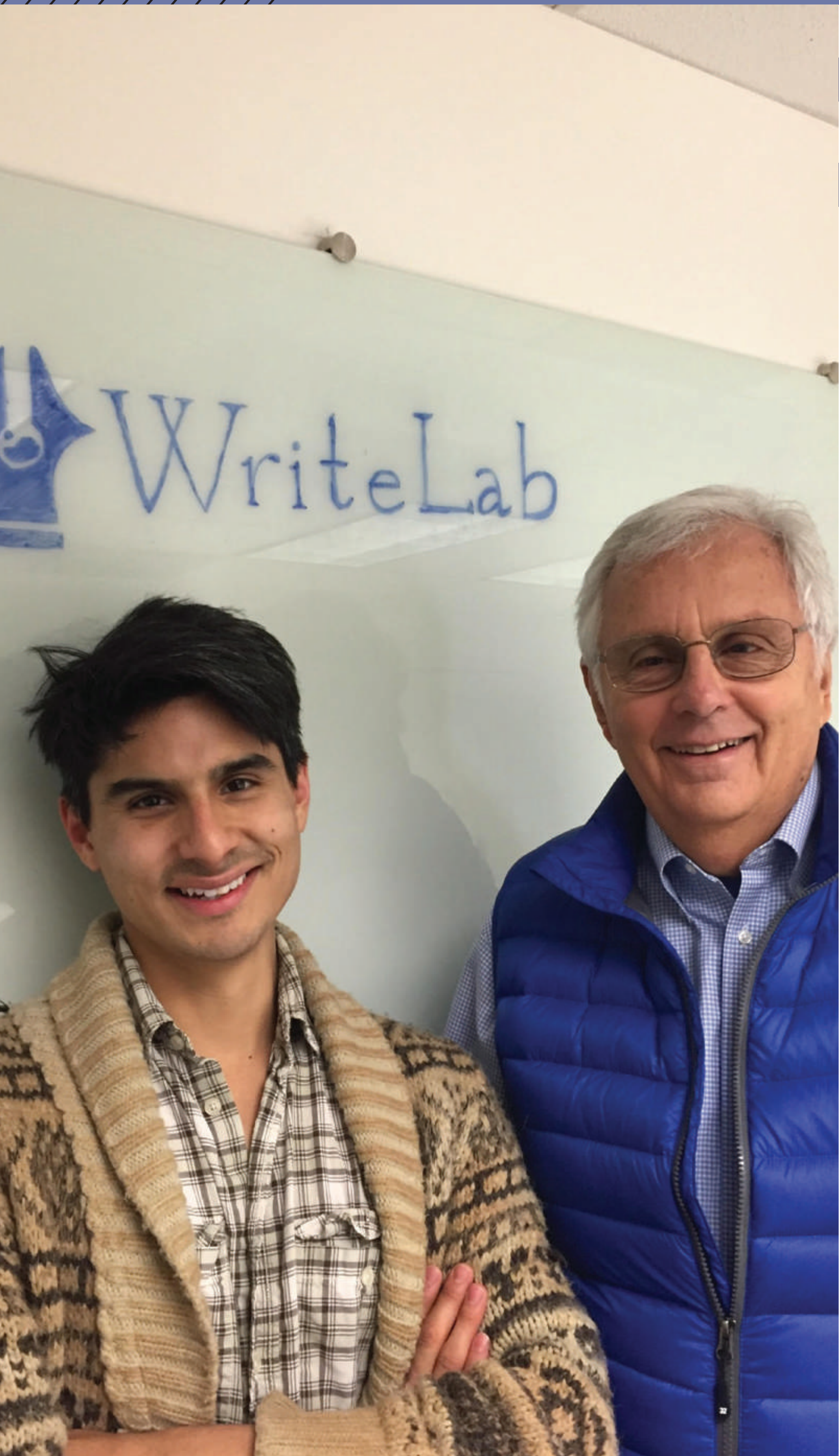
Getting Personal with Writelab



WriteLab/Photo Credit: Matthew Ramirez

Cofounders

MATTHEW RAMIREZ

PhD, University of California, Berkeley, undecided

DONALD MCQUADE

Professor, English, University of California, Berkeley

Dialogue *with* Matthew Ramirez

FAVORITE PERSON I FOLLOW ON INSTRAGRAM
gatesfoundation

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
That virality is something you can carefully engineer

BEST PART OF BEING A STUDENT
That you can spend time learning diverse subjects and fuse them together in projects

MY BIGGEST WORRY AS AN ENTREPRENEUR
That we won't be able to innovate as quickly as the world needs solutions

FIRST ENTREPRENEURIAL EXPERIENCE
Taking food from my fridge as a toddler and reselling it to my parents

MY FAVORITE SMARTPHONE APP
Google Analytics

CHAPTER 5

Industry and Competitor *Analysis*

MyLab Entrepreneurship

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OPENING PROFILE

WRITELAB

Occupying a Unique Position in a Challenging Industry—and Thriving

• *Web: https://home.writelab.com* • *Facebook: WriteLab* • *Twitter: @WriteLab*

It was one of those moments in time when a business idea begins to take shape. Matthew Ramirez, a PhD student in English at the University of California, Berkeley, was grading a stack of papers. As part of his PhD program, he taught undergraduate English classes. He noticed that he was giving the same feedback to his students again and again. Grading papers frustrated Ramirez. It took time to work through a stack of papers, and he knew that by the time he returned papers to his students, they would have moved on to other projects. What they needed was to receive their graded papers back more quickly, so they could learn from the feedback.

This conundrum got Ramirez thinking. At the time, he was also doing work in the School of Information at Berkeley. What if he could write computer algorithms that would automatically generate the routine feedback he was giving his students? That would free his time to provide feedback in more substantive areas, and it would speed up the entire process. Ramirez took his idea to Donald McQuade, one of his English professors. McQuade is the author of several books on writing composition and is very active in the writing community. McQuade agreed to work with Ramirez on the project, and WriteLab was born.

WriteLab, which began in late 2013, went through several iterations before settling on the format it features today. It rolled out in 2015. On the backend, WriteLab uses probability and statistics to identify patterns and choices in language. On the front end, this is how it works. A student accesses WriteLab, which is either provided by their school or purchased on their own. The student loads his or her paper into WriteLab, and WriteLab returns it immediately with feedback. The feedback focuses on four areas that are important for good quality writing—clarity, concision (the quality or state of being concise), grammar, and logic. The feedback is not framed in a negative manner—it never tells a student a sentence or thought is wrong. The reason for this is that negative feedback causes students to become defensive. Instead, the color-coded feedback is in the form of suggestions, comments, and questions. A student can respond to an individual piece of feedback or mark it "not helpful" and move on. The feedback is designed to be "actionable"—in other words, a student can use it to strengthen a sentence or thought. If a student doesn't understand a comment or suggestion, the student can click the "?" icon in the corner of the comment bar and

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain the purpose of an industry analysis.
2. Identify and discuss the five competitive forces that determine industry profitability.
3. Explain the value that entrepreneurial firms create by successfully using the five forces model.
4. Identify the five primary industry types and the opportunities they offer.
5. Explain the purpose of a competitor analysis and a competitive analysis grid.

be taken to the corresponding section of the user guide. An individual paper can be submitted multiple times. WriteLab uses machine learning to remember how a specific student writes. Over time, WriteLab adapts to a particular student's writing preferences and adjusts its comments and suggestions accordingly. For the instructor, WriteLab's analytics provide comprehensive information about the progress each student is making. Grading goes faster for instructors who utilize WriteLab in their classrooms. Consistent with Ramirez's original vision, WriteLab has already taken care of routine feedback, which is normally addressed by the student. Teachers who use WriteLab also see their students engage in writing on a deeper level. Good quality feedback tends to make a student feel more valued as a writer.

WriteLab participates in the EdTech, or educational technology, industry. This is a challenging industry for several reasons including the fact that K–12 schools and colleges and universities operate within constrained budgets and long buying cycles. For many schools, the decision to adopt a product such as WriteLab must go through multiple levels of analysis before it happens. Many teachers are also resistant to change. There is a lot of inertia in education with traditional methods of instruction. WriteLab has fought through these challenges and is now being used by more than 30,000 students at 500 schools. Its primary users are high school AP English students and college freshmen and sophomore composition students. An advantage WriteLab has, which is a barrier to entry for potential competitors, is that Donald McQuade, one of its cofounders, is well established in the writing community. He is the past chairman of the National Writing Project, a network that supports writing teachers with research and professional development. This factor has opened doors for WriteLab that might not have opened otherwise and that may be closed to potential competitors.

In terms of competitors, no one has a product quite like WriteLab, but other players in WriteLab's space include Microsoft Word's grammar checker and Grammarly, which is an online proofreading tool that checks for grammar, punctuation, and style. It also checks for plagiarism. Additionally, there is an entire generation of "robo-readers," which are software platforms that scan student essays and assign a grade. These programs provide coarse-grained assessments based on proxies like word count, the number of complex sentences, and the frequency of esoteric vocabulary. WriteLab does not assign a grade—it leaves that to the teacher. Instead, it provides feedback to spur review and revision. WriteLab is careful to say that its goal is not to replace the teacher. Its goal is to be a tool that can help teachers save time and give more meaningful feedback to students.

WriteLab has raised over $2.1 million in funding. The firm plans to increase its penetration in U.S. markets and is working to make its platform available in multiple languages. It also has several partnerships in the education space and is working with a Japanese company that provides Test of English as a Foreign Language (TOEFL) services. WriteLab also sees a future beyond writing. Its founders are interested in how their technology can help people improve speaking. If WriteLab moves in that direction, it will enter an adjacent industry with new opportunities and challenges.

WriteLab is a success in part because of Matthew Ramirez's ability to analyze the educational technology (EdTech) industry and precisely position WriteLab within it. In this chapter, we'll look at industry analysis and competitor analysis. The first section considers **industry analysis**, which is business research that focuses on the potential of an industry. An **industry** is a group of firms producing a similar product or service, such as music, Pilates and Yoga studios, and solar panels. Once it is determined that a new venture is feasible in regard to the industry and the target market in which it intends to compete, a more in-depth analysis is needed to learn the operational realities associated with the chosen industry. The in-depth analysis helps a firm determine if the niche or target markets it identified during its feasibility analysis are accessible and the ones that represent the best point of entry for the new firm.

We focus on competitor analysis in the second section. A **competitor analysis** is a detailed evaluation of a firm's competitors. Once a firm decides to enter an industry and chooses a market in which to compete, it must gain an understanding of its competitive environment. We will look at how a firm identifies its competition and the importance of completing a competitive analysis grid.

Industry Analysis

LEARNING OBJECTIVE

1. Explain the purpose of an industry analysis.

When studying an industry, an entrepreneur must answer three questions before pursuing the idea of starting a firm. First, is the industry accessible—in other words, is it a realistic place for a new venture to enter? Second, does the industry contain markets that are ripe for innovation or are underserved? Third, are there positions in the industry that will avoid some of the negative attributes of the industry as a whole? It is useful for a new venture to think about its **position** at both the company level and the product or service level. At the company level, a firm's position determines how the company is situated relative to its competitors, as discussed in Chapter 4. For example, Fresh Healthy Vending has positioned itself as a vending machine provider that specializes in healthy alternatives to traditional vending machine snack foods and beverages. The company's climate-controlled machines offer carrots, yogurt, smoothies, granola bars, and beverages such as milk, juice, and teas. This is a much different position than the vending machine providers that offer the standard fare such as chips, pretzels, salted peanuts, candy bars, sports drinks, and sodas.[1]

The importance of knowing the competitive landscape, which is what an industry is, may have been first recognized in the fourth century BC by Sun Tzu, a Chinese philosopher. Reputedly he wrote *The Art of War* to help generals prepare for battle. However, the ideas in the book are still used today to help managers prepare their firms for the competitive wars of the marketplace. The following quote from Sun Tzu's work points out the importance of industry analysis:

> We are not fit to lead an army on the march unless we are familiar with the face of the country—its pitfalls and precipices, its marshes and swamps.[2]

These words serve as a reminder to entrepreneurs that regardless of how eager they are to start a business, they are not adequately prepared until they are "familiar with the face of the country"—that is, until they understand the industry or industries they plan to enter and in which they intend to compete.

It is also important to know that some industries are simply more attractive than others in terms of their annual growth rate and other factors. For example, according to IBISWorld the industry for e-book publishing is expected to grow at an annual rate of 3.7 percent over the next five years.[3] For the same period, the industry for traditional book publishing is expected to decline at an annual rate of −0.8 percent per year.[4] What this means is that the conditions for growing a company are significantly more favorable in the e-book industry than in the traditional book publishing industry.[5] These types of differences exist for comparisons across other types of industries. The differences can be mitigated some by firm-level factors, including a company's products, culture, reputation, and other resources.[6] Still, in various studies researchers have found that from 8 to 30 percent of the variation in firm profitability is directly attributable to the industry in which a firm competes.[7] As a result, the overall attractiveness of an industry should be part of the equation when an entrepreneur decides whether to pursue a particular opportunity.

Studying industry trends and using the five forces model are two techniques entrepreneurs have available for assessing industry attractiveness.

Studying Industry Trends

The first technique an entrepreneur has available to discern the attractiveness of an industry is to study industry trends. Environmental and business trends are the two most important trends for entrepreneurs to evaluate.

Environmental Trends As discussed in Chapter 2, environmental forces or trends are very important. The strength of an industry often surges or wanes not so much because of the management skills of those leading firms in a particular industry, but because environmental trends shift in favor or against the products or services sold by firms in the industry.

Economic trends, social trends, technological advances, and political and regulatory changes are the most important environmental trends for entrepreneurs to study. For example, companies in industries selling products to seniors, such as the eyeglasses industry and the hearing aid industry, benefit from the social trend of the aging of the population. In contrast, industries selling food products that are high in sugar, such as the candy industry and the sugared soft-drink industry, suffer as the result of a renewed emphasis on health and fitness. Sometimes there are multiple environmental changes at work that set the stage for an industry's future. This point is illustrated in the following statement from IBISWorld's assessment of the future of the gym, health, and fitness clubs industry in the United States. After first reporting that gym, health, and fitness club sales are anticipated to increase at an annualized rate of 2.6 percent between 2016 and 2021 to reach a sales volume of $34.4 billion, the report goes on to say that:

> The Gym, Health and Fitness Clubs industry has benefited from recent marketing campaigns aimed at fighting obesity, as well as consumer trends towards improved health. Further driving demand for industry services, many health-conscious individuals have incorporated fitness into their daily regimen. Additionally, the number of people aged 20 to 64, the largest gym-going demographic, has grown, spurring demand for gym memberships over the period.[8]

This short assessment about sales in the gym, health, and fitness clubs industry illustrates the degree to which environmental trends affect an industry's prospects. In other parts of the report, the industry is credited with offering its members more targeted experiences (like yoga and Pilates), lower-cost memberships, and more convenient operating hours. Still, the somewhat positive assessment of the gym, health, and fitness clubs industry's future is largely tied to environmental trends—an increased emphasis on health and fitness and the growth in the demographic group of people who are the biggest gym-goers. Similar environmental forces are at work in all industries.

Business Trends Other trends affect industries that aren't environmental trends per se but are important to mention. For example, the firms in some industries benefit from an increasing ability to outsource manufacturing or service functions to lower-cost foreign labor markets, while firms in other industries don't share this advantage. In a similar fashion, the firms in some industries are able to move customer procurement and service functions online, at considerable cost savings, while the firms in other industries aren't able to capture this advantage. Trends such as these favor some industries over others.

It's important that start-ups stay on top of both environmental and business trends in their industries. One way to do this is via participation in industry trade associations, trade shows, and trade journals, as illustrated in the nearby "Partnering for Success" feature.

PARTNERING FOR SUCCESS

Three Ts That Are Important for Becoming Active in an Industry: Trade Associations, Trade Shows, and Trade Journals

One thing that's important for a start-up is to become active in the industry it has chosen to enter. Activity leads to learning about and understanding the industry, finding business partners, and becoming recognized as an industry leader. Three important Ts that lead to industry activity are trade associations, trade shows, and trade journals. Start-ups should consider utilizing these Ts as a part of their early and ongoing activities:

Trade Associations

A trade association (or trade group) is an organization that firms in the same industry form for the purpose of collecting and disseminating trade information, offering legal and technical advice, furnishing industry-related training, and providing a platform for collective lobbying. In addition to promoting industry-related issues, trade associations typically provide a variety of other services to their members. For example, the American Watchmakers-Clockmakers Institute provides its members education and certifications, an online store, a career center (with a job board), an online directory of members, and other industry specific professional and business services.[9]

Trade associations are typically governed by a paid staff and a volunteer board. Busy CEOs and entrepreneurs are motivated to serve on trade association boards, not only to influence the direction of the associations but because their service provides them visibility and a platform to network closely with other members of the association. These types of interactions can lead to businesses forming partnerships and working together in other ways.

There are 7,600 national trade associations in the United States. The vast majority have websites that list their activities and their members.

Trade Shows

A trade show (or a trade fair) is an exhibition organized to create opportunities for companies in an industry to showcase and demonstrate their products and services. Some trade shows are open to the public, while others can only be attended by company representatives and members of the press. Over 10,000 trade shows are held annually in the United States. There are several online directories, such as the Trade Show News Network (www.tsnn.com), which help organizers, attendees, and marketers identify the most appropriate trade shows to attend. The largest trade show in the United States is the Consumer Electronics Trade Show, which is held every January in Las Vegas, and is not open to the public. In 2016, it had 104,753 attendees, 65,095 exhibitor personnel, 7,545 members of the media, and 2.47 million square feet of exhibit space.

Along with displaying their products and services, businesses attend trade shows to study their rivals, meet members of the press, and network with industry participants. Companies must rent exhibit space at trade shows. Some of the high-quality shows, which usually last just under a week, cost upward of $20,000 to attend. Small companies are often able to share exhibit space and split the cost. Trade shows offer prime opportunities for networking in order to generate business and to establish new relationships and nurture existing ones. In fact, there are many articles and "how-to" guides published in periodicals and posted on websites that teach businesses how to maximize their time at trade shows and establish business relationships.

Trade Journals

Trade journals or magazines are usually published by trade associations and contain articles and advertising focused on a specific industry. Very little general-audience advertising appears in trade journals. They may also include industry-specific job notices and classified advertising.

Some trade journals are available to the general public, while others are very specifically controlled—meaning that you must be an industry participant to receive the journal. This practice ensures advertisers that their ads will be viewed by their target audience. Many of the articles in trade journals are written about companies in the industry. It enhances the stature and visibility of a company to have a favorable article written about it in a premier industry trade journal.

Along with trade journals, some industries have peer-reviewed journals that contain both technical articles and heavy advertising content. The articles are often coauthored by people who work for vendors that advertise in the journal. *BioTechniques: International Journal of Life Sciences Method* is an example of an industry-specific, peer-reviewed journal that follows this format. These journals blur the distinction somewhat between trade journals and peer-reviewed journals.

Although trade journals do not provide the direct networking opportunities that trade associations and trade shows do, the visibility a company can obtain by being featured in an article or by running ads can result in multiple positive outcomes.

Questions for Critical Thinking

1. Pick an industry in which you have an interest. Make a list of the premier trade associations, trade shows, and trade journals associated with that industry.
2. How can an entrepreneur assess whether offering to serve in a leadership capacity in a trade association, on a voluntary basis, will be worth the time and effort? Establish a set of criteria that you would follow if making this type of decision.
3. Spend some time looking at the Organic Trade Association. Make a list of networking opportunities available via membership in this organization.

4. What are the risks involved with networking? For example, are there risks involved with sharing information with industry participants about how your firm competes? How can a company strike the right balance between giving out enough information about itself to attract the attention of potential partners without divulging too much proprietary information?

Sources: American Watchmakers-Clockmakers Institute Homepage, www.awci.com (accessed February 17, 2017); B. Barringer and J. Harrison, "Walking a Tightrope: Creating Value Through Interorganizational Relationships," *Journal of Management* 26, no. 3, 1999: 367–403; Organic Trade Association Homepage, www.craftandhobby.org (accessed February 17, 2017).

The Five Forces Model

LEARNING OBJECTIVE

2. Identify and discuss the five competitive forces that determine industry profitability.

The five forces model is a framework entrepreneurs use to understand an industry's structure. Professor Michael Porter developed this important tool. Shown in Figure 5.1, the framework is comprised of the forces that determine industry profitability.[10] These forces—the threat of substitutes, the threat of new entrants (that is, new competitors), rivalry among existing firms, the bargaining power of suppliers, and the bargaining power of buyers—determine the average rate of return for the firms competing in a particular industry (e.g., the restaurant industry) or a particular segment of an industry (e.g., the fast-casual segment of the restaurant industry).

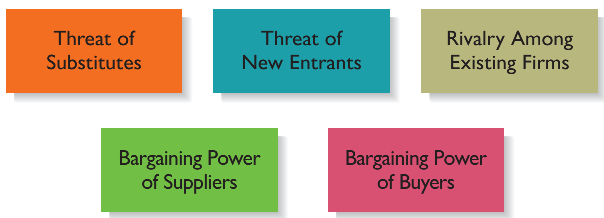
Each of Porter's five forces affects the average rate of return for the firms in an industry by applying pressure on industry profitability. Well-managed companies try to position their firms in a way that avoids or diminishes these forces—in an attempt to beat the average rate of return for the industry. Casper Mattresses for example, will continuously try to find ways to differentiate itself from new competitors such as Yogabed, Tuft & Needle, Leesa, and Saatva in order to reduce the potentially negative effect on its profitability that results from intense competition among these firms.

In his book *Competitive Advantage*, Porter points out that industry profitability is not a function of *only* a product's features. Although the book was published in 1980 and the dynamics of the industries mentioned have changed, Porter's essential points still offer important insights for entrepreneurs, such as the insight suggested by the following quote:

> Industry profitability is not a function of what the product looks like or whether it embodies high or low technology but of industry structure. Some very mundane industries such as postage meters and grain trading are extremely profitable, while some more glamorous, high-technology industries such as personal computers and cable television are not profitable for many participants.[11]

The five competitive forces that determine industry profitability are described next. As mentioned in previous chapters, industry reports, produced by companies such as IBISWorld and Mintel, provide substantive information for analyzing

FIGURE 5.1
Forces That Determine Industry Profitability



the impact of the five forces on specific industries. These two resources are available free through many university library websites and are highlighted in the Internet Resources Table in Appendix 3.3.

Threat of Substitutes

In general, industries are more attractive when the threat of substitutes is low. This means that products or services from other industries can't easily serve as substitutes for the products or services being made and sold in the focal firm's industry. For example, there are few if any substitutes for prescription medicines, which is one of the reasons the pharmaceutical industry has historically been so profitable. In contrast, in industries where close substitutes for a product do exist, industry profitability is suppressed because consumers will opt not to buy when the price is too high. Consider the price of airplane tickets. If the price gets too high, businesspeople will increasingly switch to videoconferencing services such as Skype or Google Hangouts as a substitute for travel. This problem is particularly acute if the substitutes are free or nearly free. For example, if the price of express mail gets too high, people will increasingly attach documents to e-mail messages rather than sending them via UPS or FedEx.

The extent to which substitutes suppress the profitability of an industry depends on the propensity of buyers to substitute alternatives. This is why the firms in an industry often offer their customers amenities to reduce the likelihood they'll switch to a substitute product, even in light of a price increase. Let's look at the coffee restaurant industry as an example of this. The coffee sold at Starbucks is relatively expensive. A consumer could easily find a less expensive cup of coffee at a convenience store or brew coffee at home rather than pay more at Starbucks. To decrease the likelihood that customers will choose either of these alternatives, Starbucks offers high-quality fresh coffee, a pleasant atmosphere (often thought of as part of the "Starbucks experience"), and good service. Starbucks doesn't do this just so its customers don't go to a different coffee restaurant. It offers the service so its customers won't switch to substitute products as well. Although this strategy is still working for

Kzenon/Shutterstock

This independently owned coffee shop doesn't just sell coffee. It also offers its patrons a convenient and pleasant place to meet, socialize, and study. The shop offers these amenities in part to decrease the likelihood that its customers will "substitute" coffee at this shop for a less expensive alternative.

Starbucks, there have been times when the firm has been less effective than it wants to be the case. Because of this, Starbucks is now experimenting with offering less expensive coffees while maintaining its commitment to quality and providing customers with what the firm believes is the unique Starbucks experience.

Threat of New Entrants

In general, industries are more attractive when the threat of entry is low. This means that competitors cannot easily enter the industry and successfully copy what the industry incumbents are doing to earn profits. There are a number of ways that firms in an industry can keep the number of new entrants low. These techniques are referred to as barriers to entry. A **barrier to entry** is a condition that creates a disincentive for a new firm to enter an industry.[12] Let's look at the six major sources of barriers to entry:

- **Economies of scale** Industries that are characterized by large economies of scale are difficult for new firms to enter, unless they are willing to accept a cost disadvantage. **Economies of scale** occur when mass-producing a product results in lower average costs. For example, Intel has huge microprocessor factories that produce vast quantities of computer chips, thereby reducing the average cost of each chip produced. It would be difficult for a new entrant to match Intel's advantage in this area. There are instances in which the competitive advantage generated by economies of scale can be overcome. For example, many microbreweries have successfully entered the beer industry by brewing their beer locally and relying on a local niche market clientele. By offering locally brewed, high-quality products, successful microbreweries counter the enormous economies of scale (and the lower price to consumers they permit) of major and often global brewers, such as Anheuser-Busch, which manages a portfolio of over 100 beer brands.[13]
- **Product differentiation** Industries such as the soft-drink industry that are characterized by firms with strong brands are difficult to break into without spending heavily on advertising. For example, imagine how costly it would be to compete head-to-head against PepsiCo (owner of the Pepsi brands) or the Coca-Cola company. Product innovation is another way a firm can differentiate its good or service from competitors' offerings. Apple is an example of a company that has differentiated itself in laptop computers by regularly improving the features on its line of MacBooks, such as the MacBook Pro, as well as the unqiuness of the accessories customers can buy to enhance their experience as users. It does this to not only keep existing customers and win new ones, but also to deter competitors from making a big push to try to win market share from Apple in the laptop computer industry.
- **Capital requirements** The need to invest large amounts of money to gain entrance to an industry is another barrier to entry. The automobile industry is characterized by large capital requirements, although Tesla, which launched in 2003, was able to overcome this barrier and raise substantial funds by winning the confidence of investors through its expertise and innovations in electric car technology. Current evidence suggests that this firm may have potential to achieve long-term success. In early 2017, for example, Tesla CEO Elon Musk predicted the company will produce 500,000 cars in 2017 and one million vehicles per year by 2020.[14] Building still further investor confidence and by using its available capital, Tesla started selling cars in the United Arab Emirates in spring, 2017. Overall, the firm seeks to sell a large number of its luxury cars in the Middle East in the coming years.[15]

- **Cost advantages independent of size** Entrenched competitors may have cost advantages not related to size that are not available to new entrants. Commonly, these advantages are grounded in the firm's history. For example, the existing competitors in an industry may have purchased land and equipment in the past when the cost was far less than new entrants would have to pay for the same assets at the time of their entry.
- **Access to distribution channels** Distribution channels are often hard to crack. This is particularly true in crowded markets, such as the convenience store market. For a new sports drink to be placed on a convenience store shelf, it typically has to displace a product that is already there. If WriteLab decided to start producing guides for better writing, it would find it difficult to gain shelf space in bookstores where books focused on improving one's writing are already available.
- **Government and legal barriers** In knowledge-intensive industries, such as biotechnology and software, patents, trademarks, and copyrights form major barriers to entry. Other industries, such as banking and broadcasting, require the granting of a license by a public authority.

When start-ups create their own industries or create new niche markets within existing industries, they must create barriers to entry of their own to reduce the threat of new entrants. It is difficult for start-ups to create barriers to entry that are expensive, such as economies of scale, because money is usually tight. The biggest threat to a new firm's viability, particularly if it is creating a new market, is that larger, better-funded firms will step in and copy what it is doing. The ideal barrier to entry is a patent, trademark, or copyright, which prevents another firm from duplicating what the start-up is doing. But in many instances patents do not apply. There is a category of barriers to entry called nontraditional barriers to entry, which are barriers particularly suited to start-up firms. These barriers include factors such as the strength of a company's management team, a first-mover advantage, a unique business model, or inventing a new approach to an industry. The business model being rolled out by Natalie Edell and IndieU, for example, or the unique approach to the mattress industry being pursued by Casper, the subject of Case 5.2, fit into this category. In Table 5.1, we provide a list of nontraditional barriers to entry that start-ups often employ.

Rivalry among Existing Firms

In most industries, the major determinant of industry profitability is the level of competition among the firms already competing in the industry. Some industries are fiercely competitive to the point where prices are pushed below the level of costs. When this happens, industry-wide losses occur. In other industries, competition is much less intense and price competition is subdued. For example, the airline industry is fiercly competitive and profit margins hinge largely on fuel prices and consumer demand. In contrast, the market for specialized medical equipment is less competitive, and profit margins are higher.

There are four primary factors that determine the nature and intensity of the rivalry among existing firms in an industry.

- **Number and balance of competitors** With a larger number of competitors, it is more likely that one or more will try to gain customers by cutting prices. Price-cutting causes problems throughout the industry and occurs more often when all the competitors in an industry are about the same size and when there is no clear market leader.
- **Degree of difference between products** The degree to which products differ from one producer to another affects industry rivalry. For example, commodity industries such as paper product producers tend to compete

TABLE 5.1 Nontraditional Barriers to Entry

Barrier to Entry	Explanation	Example
Strength of management team	If a start-up puts together a world-class management team, it may give potential rivals pause in taking on the start-up in its chosen industry.	Square
First-mover advantage	If a start-up pioneers an industry or a new concept within an existing industry, the name recognition the start-up establishes may create a formidable barrier to entry.	Facebook
Passion of management team and employees	If the key employees of a start-up are highly motivated by its unique culture, are willing to work long hours because of their belief in what they are doing, and anticipate large financial gains through stock options, this is a combination that is very difficult for larger firms to learn how to replicate. Think of the employees of a biotech firm trying to find a cure for a disease.	Amgen
Unique business model	If a start-up is able to construct a unique business model and establish a network of relationships that make the business model work, this set of advantages creates a barrier to entry.	IndieU
Internet domain name	Some Internet domain names are so "spot-on" in regard to a specific product or service that they give a start-up a meaningful leg up in terms of e-commerce opportunities. Think of www.1800flowers.com, www.1800gotjunk.com, and www.bodybuilding.com.	www.1800contacts.com
Inventing a new approach to an industry and executing the idea in an exemplary fashion	If a start-up invents a new approach to an industry and executes it in an exemplary fashion, these factors create a barrier to entry for potential imitators.	Casper

on price because there is no meaningful difference between one manufacturer's products and another's.

- **Growth rate of an industry** The competition among firms in a slow-growth industry is stronger than among those in fast-growth industries. Slow-growth industry firms, such as insurance, must fight for market share, which may tempt them to lower prices or increase quality to obtain customers. In fast-growth industries, such as e-book publishing, there are enough customers to satisfy most firms' production capacity, making price-cutting less likely.
- **Level of fixed costs** Firms that have high fixed costs must sell a higher volume of their product to reach the break-even point than firms with low fixed costs. Once the break-even point is met, each additional unit sold contributes directly to a firm's bottom line. Firms with high fixed costs are anxious to fill their capacity, and this anxiety may lead to price-cutting.

Bargaining Power of Suppliers

In general, industries are more attractive when the bargaining power of suppliers is low. In some cases, suppliers can suppress the profitability of the industries to which they sell by raising prices or reducing the quality of the components they provide. If a supplier reduces the quality of the components it supplies, the quality of the finished product will suffer, and the manufacturer will eventually have to lower its price. If the suppliers are powerful relative to the firms in the industry to which they sell, industry profitability can suffer.[16] For example, Intel, with its Pentium chip, is a powerful supplier to the PC industry. Because most PCs feature Pentium chips, Intel can command a premium price from PC manufacturers, thus directly affecting the overall profitability of the PC industry. Several factors have an impact on the ability of suppliers to exert pressure on buyers and suppress the profitability of the industries they serve. These include the following:

- **Supplier concentration** When there are only a few suppliers to provide a critical product to a large number of buyers, the supplier has an advantage. This is the case in the pharmaceutical industry, where relatively few drug manufacturers are selling to thousands of doctors and their patients.
- **Switching costs** Switching costs are the fixed costs that buyers encounter when switching or changing from one supplier to another. If switching costs are high, a buyer will be less likely to switch suppliers. For example, suppliers often provide their largest buyers with specialized software that makes it easy to buy their products. After the buyer spends time and effort learning the supplier's ordering and inventory management systems, it will be less likely to want to spend time and effort learning another supplier's system.
- **Attractiveness of substitutes** Supplier power is enhanced if there are no attractive substitutes for the products or services the supplier offers. For example, there is little the computer industry can do when Microsoft and Intel raise their prices, as there are relatively few substitutes for these firms' products (although this is less true today than has been the case historically).
- **Threat of forward integration** The power of a supplier is enhanced if there is a credible possibility that the supplier might enter the buyer's industry. For example, Microsoft's power as a supplier of computer operating systems is enhanced by the threat that it might enter the PC industry if PC makers balk too much at the cost of its software or threaten to use an operating system from a different software provider.

Bargaining Power of Buyers

In general, industries are more attractive when the bargaining power of buyers (a start-up's customers) is low. Buyers can suppress the profitability of the industries from which they purchase by demanding price concessions or increases in quality. For example, the automobile industry is dominated by a handful of large automakers that buy products from thousands of suppliers in different industries. This enables the automakers to suppress the profitability of the industries from which they buy by demanding price reductions. Similarly, if the automakers insisted that their suppliers provide better-quality parts for the same price, the profitability of the suppliers would suffer. Several factors affect buyers' ability to exert pressure on suppliers and suppress the profitability of the industries from which they buy. These include the following:

- **Buyer group concentration** If the buyers are concentrated, meaning that there are only a few large buyers, and they buy from a large number of suppliers, they can pressure the suppliers to lower costs and thus affect the profitability of the industries from which they buy.
- **Buyer's costs** The greater the importance of an item is to a buyer, the more sensitive the buyer will be to the price it pays. For example, if the component sold by the supplier represents 50 percent of the cost of the buyer's product, the buyer will bargain hard to get the best price for that component.

- **Degree of standardization of a supplier's products** The degree to which a supplier's product differs from its competitors' offering affects the buyer's bargaining power. For example, a buyer who is purchasing a standard or undifferentiated product from a supplier, such as the corn syrup that goes into a soft drink, can play one supplier against another until it gets the best combination of features such as price and service.
- **Threat of backward integration** The power of a buyer is enhanced if there is a credible threat that the buyer might enter the supplier's industry. For example, the PC industry can keep the price of computer monitors down by threatening to make its own monitors if the price gets too high.

In summary, the five competitive forces help the founder or founders of a new venture understand the structure of the industry they are about to enter. There are additional benefits of the five forces model. When a firm doesn't understand the structure and dynamics of the industry it is about to enter, its task is twice as hard. In fact, it might even lead to failure. Regrettably, this was the case with SharpScholar, a firm that entered the educational technology industry. SharpScholar's story is provided in the nearby "What Went Wrong?" feature. The story is a compelling reminder of the importance of thoroughly understanding the industry in which your firm has chosen to compete.

The Value of the Five Forces Model

LEARNING OBJECTIVE

3. Explain the value that entrepreneurial firms create by successfully using the five forces model.

Along with helping a firm understand the dynamics of the industry it plans to enter, the five forces model can be used in two ways—to help a firm determine (1) whether it should enter a particular industry and (2) whether it can carve out an attractive position in that industry. Let's examine these two positive outcomes.

First, the five forces model can be used to assess the attractiveness of an industry or a specific position within an industry by determining the level of threat to industry profitability for each of the forces, as shown in Table 5.2. This analysis of industry attractiveness should be more in-depth than the less rigorous analysis conducted during feasibility analysis. For example, if a firm filled out the form shown in Table 5.2 and several of the threats to industry profitability were high,

TABLE 5.2 Determining the Attractiveness of an Industry Using the Five Forces Model

	Threat to Industry Profitability		
Competitive Force	**Low**	**Medium**	**High**
Threat of substitutes			
Threat of new entrants			
Rivalry among existing firms			
Bargaining power of suppliers			
Bargaining power of buyers			

Instructions:

Step 1 Select an industry.
Step 2 Determine the level of threat to industry profitability for each of the forces (low, medium, or high).
Step 3 Use the table to develop an overall feel for the attractiveness of the industry.
Step 4 Use the table to identify the threats that are most often relevant to industry profitability.

WHAT WENT WRONG?

SharpScholar: Lessons Learned from a Failed EdTech Start-up

SharpScholar was started by Jawwad Siddiqui and some friends. Siddiqui was a junior at his university and was dissatisfied with the varying quality of instruction in his classes. SharpScholar was a software platform designed to better connect students and teachers. For teachers, it allowed them to upload content, add interaction, engage students, collect analytics on what was being learned and what was being missed, and improve their teaching. For the student, the platform acted as a coach so they could learn the material and come to class prepared.

At its peak, SharpScholar had 5,000 students, five top universities in Canada, and 12 professors signed on. The service received plenty of attention. The founders appeared on Dragons' Den, Canada's equivalent of Shark Tank. They were offered a $100,000 investment for a 15 percent stake in the company, but turned it down. They won awards, got accepted into a prestigious incubator, and interacted with people at the Khan Academy, GoogleX, and other high-profile organizations. Yet, after only two years in business, SharpScholar shut down. What went wrong?

In a thoughtful blog post titled "We Shut Down Our Edtech Startup. Here's What We Learned," Siddiqui offered four pieces of advice for entrepreneurs based on SharpScholar's failure:

Have a Direct Relationship with Your "Customer"

SharpScholar struggled to identify its customer. Was it the student, the teacher, the school administration, the government? They were all intertwined. This meant if a teacher liked the product he or she would have to keep in mind the student, the budget, the school policy, and even get approval from administration. This factor complicated SharpScholar's relationship with the teacher. It also resulted in a lack of focus with respect to for whom the firm was tailoring its product.

Lesson Learned: Teachers (and others) don't like to use tools that require different layers of approval from others. Make products that do not require multiple layers of approval to be purchased.

Don't Confuse Your Customers, Consumers, and Capacity to Pay

In most industries, the person who pays for a product is the one who uses it. This is often not true in education. The person who uses the product (teacher and/or student) is often not the one who pays for it. Teachers sometimes have budgets—but not always. Parent groups and nonprofit organizations sometimes help—but that is hit and miss. Funding from school districts for technology products varies dramatically from district to district.

Lesson Learned: A business model that relies on a different person or entity to pay for a product than the one who uses it is a challenging model.

Beware the Priority Gap between You and Your Customer

Teachers and entrepreneurs have priorities that don't always align. An entrepreneur that has a technology product to sell wants to close the sale and get the product in the classroom. Teachers think about setup time, how much effort it will take to learn and integrate the tool into their lessons, what to do about kids who lack access to a smartphone (if the tool is an app), and so forth.

Lesson Learned: Entrepreneurs want to make sales and grow their businesses. Teachers want to take their time. This gap can be so large it causes an edtech start-up to fail.

We're Used to Free

The flood of free tools—from Facebook to Google to Dropbox (basic version) to Google Docs—has primed people to expect certain services to be free. In addition, many big companies that make their money from consumers and businesses offer educational versions of the product for free or at deep discounts.

Lesson Learned: Many target customers in the education space (and other spaces) expect products to be free.

So, when you're thinking about launching a company ask yourself the following questions about the industry you are about to enter. How many layers of approval will my product experience prior to the purchase decision being made? Is the person who pays for my product the one who uses it? Will the priorities of my company be so different than the priorities of my customer that I could fail? And finally, how accustomed are my customers to getting products similar to mine for free?

Questions for Critical Thinking

1. What lessons does SharpScholar's failure have for entrepreneurs who are considering entering the EdTech industry?
2. We studied business models in Chapter 4. Would you classify SharpScholar's business model as *standard* or *disruptive*? What types of execution-related challenges are associated with the type of business model you believe SharpScholar sought to implement?
3. As explained in this feature, SharpScholar did not have a precise image of who was the firm's target customer. Examine the "bargaining power of buyers" from the perspective of the different customers mentioned in the feature who may have been SharpScholar's target customer. Which of the potential target customers would possess the greatest amount of buyer power relative to SharpScholar and why?

4. What actions could SharpScholar have taken, throughout the life of its business, that may have enabled it to remain competitive and still be a successful firm today?

Sources: J. Siddiqui, "We Shut Down Our Edtech Startup. Here's What We Learned, available at https://www.edsurge.com/news/2016-06-12-we-shut-down-our-edtech-startup-here-s-what-we-learned (posted June 12, 2016, accessed February 13, 2017).

the firm may want to reconsider entering the industry or think carefully about the position it will occupy in the industry. In the restaurant industry, for example, the threat of substitute products, the threat of new entrants, and the rivalry among existing firms are high. For certain restaurants, such as fresh-seafood restaurants, the bargaining power of suppliers may also be high (the number of seafood suppliers is relatively small compared to the number of beef and chicken suppliers). Thus, a firm that enters the restaurant industry has several forces working against it simply because of the nature of the industry. To help sidestep or diminish these threats, it must establish a favorable position. One firm that has accomplished this is Panera Bread, as discussed in Case 5.1 at the end of this chapter. By studying the restaurant industry, Panera found that some consumers have tired of fast food but don't always have the time to eat at a sit-down restaurant. To fill the gap, Panera helped to pioneer a new category called "fast casual," which combines relatively fast service with high-quality food. Panera has been very successful in occupying this unique position in the restaurant industry. You'll learn more about Panera Bread's success while reading Case 5.1.

The second way a new firm can apply the five forces model to help determine whether it should enter an industry is by using the model pictured in Figure 5.2 to answer several key questions. By doing so, a new venture can assess the thresholds it may have to meet to be successful in a particular industry:

Question 1: Is the industry a realistic place for our new venture to enter? This question can be answered by looking at the overall attractiveness of an industry, as depicted in Table 5.2, and by assessing whether the window of opportunity is open. It's up to the entrepreneur to determine if the window of opportunity for the industry is open or closed.

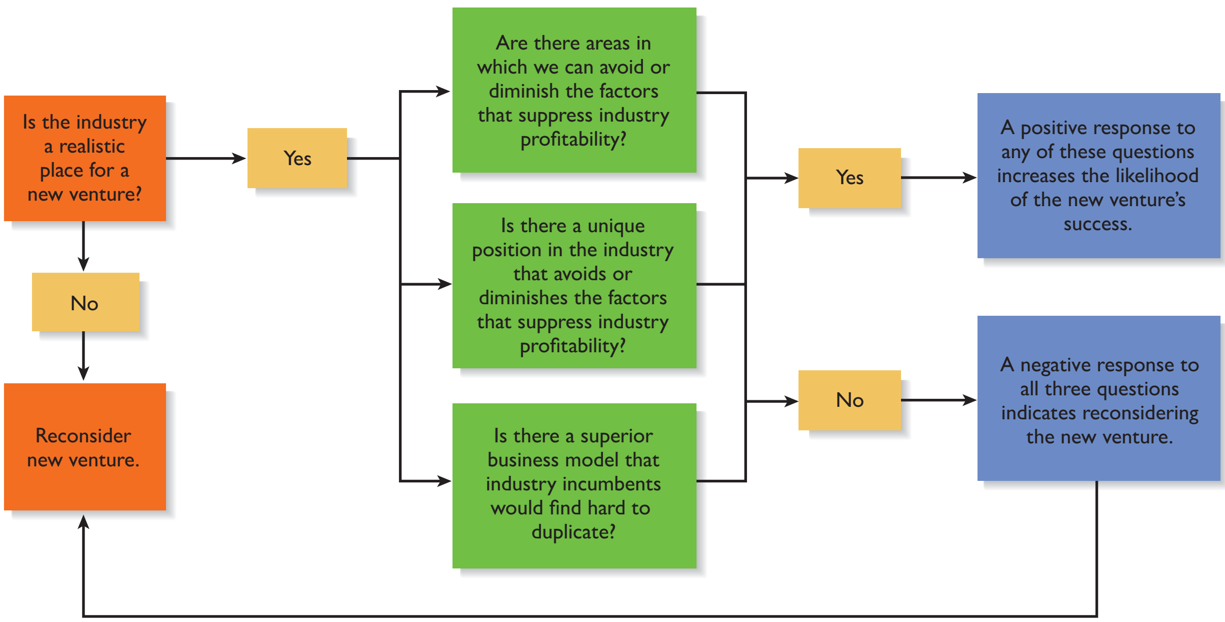


FIGURE 5.2
Using the Five Forces Model to Pose Questions to Determine the Potential Success of a New Venture

Question 2: If we do enter the industry, can our firm do a better job than the industry as a whole in avoiding or diminishing the impact of the forces that suppress industry profitability? Entering an industry with a fresh brand, innovative ideas, and a world-class management team and performing better than the industry incumbents increases the likelihood a new venture will be successful. This was the case when Google entered the Internet search engine industry and displaced Yahoo as the market leader. Outperforming industry incumbents can also be achieved if a new venture brings an attractive new product to market that is patented, preventing others from duplicating it for a period of time.

Question 3: Is there a unique position in the industry that avoids or diminishes the forces that suppress industry profitability? As we've described, this is the advantage that Panera Bread has captured.

Question 4: Is there a superior business model that can be put in place that would be hard for industry incumbents to duplicate? Keep in mind that the five forces model provides a picture of an industry "as is," which isn't necessarily the way a new venture has to approach it. Sometimes the largest firms in an industry are trapped by their own strategies and contractual obligations, providing an opening for a start-up to try something new. For example, when Dell started selling computers directly to consumers, its largest rivals—Hewlett-Packard, Compaq, and IBM—were not able to respond quickly and effectively. They were locked into a strategy of selling through retailers. If they had tried to mimic Dell and sell directly to end users or customers, they would have alienated their most valuable partners—retailers such as Sears and Best Buy. However, with the passage of time, Dell's competitors have learned how to effectively and efficiently sell directly to consumers, largely erasing Dell's historic advantage in the process of doing so.

The steps involved in answering these questions are pictured in Figure 5.2. If the founders of a new firm believe that a particular industry is a realistic place for their new venture, a positive response to one or more of the questions posed in Figure 5.2 increases the likelihood that the new venture will be successful.

Industry Types and the Opportunities They Offer

LEARNING OBJECTIVE

4. Identify the five primary industry types and the opportunities they offer.

Along with studying the factors discussed previously, it is helpful for a new venture to study industry types to determine the opportunities they offer.[17] The five most prevalent industry types, depicted in Table 5.3, are emerging industries, fragmented industries, mature industries, declining industries, and global industries.[18] There are unique opportunities associated with each type of industry.

Emerging Industries

An **emerging industry** is a new industry in which standard operating procedures have yet to be developed. The firm that pioneers or takes the leadership of an emerging industry often captures a first-mover advantage. A **first-mover advantage** is a sometimes insurmountable advantage gained by the first company to establish a significant position in a new market.

Because a high level of uncertainty characterizes emerging industries, any opportunity that is captured may be short-lived. Still, many new ventures enter emerging industries because barriers to entry are usually low and there is no established pattern of rivalry.

Home health care is an example of a fragmented industry. A fragmented industry is fertile ground for an entrepreneurial start-up.

stockbroker/123rf.com

Fragmented Industries

A **fragmented industry** is one that is characterized by a large number of firms of approximately equal size. The primary opportunity for start-ups in fragmented industries is to consolidate the industry and establish industry leadership as

TABLE 5.3 Industry Structure and Opportunities

Industry Type	Industry Characteristics	Opportunities	Examples of Entrepreneurial Firms Exploiting These Opportunities
Emerging industries	Recent changes in demand or technology; new industry standard operating procedures have yet to be developed	First-mover advantage	■ Prynt's method of instantly printing smartphone photos ■ Wiivv's 3D printed insoles ■ Owlet Baby Care's process of monitoring a baby's heart rate and respiration
Fragmented industries	Large number of firms of approximately equal size	Consolidation	■ Chipotle Mexican Grill in fast-casual restaurants ■ 1-800-GOT-JUNK? in junk removal ■ Riffraff in women's clothing
Mature industries	Slow increases in demand, numerous repeat customers, and limited product innovation	Process and after-sale service innovation	■ Justin's in peanut butter ■ Rover.com in dog care ■ Zagster in bike sharing
Declining industries	Consistent reduction in industry demand	Leaders, niche, harvest, and divest	■ Nucor in steel ■ JetBlue in airlines ■ Cirque du Soleil in circuses
Global industries	Significant international sales	Multinational and global	■ Uber in providing rides ■ d.light in solar-powered lanterns

a result of doing so. The most common way to do this is through a **geographic roll-up strategy**, in which one firm starts acquiring similar firms that are located in different geographic areas.[19] This is an often observed path for growth for businesses such as auto repair shops and beauty salons. It is difficult for them to generate additional income in a single location, so they grow by expanding into new geographic areas via either organic growth or by acquiring similar firms.

Mature Industries

A **mature industry** is an industry that is experiencing slow or no increase in demand, has numerous repeat (rather than new) customers, and has limited product innovation. Occasionally, entrepreneurs introduce new product innovations to mature industries, surprising incumbents who thought nothing new was possible in their industries. This is what Casper Mattresses accomplished (see Case 5.2) in what was the staid mattress industry. Another example is Steve Demos, the founder of White Wave, a company that makes vegetarian food products. White Wave introduced a new product—Silk Soymilk—into a mature industry—consumer milk. Silk Soymilk became the best-selling soymilk in the country. Soymilk isn't really milk at all—it's a soybean-based beverage that looks like milk and has a similar texture. Still, it has made its way into the dairy section of most supermarkets in the United States and has positioned itself as a healthy substitute for milk. Who would have thought that a major innovation was possible in the milk industry?

The lure of mature industries, for start-ups, is that they're often large industries with seemingly vast potential if product and/or process innovations can be effectively introduced and the industry can be revitalized. This is the hope for a company such as Beyond Meat, the subject of the "You Be the VC 6.1" feature. Beyond Meat is producing a plant-based substitute for chicken strips, called Chicken-Free Strips, which replicate the look, taste, and sensory experience of eating meat. The company is not targeting people who are ultra careful about what they eat, but a more mainstream market of people who are trying to eat healthier. Beyond Meat is now working on a similarly healthy substitute for ground beef. Meat is a mature industry. If Beyond Meat's products can be effectively introduced into the marketplace and it is successful in revitilizing the meat industry, the firm's market potential is huge.

Declining Industries

A **declining industry** is an industry or a part of an industry that is experiencing a reduction in demand. The renting of DVDs and video games by mail and producing and distributing hard copy textbooks are examples of products associated with industries or segments of an industry that are in some state of decline. Typically, entrepreneurs shy away from declining industries because the firms in them are not finding the types of attractive opportunities that we described in Chapter 2. There are occasions, however, when a start-up will do just the opposite of what conventional wisdom would suggest and, by doing so, stakes out a position in a declining industry that isn't being hotly contested. That is what Cirque du Soleil did in the circus industry.

Entrepreneurial firms employ three different strategies in declining industries. The first is to adopt a **leadership strategy**, in which the firm tries to become the dominant player in the industry. This is a rare strategy for a start-up in a declining industry. The second is to pursue a **niche strategy**, which focuses on a narrow segment of the industry that might be encouraged to grow through product or process innovation. The third is a **cost reduction strategy**, which is accomplished through achieving lower costs than industry incumbents through process improvements. Achieving lower costs allows a firm to sell its product or service at a lower price, creating value for consumers in the process of doing so. Initially a small firm but now quite large as a result of its success, Nucor Corporation revolutionized the steel industry through the introduction of the "minimill" concept, and is an example of an entrepreneurially-minded firm that pursued this strategy. Historically, most steel mills in the United States used large blast furnaces to produce a wide line of products; however, the scale of these furnaces meant that firms had to produce and sell significant quantities of their products in order to be profitable. In contrast, Nucor's then-innovative minimills were smaller and were used to produce a narrower range of products. Of great importance, too, is the fact that minimills are energy efficient and make high-quality steel.[20] Nucor proved its concept and quickly found growth markets within the largely declining U.S. steel industry.

Global Industries

A **global industry** is an industry that is experiencing significant international sales. Many start-ups enter global industries and from day one try to appeal to international as well as to domestic markets. The two most common strategies pursued by firms in global industries are the multidomestic strategy and the global strategy. Firms that pursue a **multidomestic strategy** compete for market share on a country-by-country basis and vary their product or service offerings to meet the demands of the local market. In contrast, firms pursuing a **global strategy** use the same basic approach in all foreign markets. The choice between these two strategies depends on how similar consumers' tastes are from market to market. For example, food companies typically are limited to a multidomestic strategy because food preferences vary significantly from country to country. Firms that sell more universal products, such as athletic shoes, have been successful with global strategies. Entrepreneurial firms can use both strategies successfully. The key to achieving success is gaining a clear understanding of customers' needs and interests in each market in which the firm intends to compete.[21]

Competitor Analysis

LEARNING OBJECTIVE

5. Explain the purpose of a competitor analysis and a competitive analysis grid.

After a firm has gained an understanding of the industry and the target market in which it plans to compete, the next step is to complete a competitor analysis. A competitor analysis is a detailed analysis of a firm's competition. It helps a firm understand the positions of its major competitors and the opportunities that are available to obtain a competitive advantage in one or more areas. These are important issues, particularly for new ventures.[22] In the words of Sun Tzu, quoted earlier in this chapter, "Time spent in reconnaissance is seldom wasted."

First we will discuss how a firm identifies its major competitors. We will then look at the process of completing a competitive analysis grid, which is a tool for organizing the information a firm collects about its primary competitors.

Identifying Competitors

The first step in a competitive analysis is to determine who the competition is. This is more difficult than one might think. For example, take a company such as 1-800-FLOWERS. Primarily, the company sells flowers. But 1-800-FLOWERS is not only in the flower business; in fact, because flowers are often given for gifts, the company is also in the gift business. If the company sees itself in the gift business rather than just the flower business, it has a broader set of competitors and opportunities to consider. In addition, some firms sell products or services that straddle more than one industry. For example, a company that makes computer software for dentists' offices operates in both the computer

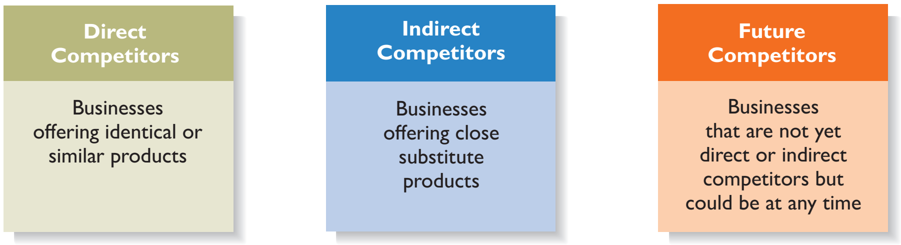


FIGURE 5.3
Types of Competitors New Ventures Face

software industry and the health-care industry. Again, this type of company has more potential competitors but also more opportunities to consider.

The different types of competitors a business will face are shown in Figure 5.3. The challenges associated with each of these groups of competitors are described here:

- **Direct competitors** These are businesses that offer products or services that are identical or highly similar to those of the firm completing the analysis. These competitors are the most important because they are going after the same customers as the new firm. A new firm faces winning over the loyal followers of its major competitors, which is difficult to do, even when the new firm has a better product.
- **Indirect competitors** These competitors offer close substitutes to the product the firm completing the analysis sells. These firms' products are also important in that they target the same basic need that is being met by the new firm's product. For example, when people told Roberto Goizueta, the late CEO of Coca-Cola, that Coke's market share was at a maximum, he countered by saying that Coke accounted for less than 2 percent of the 64 ounces of fluid that the average person drinks each day. "The enemy is coffee, milk, tea [and] water," he once said.[23]
- **Future competitors** These are companies that are not yet direct or indirect competitors but could move into one of these roles at any time. Firms are always concerned about strong competitors moving into their markets. For example, think of how the world has changed substantially for Barnes & Noble and other brick-and-mortar bookstores since Amazon.com was founded. These changes are perhaps especially dramatic for Borders, which filed for bankruptcy in 2011. Former competitor Barnes & Noble bought Borders' remaining assets (primarily its brand name) later in that year. And, think of how smartphone technology continues to change the nature of competition for a variety of firms, including those selling entertainment services, telephone services, and the like.

It is impossible for a firm to identify all its direct and indirect competitors, let alone its future competitors. However, identifying its top 5 to 10 direct competitors and its top 5 to 10 indirect and future competitors makes it easier for the firm to complete its competitive analysis grid.

If a firm does not have a direct competitor, it shouldn't forget that the status quo can be the toughest competitor of all. In general, people are resistant to change and can always keep their money rather than spend it.[24] A product or service's utility must rise above its cost, not only in monetary terms but also in terms of the hassles associated with switching to or learning something new, to motivate someone to buy a new product or service.[25]

Creating meaningful value and sharp differentiation from competitors are actions small firms in crowded industries can take to remain competitive and gain market share. Three firms that have successfully accomplished this are profiled in the nearby "Savvy Entrepreneurial Firm" feature.

SAVVY ENTREPRENEURIAL FIRM

Thriving in a Crowded Industry by Creating Meaningful Value and Differentiation from Competitors

Raden: • Web: www.raden.com • Facebook: Raden • Twitter: @raden

Suja Juice: • Web: www.sujajuice.com • Facebook: SujaJuice • Twitter: @SujaJuice

The Muse: • Web: www.themuse.com • Facebook: The MuSe • Twitter: @dailymuse

Start-ups do well in a crowded industry when two conditions exist: (1) they create meaningful value for customers at a fair price and (2) they effectively differentiate themselves from competitors. In fact, diminishing the impact of three of Porter's five forces rests largely on these factors. A firm is able to withstand rivalry among existing firms, is able to deter substitutes, and is able to discourage new entrants from entering the market by creating value for its customers and offering something that people can't get anywhere else.

The following are examples of three businesses that are creating unique value in their industries and have differentiated themselves from competitors. Each industry is very competitive, yet these companies are growing and thriving.

Raden Smart Luggage

Think about the luggage industry. Can you think of a brand that integrates technology, value, and stylish design into a single bag? If not, neither could Josh Udashkin, the founder of Raden, so he spent two years creating his firm's product. Raden bags are not only attractive, lightweight, sturdy, and provide plenty of interior space, but they take much of the worry out of travel. To avoid worry about your smartphone going dead, the bags have integrated 7,800Ah batteries that allow for up to four full smartphone charges. To avoid worry about the bags being overweight, the ergonomic handle doubles as a scale. And to avoid worry about when your bag will be on the baggage carousel, each Raden bag is equipped with Bluetooth technology that can tell you if your bag is nearby.

The bags themselves have dual-extension aluminum handles and four spinner wheels. Inside, they feature nicely separated fabric compartments. The two halves of the suitcase each have a fabric cover that keeps things in place, and there's a second pouch on the right hand side. The bags open and close with a zipper, which has water-resistant flaps. Raden bags come in two sizes, seven colors, and two finishes. The sizes are a 22-inch, carry-on bag and a 28-inch, check case. Both bags are integrated with a smartphone app. The app has three primary functions. You can check the case's battery status (the battery that recharges your smartphone must itself be periodically recharged), you can lift the handle to weigh the case, and you can track the location of your bag (sort of). At the time this feature was written (spring 2017), the locator could tell you if your bag was fairly close, so it could alert you when your bag was about to pop-out on a baggage carousel. In regard to helping you track your bag if it's been lost, it can tell you if the bag has been detected by anyone else with a Raden app, anywhere in the world. This feature will become more valuable when a larger critical mass of people are using the Raden app.

Suja Juice

Suja Juice is competing in the rough and tumble juice and meal-replacement industries. Suja is "cold-pressed" juice, which means that it uses a hydraulic press to extract its juice from fruits and vegetables as opposed to other methods. Cold-pressed juice has been proven to contain high degrees of nutrients and can be stored for up to 30 days. Advocates of cold-pressed juice claim that it tastes better and contains more nutrients than pasteurized juices.

Suja means "long, beautiful life." The company was founded by four San Diego natives—a lifetime juicer, a raw food chef, an award-winning restaurateur, and a Harvard MBA and successful social entrepreneur. Their mission was to formulate and distribute a top quality organic and non-GMO juice—something better than anything currently available. In 2016, Suja was listed as the Fastest Growing Food & Beverage Company in the *Inc.* 500. Early on, the founders sold their juice via a home-delivery service. Suja products are now available in stores nationwide including Whole Foods Markets, Publix, and Target.

All Suja Juice products are made from organic, non-GMO fruits and vegetables, and are vegan, kosher, gluten-free, dairy-free, soy-free, and preservative-free. Suja has five product lines: Suja, Classic, Elements, Probiotic Waters, and Drinking Vinegars. The juices, along with Suja's other products, come in a variety of flavors and have colorful names. The juices include Mango Magic, Berry Goodness, and Carrot Crush. Many people use Suja products to do a juice cleanse, which is a specific short-term diet. You drink only juice for a short period of time and then eat healthy foods after. The idea is to give your digestive tract a chance to rest and recover from the daily grind of normal foods.

Suja products can be bought individually or on a subscription basis. The price is not for the faint-of-heart. A single-16-ounce bottle can cost upwards of $6.66.

The Muse

The Muse is in the competitive recruitment and placement industry. The problem this firm is solving is that most job sites are uninspiring. Usually there is a straightforward description of a job, followed by a list of skills and educational background needed and a standard description of the company. Rarely is any insight provided about the culture of a company, what its work environment is like, and what the experiences are of the people who have worked there. These types of insights are available if a person is granted an interview and visits the company in which he or she desires to work. But there are occasions when both a company and an applicant spend a considerable amount of time learning about one another, only to discover that the job isn't a good fit.

The Muse solves these problems by providing job applicants much richer detail about the company, its culture, and what it would be like to work there as part of the job solicitation process. The Muse's job postings include job descriptions along with photos of the company's workspace and short interviews with current employees. The goal is to give job seekers as keen an insight as possible about the culture of a company and the type of people who work there. The Muse's goal isn't to make every company sound like the best place in the world to work. Instead, the goal is to give job seekers an honest and realistic look at a company so they will be able to make an informed judgment about whether to pursue a specific job. You can view profiles of companies that are currently recruiting on the Muse at www.themuse.com.

Questions for Critical Thinking

1. What are the common attributes across the three companies in this feature? How do these attributes help the companies thrive in otherwise competitive industries?
2. In what ways are each company's features redefining the customer experience in their industries?
3. Of the three companies featured, which one do you think will have the most profound impact on its industry? Describe what you think the impact or impacts will be.
4. Find an example of another company that is thriving in a highly competitive industry. Analyze the company and discern what sets it apart from competitors.

Sources: Raden Homepage, www.raden.com (accessed February 15, 2017); Suja Juice Homepage, www.sujajuice.com (accessed February 15, 2017); The Muse Homepage, www.themuse.com (accessed February 15, 2017); V. Decker, "With $3.5M in Funding, Raden Is the Latest Smart Luggage Company Aimed at Tech-Savvy Travelers," *Forbes*, March 29, 2016; Wikipedia, Suja Juice, www.wikipedia.com (accessed February 15, 2017).

Sources of Competitive Intelligence

To complete a meaningful competitive analysis grid, a firm must first understand its competitors' strategies and behaviors. The information that is gathered by a firm to learn about its competitors is called **competitive intelligence**. Obtaining sound competitive intelligence is not always a simple task. If a competitor is a publicly traded firm, a description of the firm's business and its financial information is available through annual reports filed with the Securities and Exchange Commission (SEC). These reports are public records and are available at the SEC's website (www.sec.gov). If one or more of the competitors is a private company, the task is more difficult, given that private companies are not required to divulge information to the public. There are a number of ways that a firm can ethically obtain information about its competitors. A sample of the most common techniques is shown in Table 5.4.

Completing a Competitive Analysis Grid

As we mentioned previously, a **competitive analysis grid** is a tool for organizing the information a firm collects about its competitors. It can help a firm see how it stacks up against its competitors, provide ideas for markets to pursue, and, perhaps most importantly, identify its primary sources of competitive advantage. To be a viable company, a new venture must have at least one clear competitive advantage over its major competitors.

An example of a competitive analysis grid is provided in Table 5.5. This grid is for Panera Bread, the fast-casual restaurant chain featured in Case 5.1. The main competitive factors in the fast-casual restaurant industry, which are different from the restaurant industry as a whole, are price; selection; perception of providing good, wholesome food; dining environment; speed of service; availability of gluten free, non-GMO, organic, etc.; and social consciousness/philanthropy. These factors are placed on the vertical axis of Panera Bread's competitive analysis grid. The horizontal axis contains Panera Bread and its four main competitors. In each box, Panera Bread rates itself against its main competitors. The purpose of this exercise is for a company to see how it stacks up against its competitors and to illustrate the areas in which it has an advantage

TABLE 5.4 Sources of Competitive Intelligence

Source	Description/Benefit
Attend conferences and trade shows	Participants talk about the latest trends in the industry and display their most current products.
Purchase competitors' products	Purchasing and using a competitor's products can provide insight into their benefits and shortcomings. The purchase process itself can provide data about how a competitor treats its customers.
Study competitors' websites and social media pages	Many companies put a lot of information on their websites, including product information and the latest news about the company. The same goes for a company's pages on social media outlets, such as Facebook and Twitter.
Set up Google e-mail alerts	Google e-mail alerts are updates of the latest Google results, including press releases, news articles, and blog posts, on any keywords of interest. You can set up e-mail alerts using your company's name or the name of a competitor.
Read industry-related books, magazines, websites, and blogs	Many of these sources contain articles or features that have information about competitors.
Talk to customers about what motivated them to buy your product as opposed to your competitor's product	Customers can provide a wealth of information about the advantages and disadvantages of competing products.

(and suffers a disadvantage). For example, Panera Bread rates itself as having an advantage over at least some of its competitors in terms of perception of providing good, wholesome food, dining environment, and social consciousness/philanthropy. It will likely use this information in its advertising and promotions. An additional benefit of completing a competitive analysis grid is that it helps a company fine-tune its offering. For example, Panera Bread rates itself as "even" with its competitors on several criteria. It might use that knowledge to look for ways to up its game on one or more of these criteria to increase its overall competitiveness.

TABLE 5.5 Competitive Analysis Grid for Panera Bread

Name	Panera Bread	McAlister's Deli	Chipotle Mexican Grill	Panda Express	Qdoba
Price	Even	Even	Even	Advantage	Even
Selection	Even	Even	Disadvantage	Disadvantage	Disadvantage
Perception of providing good, wholesome food	Advantage	Even	Even	Disadvantage	Even
Dining environment	Advantage	Even	Even	Disadvantage	Disadvantage
Speed of service	Even	Even	Advantage	Advantage	Advantage
Availability of gluten free, non-GMO, organic, etc.	Even	Even	Even	Disadvantage	Even
Social Consciousness/ Philanthropy	Advantage	Even	Advantage	Even	Even

Chapter Summary

LO1. To compete successfully, a firm needs to understand the industry in which it intends to compete. Industry analysis is a business research framework or tool that focuses on an industry's potential. The knowledge gleaned from this analysis helps a firm decide whether to enter an industry and if it can carve out a position in that industry that will provide it a competitive advantage. Environmental trends and business trends are the two main components of "industry trends" that firms should study. Environmental trends include economic trends, social trends, technological advances, and political and regulatory changes. Business trends include other business-related trends that aren't environmental trends but are important to recognize and understand.

LO2. Firms use the "five forces model" to understand an industry's structure. The parts of Porter's five forces model are threat of substitutes, threat of new entrants, rivalry among existing firms, bargaining power of suppliers, and bargaining power of buyers.

LO3. What entrepreneurs should understand is that each individual force has the potential to affect the ability of any firm to earn profits while competing in the industry or a segment of an industry. The challenge is to find a position within an industry or a segment of an industry in which the probability of the firm being negatively affected by one or more of the five forces is reduced. Additionally, successfully examining an industry yields valuable information to those starting a business. Armed with the information it has collected, firms are prepared to consider four industry-related questions that should be examined before deciding to enter an industry. These questions are: Is the industry a realistic place for a new venture? If we do enter the industry, can our firm do a better job than the industry as a whole in avoiding or diminishing the threats that suppress industry profitability? Is there a unique position in the industry that avoids or diminishes the forces that suppress industry profitability? Is there a superior business model that can be put in place that would be hard for industry incumbents to duplicate?

LO4. There are five primary industry types of entrepreneurial firms to consider when choosing the industry in which they will compete. These industry types and the opportunities they offer are as follows: emerging industry/first-mover advantage; fragmented industry/consolidation; mature industry/emphasis on service and process innovation; declining industry/leadership, niche, harvest, and divest; and global industry/multidomestic strategy or global strategy.

LO5. A competitor analysis is a detailed analysis of a firm's competition. It helps a firm understand the positions of its major competitors and the opportunities that are available to obtain a competitive advantage in one or more areas. Direct competitors, indirect competitors, and future competitors are the three groups of competitors a new firm faces.

Successful competition demands that a firm understand its competitors and the actions they may take—both today and in the future. There are a number of ways a firm can ethically obtain the information it seeks to have about its competitors, including attending conferences and trade shows; purchasing competitors' products; studying competitors' websites; setting up Google e-mail alerts; reading industry-related books, magazines, and websites; and talking to customers about what motivated them to buy your product as opposed to your competitor's product.

A competitive analysis grid is a tool for organizing the information a firm collects about its competitors. This grid can help a firm see how it stacks up against its competitors, provide ideas for markets to pursue, and, perhaps most importantly, identify its primary sources of competitive advantage.

Key Terms

barrier to entry, **194**
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competitive intelligence, **207**
competitor analysis, **189**
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MyLab Entrepreneurship
If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

5-1. What is an industry?
✪ 5-2. What is an industry analysis and why is it important for a new firm to analyze the industry in which it may choose to compete?
5-3. How can startups stay on top of environmental and business trends in their industries?
5-4. What are the five forces that determine an industry's profitability?
5-5. How can the threat of substitute products suppress an industry's profitability?
5-6. How can the threat of new entrants suppress an industry's profitability?
5-7. What are the major determinants of profitability in most industries?
5-8. How does rivalry among existing firms have the potential to suppress an industry's profitability?
5-9. What are the two values created by firms when they successfully use the five forces model?
5-10. How does the bargaining power of suppliers have the potential to suppress an industry's profitability?
5-11. What are the five primary industry types, and what are the opportunities they offer?
5-12. How does the bargaining power of buyers have the potential to suppress an industry's profitability?
5-13. What are the nontraditional barriers to entry that are particularly suitable for entrepreneurial firms to study when selecting an industry in which to compete?
5-14. How can a start-up avoid or sidestep the pressure applied by one of the five forces on industry profitability by establishing a unique "position" in an industry?
✪ 5-15. What are the characteristics of a fragmented industry and why are these important for entrepreneurs?
5-16. What is the primary opportunity for new firms in fragmented industries?
5-17. What are the characteristics of a mature industry?
5-18. What is the primary opportunity for new firms in a mature industry?
5-19. What is a global industry?
5-20. What are the two most common strategies pursued by firms in global industries?
5-21. What is the purpose of a competitor analysis?
5-22. What are the differences among direct competitors, indirect competitors, and future competitors?
5-23. What is the meaning of the term *competitive intelligence*?
5-24. Why is it important for firms to collect intelligence about their competitors?
5-25. What are the three different strategies that may be adopted by a firm in a declining industry?
5-26. What is the purpose of completing a competitive analysis grid?

Application Questions

5-27. Linda Henricks is thinking about starting a firm in the home health-care provider industry. When asked by a potential investor if she had studied the industry, Linda replied, "With the aging of the population and the fact that people are living longer than ever, the home health-care provider industry is so full of potential it doesn't require formal analysis." In what ways will Linda limit her possibilities with the potential investor if her current attitude about the importance of industry analysis doesn't change?

5-28. The You Be the VC 5.1 feature focuses on Little Riot, a company in the technology market. What environmental and business trends favor Little Riot's unique solution to a problem?

5-29. Eric Andrews has been investigating the possibility of starting a service that will partner with grocery stores to provide a delivery service for their customers. The idea is that after purchasing their groceries, customers could go to a kiosk in the store, pay a small fee, and have their groceries delivered to their homes within 60 minutes. Which of the five forces in Porter's five forces model do you anticipate will most strongly affect Eric's potential business and why?

5-30. Read Case 5.1, which focuses on Panera Bread. What are some of the barriers to entry a firm would have to deal with and try to overcome if it tried to compete against Panera Bread in the casual dining segment of the restaurant industry?

5-31. It is helpful for a new business to study industry types and determine the opportunities that they offer in order to choose the industry in which it can compete. In groups of two, choose a new venture of your interest, and identify the industry type that it has chosen to operate in, and the opportunities that the industry offers. You may use Table 5.3 in the chapter as a guide for your analysis.

5-32. A friend of yours has come to you for advice. She is in the middle of preparing a competitive analysis grid for her online clothing business. She understands that in order for her to prepare the analysis grid, she needs to first understand the strategies and behaviors of her competitors. However, she does not know how to ethically obtain sensitive information on her competitors. Advise her.

5-33. Think about and find some information about trends in the motorcycle industry. In particular, identify the effects of economic, demographic, and regulatory changes that may affect the motorcycle industry at the time you are reading this book. Write a paragraph or two to describe the trends, and their implications for entrepreneurial firms, that you located while searching for information.

5-34. Your friend has developed what he believes is a novel floor cleaning product. The advantage to this product, he tells you, is that because of the unique chemicals used to create the cleaning fluid, people are able to use a fraction of the amount of fluid to clean floors compared to the amount of fluid that is necessary when using traditional, well-established products. Your friend is convinced that even Walmart will be willing to pay a handsome amount to him in order to stock and sell his product. Use your knowledge about the power of buyers to offer your friend a different perspective as to how Walmart might deal with him as he tries to sell his product to this giant firm.

5-35. Your friend, Lisa Ryan, is opening a smoothie shop that will sell a variety of smoothie drinks in the $5 to $7 price range. When you ask her if she is worried that the steep price of her smoothies might encourage prospective customers to buy a soft drink or a sports drink instead of buying her product, Lisa says: "You are right. This is a real concern I have. Is there anything I can do to discourage potential customers from making such a choice?" What information would you provide to Lisa in response to her question?

YOU BE THE VC 5.1 COMPANY: Little Riot

• **Web: www.littleriot.com/pillow-talk** • **Facebook: en-gb.facebook.com/LittleRiotLtd** • **Twitter: @LittleRiot**

Business Idea: Build a unique product called Pillow Talk that helps you connect with your partner in a heartbeat.

Pitch: Little Riot is a small engineering and design company based in London, and Pillow Talk is their flagship product. Joanna Montgomery, founder of Little Riot, came up with the idea in 2010 at university of a device that allows you to hear the heartbeat of your partner and your partner to hear yours, wherever you are in the world. This is a unique solution for long-distance relationships. A wristband picks up the heartbeat in real time and sends it to your partner, and their wristband does the same.

The entire enterprise nearly failed due to glitches in the Kickstarter payments system, due to which Little Riot lost around 40 percent of its pledges. In December 2015, Little Riot's Pillow Talk raised nearly $100,000; it was over-funded by 10 per cent, but a glitch resulted in an email being sent to Little Riot's backers telling them that their payment had been declined. Little Riot was inundated with emails from anxious customers; some of whom went so far as to cancel their payments. One bank froze all payments from their customers to the business.

Kickstarter refused to help despite the fact that only 60 percent of the payments actually came in. Furthermore, they still demanded their 5 percent commission. This proved to be an enormous financial strain for the new business. However, within a week or so, the company had managed to recoup some of the lost sales.

Little Riot had previewed the product well in advance of its Kickstarter campaign, and their YouTube channel had amassed around 50,000 followers. The Kickstarter fiasco taught the entrepreneurs some very tough lessons, not least about handling the anger and frustration from their backers.

Undaunted, Little Riot pressed on, shipping its 1,000 pre-orders, opening its own web store, and entering negotiations with retail partners. The entrepreneurs admit that they should probably have gone down this route right from the start and taken advance orders from their own web store. Little Riot has commissioned a Chinese manufacturer to fabricate and assemble the product.

The product itself consists of a wristband, a speaker (which is placed under the partner's pillow), and a smartphone app. It is not a conventional wearable such as a fitness tracker; it has more in common with a communications device. One of the key target markets are military and other uniformed services families, where one person in the relationship may be working abroad or spending extended spells away from home. Another significant market are partners studying at different universities.

Initially, Little Riot managed to create prototypes using funds raised from private investors; the company is based out of Wayra, Telefónica's start up accelerator, in London. Wayra is convinced that the product is a great example of something that meets modern needs and allows people to interact in a radically different way with technology.

5-36. Based on the material covered in this chapter, what questions would you ask the firm's founder before making your funding decision? What answers would satisfy you?

5-37. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 5.2 COMPANY: ZUtA Labs

• **Web: www.zutalabs.com** • **Facebook: ZUtA Labs** • **Twitter: @ZUtALabs**

Business Idea: Develop and deploy a small, easy-to-use mobile robotic printer that will enable people to print anywhere and on any size paper.

Pitch: Smartphones, laptops, and tablets make it easy for people to work on the go, but printers are another thing. Traditionally, printers have been difficult to use out of the office—until now. ZUtA Labs has created a printer that's only a little bigger than a breakfast muffin and allows people to print anywhere they are working.

The ZUtA printer is about four inches wide and three inches high and weighs just under a pound. It can connect wirelessly to smartphones, tablets, laptops, and PCs via an app. To print, a person switches on the device, places it at the top left hand corner of a sheet of paper, and sends the print job to the printer. The printer can print a standard sized sheet of paper every 50 to 60 seconds with a resolution of 300 dpi. The printer's omniwheel system allows it to move back and forth on the page. If the print job involves more than one page, the printer will stop when it gets to the bottom of the first page and wait until it is placed at the top of the next page. The printer's rechargeable battery lasts about an hour, which is long enough to print 60 pages. It takes three hours to recharge the battery. The device prints in black with a replaceable cartridge. A single cartridge can print approximately 1,000 pieces of paper.

The ZUtA printer is stylish and compact, and is small enough to fit in a pocket or a bag. While printing, it smoothly travels from left to right across the page, and then shifts down and travels from right to left to print the next line. The product is available in white and black. The ZUtA printer solves the problem of not having a printer available when working remotely. Imagine yourself in a coffee shop working on an assignment or a report that needs to be printed. Previously, you'd need to wait until you got home or to an office to print what you created. The ZUtA printer relieves you of that complication. It is also ideal for people who work remotely, and either box up a traditional printer to take with them or become frustrated when they need a printer but don't have one available. For example, people who run trade show booths, sell products at craft shows or farmers' markets, or are working away from their office for any other reason are ideal candidates for owning a ZUtA printer.

ZUtA Labs ran a successful Kickstarter campaign in 2014 to fund the development of its product. The firm started with a goal of $400,000, and ended up raising $511,662 from 3,081 backers. The initial iteration of the ZUtA printer is designed to print on paper. Future versions of the printer are intended to be able to print on any surface, including wood and vinyl.

5-38. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

5-39. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 5.1

Panera Bread: Occupying a Favorable Position in a Highly Competitive Industry

• *Web: www.panerabread.com* • *Facebook: Panera Bread* • *Twitter: @panerabread*

Bruce R. Barringer,
Oklahoma State University

R. Duane Ireland,
Texas A&M University

Introduction

If you analyzed the restaurant industry using Porter's five forces model, you wouldn't be favorably impressed with the results. Three of the threats to profitability—the threat of substitutes, the threat of new entrants, and rivalry among existing firms—are high. Despite these threats, one restaurant chain is moving forward in a very positive direction. St. Louis–based Panera Bread, a chain of specialty bakery-cafés, has grown from 602 company-owned and franchised units in 2003 to 2,100 in early 2017. In 2016, system wide sales reached $2.7 billion, up 6 percent from the previous year; and, sales revenue was ticking upward in 2017 as well. These numbers reflect a strong performance for a restaurant chain. So what's Panera's secret? How is it that this company flourishes while its industry as a whole is experiencing difficulty? As we'll see, Panera Bread's success can be explained in two words: positioning and execution.

Changing Consumer Tastes

Panera's roots go back to 1981, when it was founded under the name of Au Bon Pain Co. and consisted of three Au Bon Pain bakery-cafés and one cookie store. The company grew slowly until the mid-1990s, when it acquired Saint Louis Bread Company, a chain of 20 bakery-cafés located in the St. Louis area. About that time, the owners of the newly combined companies observed that people were increasingly looking for products that were "special"—meaning that they differed from run-of-the-mill restaurant food. Second, they noted that although consumers were tiring of standard fast-food fare, they didn't want to give up the convenience of quick service. This trend led the company to conclude that consumers wanted the convenience of fast food combined with a higher-quality experience. In slightly different words, they wanted good food served quickly in an enjoyable environment.

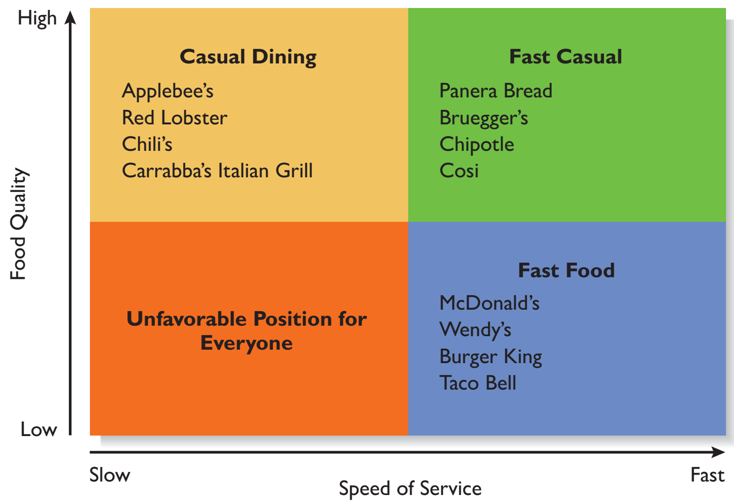
The Emergence of Fast Casual

As a result of these changing consumer tastes, a new category in the restaurant industry, called "fast casual," emerged. This category provided consumers the alternative they wanted by capturing the advantage of both the fast-food category (speed) and the casual dining category (good food), with no significant disadvantages. The owners of Au Bon Pain and Saint Louis Bread Company felt that they could help pioneer this new category, so they repositioned their restaurants and named them Panera Bread. The position that Panera moved into is depicted in the graphic titled "Positioning Strategy of Various Restaurant Chains." A market positioning grid provides a visual representation of the positions of various companies in an industry. Panera Bread emerged as a bakery-café that sells flavorful, wholesome food in a warm, friendly environment. Customers order their meal at a counter and receive it from a server in a booth or at a table, usually in less than 10 minutes.

Panera's Version of Fast Casual

To establish itself as the leader in the fast-casual category and to distinguish itself from its rivals, Panera (which is Latin for "time for bread") added a bonus to

Positioning Strategy of Various Restaurant Chains



the mix—specialty food. The company has become known as the nation's bread expert and offers a variety of artisan and other specialty breads, along with bagels, pastries, muffins, scones, and baked goods. The bread and bakery items are typically baked by an on-staff baker each day before dawn. Some locations also participate in a program that donates their unsold baked goods to local charities after closing each day. Panera Bread's restaurants are open for breakfast, lunch, and dinner, and also offer hand-tossed salads, signature sandwiches, and hearty soups served in edible sourdough bread bowls, along with hot and cold coffee drinks and other beverages. The company also provides catering services. Its restaurants present customers with a neighborly atmosphere and relaxing decor, adding to their appeal. Panera even suggests a new time of day to eat specialty foods, calling the time between lunch and dinner "chill-out" time.

With high hopes for future expansion, Panera Bread is an acknowledged leader in the fast-casual category. Its unique blend of fast-casual service and specialty foods also continues to gain momentum. This sentiment is captured in the following quote from Mark von Waaden, an investor and restaurateur who signed an agreement to open 20 Panera Bread restaurants in the Houston, Texas, area early in the company's growth spurt. Commenting on why he was attracted to Panera Bread as opposed to other restaurant chains, von Waaden said, "My wife, Monica, and I fell in love with the fresh-baked breads and the beautiful bakery-cafés. We think the Panera Bread concept of outstanding bread coupled with a warm, inviting environment is a natural fit with the sophistication that the Houston market represents."

The spirit of von Waaden's statement captures the essence of Panera's advantage. It isn't just another restaurant. By observing trends and listening to customers, its leaders helped the firm carve out a unique and favorable position in a difficult industry.

A Panera Bread Bakery-Café

Mira/Alamy Stock Photo

Present Status and Challenges Moving Forward

Panera's leadership in the fast-casual category and its financial performance have drawn considerable attention. The company employs more than 47,000 people, serves 8.3 million customers per week, and is currently one of the largest restaurant chains in the United States. It also continues to innovate and evolve. In 2012, Panera started testing a notion called Panera 2.0, which is a series of integrated technologies intended to enhance the guest experience. The concept was rolled out in a select number of restaurants in 2014 with more being added each year. Panera 2.0 brings together new capabilities for digital ordering, payment, and operations. The Panera Bread restaurants that have transitioned to Panera 2.0 have table kiosks, which the company calls *Fast Lane*, where customers may place an order and pay without going to the counter. The orders are placed on iPads. Customers can also place orders and pay via a smartphone app.

In regard to challenges, Panera has a growing number of competitors. The fast-casual category now includes restaurant chains such as Chipotle Mexican Grill, McAlister's Deli, Panda Express, and Jimmy John's Gourmet Sandwiches among others. As a result, in 2015 Panera refined its positioning to reconceive its brand mission as one of offering craveable wellness and an elevated experience within the fast-casual space. Panera 2.0 is part of this. The company also introduced new menu items that are intended to help the firm establish a premium reputation. The items, which have become very popular, include Panera's Roasted Turkey, Apple and Cheddar Sandwich and its Ancient Grain, Arugula and Chicken Salad. As part of enhancing the customer experience, in 2016 Panera also started eliminating the few remaining preservatives, sweeteners, artificial flavors, and artificial colors that remain in its food items.

To keep its growth on track, Panera is considering additional initiatives. The company is exploring opening Panera Bakery-Cafes in nontraditional locations. It is also exploring food delivery. Given its unique positioning, Panera sees food delivery as a mass-market opportunity moving forward.

Discussion Questions

5-40. How has Panera Bread established a unique position in the restaurant industry?

5-41. How has Panera Bread's unique position in the restaurant industry contributed to the firm's success?

5-42. What barriers to entry has Panera Bread created for potential competitors?

5-43. What are Panera Bread's primary sources of competitive advantage?

5-44. What are the ways that Panera Bread can conduct ethical and proper forms of competitive analysis to learn about potential competitors entering the fast-casual category?

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CASE 5.2

How Casper Woke Up the "Sleepy" Mattress Industry

• Web: www.casper.com • Facebook: Casper • Twitter: @Casper

Bruce R. Barringer,
Oklahoma State University

R. Duane Ireland,
Texas A&M University

Introduction

Imagine the following scenario: You've known for some time that you need to shop for a new mattress. You've been putting it off because you're dreading the experience. You imagine yourself walking into a mattress store, looking at a sea of mattresses, being approached by a pushy salesperson, and trying to pick out a mattress by laying on several mattresses for a few minutes in the store. You're also dreading trying to get whatever you buy up to your second floor apartment.

Then you hear about Casper. Casper is a direct-to-consumer mattress company that sells mattresses and other sleep products online. Its tagline is "One Perfect Mattress." True to its word, it sells only one mattress in six different sizes two of which are the queen and king sizes. At the time this case was written (spring 2017), Casper was selling a queen-size mattress for $950 and a king-size mattress for $1,150. If you buy one of Casper's mattresses, it will be shipped to you in a vacuum-sealed box about the size of a mini-fridge. When you open the box, the mattress will roll out in front of you. If you'd like to know more about Casper before you buy, there are hundreds of Casper reviews and unboxing videos on YouTube, some of which have gone viral. And if you become a Casper customer, don't expect to buy the mattress and never hear from the company again. In Casper's view, you've just become part of the Casper sleep products' family.

The Beginning

In 2013, Philip Krim, Jeff Chapin, Luke Sherman, Gabriel Flateman, and Neil Parikh met at a coworking space in New York City. They got to talking about sleep, partly because sleep seemed to be on people's minds and partly because they kept seeing people fall asleep in beanbag chairs. One person in the group threw out the idea of building a perfect mattress, which spurred the discussion along. At that time, they were all working on different business ideas, but informally started investigating sleep and whether it was possible to build a perfect mattress. They were also struck by the fact that the mattress industry in the United States is a $14 billion dollar a year industry.

The discussions continued and the group reached several conclusions. First, no one liked buying mattresses. It was a process that most people found frustrating and confusing—too many choices, too many price points, too many pushy salespeople, too much buyers' remorse. Second, many of the products on the market had gratuitous upgrades, such as elaborate labeling and fancy stitching in the corners, which had nothing to do with the quality of the owners' sleep. It seemed the only purpose was to push up the price. And third, the large margins in the industry made it ripe for disruption. This combination of factors caused the group to see an opportunity. What if they could remove the frustrations with the mattress buying process, and at the same time build a mattress that everyone would like?

The opportunity was compelling enough that all members of the group set aside what they were working on and committed to it full time. They decided to start a company and called it Casper.

Learning about the Mattress Industry

The first order of business was validating their assumptions by learning as much as they could about the mattress industry. This task involved studying the industry and talking to customers. Two of the cofounders had previous mattress experience, which helped. Krim had sold mattresses in college and Chapin spent 10 years at Ideo, a design firm in the Silicon Valley. One of his projects involved mattresses.

Studying the Mattress Industry

The group started by studying the mattress industry, including environmental trends and business trends. In regard to environmental trends, there was growing interest in sleep. Many of the fitness trackers on the market, for example, allowed their users to keep track of their sleep, and drew attention to the importance of a restful night's sleep. They also looked at business trends, particularly in the areas of marketing and branding. The marketing for mattresses consisted primarily of splashy ads and loud commercials promising deep discounts. A little digging revealed that the deep discounts were possible because the margins were huge to begin with. Most of the branding was directed towards baby boomers rather than millennials. The only logical reason for this is that the margins are higher on high-priced mattresses, which baby boomers can afford. They also learned two insightful things. First, for most people buying a mattress, it is considered to be a purchase for the long term. They realize that the mattress they buy is something that they'll sleep on for 5–10 years, so they spend time researching mattresses and take the process seriously. Ironically, they also found out that mattress buyers suffer from a high degree of buyers' remorse. Regardless of the research they've done, when they get the mattress they bought home they often wonder if they made the right choice.

Talking to Customers

The five cofounders also spent time talking to mattress buyers. They discovered two things. First, as they suspected, people disliked the mattress buying process. They didn't like mattress stores, didn't enjoy interacting with commissioned salespeople, and found the choices to be confusing. Second, once they got a new mattress home, many people were dissatisfied. It either slept hot, was so bouncy you could feel your partner move during the night, was too soft or too hard, and so forth. Many people felt, in retrospect, that lying on a mattress for a few minutes in a store was a poor predictor of how comfortable it would be for an entire night. People also frequently felt that once they brought their mattress home it felt different than it did in the store.

Both of these pursuits, studying the industry and talking to customers, emboldened the group. They felt the mattress industry was ripe for disruption on two levels: the mattress buying process and the mattress itself as a product.

Designing the Mattress and the Redesigning of the Mattress Buying Process

At this point the group moved forward on two fronts: Designing the Casper mattress and redesigning the mattress buying process and the experience resulting from it. The tagline for the company, as mentioned earlier, was "One Perfect Mattress." The founders say the tagline, and what it implies, directed their efforts in both areas.

Designing the Casper Mattress

The design of the mattress was informed by the earlier interviews. One thing the interviews revealed is that people don't actually want the variety of choices that are offered to them. If you think about hotels, for example, most have a single mattress that the majority of guests are happy with. So they decided to remove the complication of choice and build a single mattress. To be successful, they knew the mattress had to meet two tests: it had to be comfortable for everyone and the aesthetics had to be acceptable to everyone. They built prototypes to show to potential users, testing different materials and different levels of firmness. They even built several king- and queen-sized mattresses that had different levels of firmness on each side of the mattress so the user could compare the levels of firmness side-by-side. Through

Steve Jennings/Stringer/Getty Images

A Casper mattress on display for customers to try out and enjoy at a Casper promotional event in San Francisco.

the testing they were able to arrive at a mattress design that most people liked. They then built prototypes of this specific design and tested them again with a group of beta testers, iterating on the additional feedback they received.

Redesigning the Mattress Buying Experience

The team also focused heavily on the mattress buying experience. Through earlier customer interviews and their own experiences, they knew that there were at least five things people didn't like about the mattress buying experience: too many choices, too many price points, too many pushy salespeople, too much buyers' remorse, and mattresses that are difficult to handle and get home. They addressed these frustrations one-by-one and designed what would become the Casper mattress buying experience. Casper would sell a single mattress. There would be several sized mattresses (single, queen, king, etc.) but there would only be one mattress to choose from. There would also be only one price point for each sized mattress. The mattresses would be sold strictly online, so there wouldn't be any pushy salespeople. And in regard to buyers' remorse, Casper would offer a 100 night guarantee. If you bought a Casper mattress and didn't like it for any reason, you would get a full refund. You wouldn't even need to put it in a box and send it back. Casper would send someone to your home or apartment to pick it up.

In regard to handling the mattress and getting it home, the mattress the Casper ended up with is made from a special blend of four types of foam: comfort foam (which provides support, cooling, and bounce), memory foam (which provides support and comfort), transition foam (which provides deep comfort through consistent weight distribution), and support form (which provides additional support). An advantage of this configuration of materials is that the mattress could be packed in a box about the size of a mini-fridge, making it easier and cheaper to ship than other mattresses and simpler to move into a house or apartment. On-demand delivery would be available in New York City, where Casper was headquartered, meaning a customer could get a mattress the same day they ordered it. It could be shipped in three to five days elsewhere. Once unboxed, the mattress would be stylish yet simple. It would dress up a room, but would not clash with the décor or furniture.

The nearby table sums up Casper's redesign of the mattress buying experience.

Casper's Redesign of the Mattress Buying Experience

What People Don't Like about the Mattress Buying Experience	*Casper's Redesign*
Too many choices	Casper sells a single mattress in six different sizes. The company tagline is "One Perfect Mattress."
Too many price points	Casper offers one price for each size mattress.
Pushy commissioned salespeople	Casper sells only online.
Buyers' remorse	Casper offers a 100 night full-refund guarantee.
Mattresses are difficult to handle and get home.	Casper's mattresses are delivered via UPS in a mini-fridge–sized box. Same day delivery is available in New York City.

Launch and Fast Growth

Based on the strengths of its tests, Casper was able to raise a seed round of $1.85 million in January 2014. On April 22, 2014, its mattress became available for sale. Casper sold $1 million worth of product in the first 28 days. Sales remained strong and the company was able to raise additional funding in August 2014. In November 2014, Casper expanded its delivery from the contiguous United States to Canada.

Several things happened that caused Casper's sales to take off, some of which Casper planned for and some of which it didn't. First, a large number of people were involved in Casper's initial testing. These people were serious about sleep, and many became Casper evangelists, posting positive comments on social media or speaking out in other ways. Second, about half the people who bought a Casper mattress talked to someone in-house, via the toll free number displayed prominently on the company's website. They would ask questions like "Do I need a box spring?" (No). Casper used the occasions to learn about its customers, and kept in touch. Third, a trend started early on, which wasn't planned, of people posting Casper mattress "unboxing" videos online. These are short videos of people that have just received their Casper mattress and film themselves taking the mattress out of the box. Several of the videos went viral, which spread the word about the company. If you'd like to see one of the videos, go to YouTube and type in "Casper mattress unboxing." You'll find many examples to pick from. Finally, Casper did conventional advertising and PR.

Along with these factors, Casper's approach worked. Its big bet—that people would accept the fact that it sold a single mattress and would buy mattresses online—resonated. The company reportedly sold $30 million worth of mattresses in its first 14 months. Other estimates report sales of $100 million in 2015 and $200 million in 2016.

Opportunities and Challenges Ahead

From the beginning, Casper saw itself as a sleep products company rather than a mattress company. As soon as it launched, it started prototyping and testing additional sleep-related products. It added pillows and sheets in early 2016. True to form, it offers a single pillow, priced at $75. The Casper pillow, like the mattress, has a 100 night guarantee. There are also limited choices for the sheets. In late summer 2016, Casper launched its fourth product—The Casper Dog Mattress. According to Casper, the company spent 11 months conducting canine sleep studies, consulting with dog psychologists and building prototypes. The result is a dog mattress that sells for $125 and promises "to create a sleep environment that caters to dogs' natural behaviors." The dog mattress reflects the somewhat whimsical nature of Casper and its founders. Commenting on the dog mattress, Casper cofounder Neil Parikh told *Fast Company* magazine that the dog mattress provides the company an opportunity "to (show) people how we think—to remind them that, 'Hey, here is a cool group of people that thinks in an interesting way."' According to reports, the dog mattress is selling briskly. In addition to adding products, Casper has been expanding internationally. Its products are now shipped to Germany, Austria, Switzerland, and the United Kingdom in addition to Canada.

Casper also has challenges. Its innovative approach has attracted several competitors. These include Yogabed, Tuft & Needle, Leesa, and Saatva. Tuft & Needle, for example, offers a similar buying experience as Casper, at a lower price point. Crunchbase says that Tuft & Needle is the #1 selling mattress on Amazon.com. The company claims to have 10,000+ reviews with a perfect score of five stars.

Casper is poised to add additional products and markets to its offerings.

Discussion Questions

5-45. To what degree do you think Casper has disrupted the mattress industry? To what degree did Casper's research about the mattress buying process resonate with you? Would you buy a Casper mattress? Why or why not?

5-46. How has Casper established a unique position in the mattress industry? To what degree do you think its unique position is the basis of its early success?

5-47. Are you surprised that Casper was able to generate so much excitement surrounding the process of buying a mattress? How did the company do that? Do you think the level of excitement and passion for buying a mattress could be translated to other non-tech industries?

5-48. Why do you think Casper added a dog mattress? What other sleep-related products do you think Casper has in its pipeline?

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ESSAY QUESTIONS

1. As explained in Case 4.2, TOMS developed a one-for-one business model that serves as the foundation for how this company creates value and delivers value to its stakeholders, including customers. In this chapter, we studied rivalry among existing firms as one of five forces with the potential to reduce the ability of firms to operate profitability within a particular industry. Visit TOMS' website and consult other sources as well (e.g., business periodicals) to learn about TOMS' rivals or competitors. Refer to the factors associated with rivalry among existing firms (the number and balance of competitors, the degree of difference between products, the industry's growth rate, and the level of fixed costs) that were discussed in this chapter. Use the insights you gather about TOMS in terms of these factors to write several paragraphs to assess the degree to which competitive rivalry in TOMS' industry may damage the ability of firms, including TOMS, to earn profits.
2. Casper Mattress is the subject of Case 5.2. Study various sources including Casper's website and industry publications to identify who you believe are this firm's *direct competitors*, its *indirect competitors*, and its potential *future competitors.* Of the competitors you identify in each category, which one is the most serious competitive threat to Casper Mattress and why?

Endnotes

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Getting Personal with ATHLETIC PROPULSION LABS

Athletic Propulsion Lab/Photo Credit: Ryan Goldstar

Cofounders

RYAN GOLDSTON

BBA, Entrepreneurship, Finance & Marketing, University of Southern California, 2009

ADAM GOLDSTON

BS, Sociology, University of Southern California, 2009

Dialogue *with* Adam Goldston

FAVORITE BAND ON MY SMARTPHONE LIST

Young Jeezy

BEST ADVICE I'VE RECEIVED

Better to ask for forgiveness than for permission

MY ADVICE FOR NEW ENTREPRENEURS

Invest in yourself

MY BIGGEST WORRY AS AN ENTREPRENEUR

Not maximizing every opportunity

BEST PART OF BEING A STUDENT

Free time and the environment

MY FAVORITE SMARTPHONE APP

Instagram

CHAPTER 6

Writing a *Business* Plan

OPENING PROFILE

ATHLETIC PROPULSION LABS

How Athletic Propulsion Labs Benefited from Writing a Business Plan

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If your instructor is using MyLab Entrepreneurship, visit **www.pearson.com/mylab/entrepreneurship** for videos, simulations, and writing exercises.

• *Web: www.athleticpropulsionlabs.com* • *Facebook: Athletic Propulsion Labs* • *Twitter: @APLbasketball*

Ryan and Adam Goldston, who are twins, have been around the athletic shoe industry their entire lives. Their dad, Mark Goldston, oversaw the creation of the Reebok Pump, and in the 1990s led L.A. Gear, the shoe company that created L.A. Lights. L.A. Lights were kids' shoes that had small LED lights in the soles that would flash brilliantly when the wearer walked. In high school, Ryan and Adam played basketball on their high school team and on travel squads, and joined the USC basketball team when they entered college. At six feet tall, they were undersized, so they were at a disadvantage. They learned early on that what basketball players wanted the most from athletic shoes was more bounce. So they set out to create a pair of shoes that could provide them a few extra inches of jump.

The pair spent their undergraduate years trying to create a footwear mechanism that enabled the wearer to jump higher. They bounced ideas off their father, and created prototypes at their dorm room table. The idea was to create technology that would be present in the front portion of a shoe and would capture the energy created when the wearer stepped down into the shoe, and would then release the energy when the wearer's foot came up to increase vertical leap. They named their proprietary technology the "Load 'N Launch" spring device.

During their time as university students, Ryan was in business school and Adam was majoring in sociology. Ryan took an entrepreneurship course and wrote a business plan around the athletic shoe ideas on which he and his brother were working. The plan had three essential elements: the shoes would be sold for $300 or more, (2) they would be sold exclusively through their own website, and (3) the shoes would make the wearer jump higher instantly. When he presented the plan in class, the professor and class didn't buy it. The feedback was that $300 was way too high, athletic shoes need to be sold via brick and mortar retail outlets, and the claim that the shoes would enable the wearer to jump higher instantly was met with skepticism. Looking back, Ryan doesn't blame his professor and classmates for the adverse feedback. He admits his business plan was unconventional and forward-thinking. He also believes that the process of writing the plan was valuable. He has said that "there is a different level of mastery when you put something on paper." He has also said that "when a young company has limited resources, a (business plan) helps keep it on track." Two years after Ryan and Adam left school, and Athletic Propulsion Labs (APL), the name they gave their company, was

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain the purpose of a business plan.
2. Describe who reads a business plan and what they are looking for.
3. Discuss the guidelines to follow to write an effective business plan.
4. Identify and describe a suggested outline of a business plan.
5. Explain how to effectively present a business plan to potential investors.

fully up-and-running, Ryan was invited back to the same class to talk to the students. His professor gave him kudos for executing a business plan of which he was initially skeptical. One person in Ryan's business school who was a believer from the start was Dean James Ellis. Ryan approached the Dean and explained his idea. After the initial explanation, he was an advocate from the beginning.

At the time Ryan was in business school, Adam was studying sociology. He doesn't regret that decision, and says that studying sociology provided him insight into how people and groups behave, which has been valuable for his company. He also believes that his understanding of sociology coupled with Ryan's knowledge of business has resulted in the two of them having complementary rather than redundant skills. One of Adam's specialties is social media. He credits his sociology background with preparing him to hone his social media skills.

Adam and Ryan formed APL two months before they graduated from USC in 2009. In 2010, they introduced their first shoe, the Concept 1, which was a basketball shoe. To obtain publicity, they tried to get the NBA interested in the shoe. They flew to New York City to pitch the shoe. They received an e-mail from the NBA, and instead of approving the shoe, the NBA banned it saying that the shoe provided an undue competitive advantage. Ryan took the e-mail to a professor on the USC campus who owned a PR firm to help form a response. As it turned out, rather than being a negative, the fact that the NBA banned the shoe because it provided an undue competitive advantage turned out to create enormous positive buzz for the company. It was the #1 news story in the United States on October 19, 2010. APL was one of the most heavily searched terms on Google. One million articles—worldwide—were published about the NBA ban. Needless to say, the ban and its media exposure accelerated sales. APL sold nine months of inventory in just three days. The company's website eventually crashed and it took eight hours—and eight servers—to get it up and running again. APL was off to the races.

Since that time, APL has experienced continuous growth. The company's product line has expanded and its shoes are now sold online and around the world in high-end retail outlets such as Barney's, Saks Fifth Avenue, and Net-a-Porter. The company's shoes are known for superior athletics and trendsetting fashion. All of APL's shoes have cushioned midsoles to help generate energy. Select shoes have the Load 'N Launch technology first worked on in Adam and Ryan's dorm room at USC. Adam and Ryan have received some nice personal honors. In 2016, the two were named to the *Forbes* "30 under 30" list in the Retail and E-commerce category.

Recently, Ryan was cleaning out his apartment and ran across a business plan for APL—it was the plan that was presented in the entrepreneurship class, the original plan with the grade visible. While some things have changed, Ryan was struck by the fact that today APL is essentially the same company described in the original plan.

This chapter discusses the importance of writing a business plan. Although some new ventures simply "wing it" and start doing business without the benefit of formal planning, it is hard to find an expert who doesn't recommend preparing a business plan. A **business plan** is a written narrative, typically 25 to 35 pages long, that describes what a new business intends to accomplish and how it intends to accomplish it. For most new ventures, the business plan is a dual-purpose document that is used both inside and outside the firm. Inside the firm, the plan helps the company develop a "road map" to follow to execute its strategies and plans. Outside the firm, it introduces potential investors and other stakeholders to the business opportunity the firm is pursuing and how it plans to pursue it.[1]

To begin this chapter, we discuss issues with which entrepreneurs often grapple when facing the challenge of writing a business plan. Topics included in the first section are the reasons for writing a business plan, a description of who reads the business plan and what they are looking for, and guidelines to follow when preparing a written business plan. In the second section, we present an outline of a business plan with a description of the material in each section of the plan. Section three deals with strategies for presenting the business plan to potential investors and others.

The Business Plan

LEARNING OBJECTIVE

1. Explain the purpose of a business plan.

As illustrated in the basic model of the entrepreneurial process shown in Chapter 1, writing a business plan is the last activity completed in the step of the entrepreneurial process titled "Developing Successful Business Ideas." It is a mistake to write a business plan too early. The business plan must be substantive enough and have sufficient details about the merits of the new venture in order to convince the reader that the new business is exciting and should receive support. Much of this detail is accumulated in the feasibility analysis stage of investigating the merits of a potential new venture.

In spite of conventional wisdom suggesting the need to do so, a relatively large percentage of entrepreneurs do not write business plans for their new ventures. In fact, a 2015 Wells Fargo/Gallup Small Business Index Survey found that only 33 percent of business owners have a formal business plan.[2] This statistic is similar to The Hartford's 2011 Small Business Success Study, which found that 35 percent of small businesses have business plans.[3] These statistics should not deter an entrepreneur from writing a business plan. Indeed, ample evidence supports the notion that writing a business plan is an extremely good investment of an entrepreneur's time and money. The Wells Fargo/Gallup Small Business Index Survey found that businesses that have a business plan have significantly higher expectations for the years ahead than those without. It also found that the businesses with a business plan were more likely to report that in the next 12 months they expected to increase employment, grow revenues, increase capital spending, and apply for new credit than companies without a business plan.[4]

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This group of young entrepreneurs plans to launch a website that will feature "game day" apparel products for college students. Here, they are discussing how to integrate the results of their feasibility analysis into their business plan. A business plan is more compelling if it contains primary research conducted by the entrepreneurs launching the business.

Reasons for Writing a Business Plan

We show the two primary reasons to write a business plan in Figure 6.1. First, writing a business plan forces a firm's founders to systematically think through each aspect of their new venture.[5] This is not a trivial effort—it usually takes several days or weeks to complete a well-developed business plan—and the founders typically meet regularly to work on the plan during this period. An example of how much work is sometimes involved, and how a well-planned new business unfolds, is provided by Gwen Whiting and Lindsey Wieber, the cofounders of The Laundress, a company that sells specially formulated laundry detergents and other fabric care products. Whiting and Wieber met at Cornell University while studying fabrics, and after graduating the pair decided to start a business. The following vignette comes from an interview they gave to Ladies Who Launch, a website that highlights the accomplishments of female entrepreneurs:

> *Gwen*: Lindsey and I went to college and studied textiles at Cornell together and always wanted to be in business together. We knew it was going to happen. We always talked about ideas. We were talking about this concept, and it was the right time for us. The first thing we did was the business plan and then a cash flow analysis. We wanted to do as much research as possible before developing the products.
>
> *Lindsey*: We spent Memorial Day weekend (2003) doing our business plan. We spent the Fourth of July weekend doing our cash flow. After we had our ideas on paper, we went back to Cornell, met with a professor there, and had a crash course in chemistry. She worked with us on the formulation of the products.
>
> *Gwen*: I found a manufacturer on Columbus Day. Every piece of free time we had, we dedicated to the business. We weren't at the beach with our friends anymore.[6]

The payoff for this level of dedication and hard work, which involved the preparation of a formal business plan, is that Whiting and Wieber have now had a successful business for 13-plus years. Their products are sold through their website and in many stores.

Consistent with Whiting and Wieber's experience, writing a business plan forces a firm's founders to intently study every aspect of their business, a process that's hard to replicate in any other way. Imagine the following scenario. Two friends are thinking about opening a seafood restaurant. They spend the next two months conducting a feasibility analysis and hashing out every detail of the business. They identify their target market, develop a preliminary menu and a drawing of what the restaurant will look like, talk to potential customers, develop a marketing plan, settle on a hiring schedule, identify the type of people they want to employ, plan their facility, determine what their start-up expenses will be, and put together five years of pro forma (projected) financial statements. After 18 meetings and talking to 100 potential customers, they produce a 30-page business plan that explains every aspect of their business.

FIGURE 6.1
Two Primary Reasons for Writing a Business Plan

Regardless of how conscientious the founders of a business are, it is difficult to find the internal discipline to cover this level of detail absent writing a business plan. As stated earlier, writing a business plan forces a business' founders to systematically think through every aspect of their business and develop a concrete blueprint to follow.

The second reason to write a business plan is to create a selling document for a company. It provides a mechanism for a young company to present itself to potential investors, suppliers, business partners, key job candidates, and others. Imagine that you have enough money to invest in one new business.[7] You chat informally with several entrepreneurs at a conference for start-ups and decide that there are two new ventures that you would like to know more about. You contact the first entrepreneur and ask for a copy of his business plan. The entrepreneur hesitates a bit and says that he hasn't prepared a formal business plan but would love to get together with you to discuss his ideas. You contact the second entrepreneur and make the same request. This time, the entrepreneur says that she would be glad to forward you a copy of a 28-page business plan, along with a 10-slide PowerPoint presentation that provides an overview of the plan. An hour or two later, the PowerPoint presentation is in your e-mail inbox with a note that the business plan will arrive the next morning. You look through the slides, which are crisp and to the point and do an excellent job of outlining the strengths of the business opportunity. The next day, the business plan arrives just as promised and is equally impressive.

Which entrepreneur has convinced you to invest in his or her business? All other things being equal, the answer is obvious—the second entrepreneur. The fact that the second entrepreneur has a business plan not only provides you with detailed information about the venture but also suggests that the entrepreneur has thought through each element of the business and is committed enough to the new venture to invest the time and energy necessary to prepare the plan. Having a business plan also gives an investor something to which she or he can react. Very few, if any, investors will free up time to "listen" to your idea for a new business, at least initially.

Who Reads the Business Plan—and What Are They Looking For?

LEARNING OBJECTIVE

2. Describe who reads a business plan and what they are looking for.

There are two primary audiences for a firm's business plan.[8] Let's look at each of them.

A Firm's Employees

A clearly written business plan, one that articulates a firm's vision and future, is important for both the management team and the rank-and-file employees. Some experts argue that it is a waste of time to write a business plan because the marketplace changes so rapidly that any plan will become quickly outdated. Although it is true that marketplaces can and often do change rapidly, the process of writing the plan may be as valuable as the plan itself.

A clearly written business plan also helps a firm's rank-and-file employees operate in sync and move forward in a consistent and purposeful manner. The existence of a business plan is particularly useful for the functional department heads of a young firm. For example, imagine that you are the newly hired vice president for management information systems for a rapidly growing start-up. The availability of a formal business plan that talks about all aspects of the business and the business's strategies and goals can help you make sure that what you are doing is consistent with firm's overall direction.

Investors and Other External Stakeholders

External stakeholders who are being recruited to join a firm, such as investors, potential business partners, and key employees, are the second audience for a business plan. To appeal to this group, the business plan must be realistic and not reflective of overconfidence on the firm's part. Overly optimistic statements or projections undermine a business plan's credibility, so it is foolish to include them. At the same time, the plan must clearly demonstrate that the business idea is viable and offers potential investors financial returns greater than lower-risk investment alternatives. The same is true for potential business partners, customers, and key recruits. Unless the new business can show that it has impressive potential, investors have little reason to become involved with it.

Investors vary in terms of the reliance they place on formal business plans.[9] Initially, many investors ask for a PowerPoint deck or the executive summary of a business plan. A PowerPoint deck is a short set of PowerPoint slides that describe a business idea, and an executive summary is a one- to two-page overview of the full plan. If their interest is sufficiently piqued, in some cases investors will ask for a full business plan, and in other cases they won't. It is still necessary to have a business plan, however. If an investor commits, in most cases a business plan will be required during the due diligence phase.[10] Due diligence refers to the process investors go through after they tentatively commit to an investment.[11] The commitment is based on a thorough investigation of the merits of the venture, whether any legal complications exist, and whether the claims made in the business plan are accurate and realistic.

A firm must validate the feasibility of its business idea and have a good understanding of its competitive environment prior to presenting its business plan to others. Sophisticated investors, potential business partners, and key recruits will base their assessment of a proposed firm's future prospects on facts, not guesswork or platitudes, as emphasized in Chapter 3. The most compelling facts a company can provide in its business plan are the results of its own feasibility analysis and the articulation of a distinctive and competitive business model. A business plan rings hollow if it is based strictly on an entrepreneur's predictions of a business's future prospects. Rent the Runway, which rents rather than sells designer dresses, is an example of a business that laid a firm foundation for its business plan via the feasibility analysis that it conducted very early on. Rent the Runway is the focus of Case 3.1.

In addition to the previously mentioned attributes, a business plan should disclose all resource limitations that the business must address before it is ready to start earning revenues. For example, a firm may need to hire service people before it can honor the warranties for the products it sells. It is foolhardy for a new venture to try to downplay or hide its resource needs. One of the main reasons new ventures seek out investors is to obtain the capital needed to hire key personnel, further develop their products or services, lease office space, or fill some other gap in their operations. Investors understand this, and experienced investors are typically willing to help the firms they fund plug resource or competency gaps.

Guidelines for Writing a Business Plan

LEARNING OBJECTIVE

3. Discuss the guidelines to follow to write an effective business plan.

There are several important guidelines that should influence the writing of a business plan. It is important to remember that a firm's business plan is typically the first aspect of a proposed venture that an investor will see. If the plan is incomplete or looks sloppy, it is easy for an investor to infer that the venture itself is incomplete and sloppy.[12] It is important to be sensitive to the structure, content, and style of a business plan before sending it to an investor or anyone else who may be involved with the new firm. Table 6.1 lists some of the "red

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The business plan is often the first aspect of a proposed venture that an investor will see. Make sure it is sharp, free of typos and other errors, and is visually appealing.

flags” that are raised when certain aspects of a business plan are insufficient or miss the mark.

Structure of the Business Plan

To make the best impression, a business plan should follow a conventional structure, such as the outline shown in the next section. Although some entrepreneurs want to demonstrate creativity in everything they do, departing from the basic structure of the conventional business plan format is usually a mistake. Typically, investors are very busy people and want a plan where they can easily find critical information. If an investor has to hunt for something because

TABLE 6.1 Red Flags in Business Plans

Red Flag	Explanation
Founders with none of their own money at risk	If the founders aren’t willing to put their own money at risk, why should anyone else?
A poorly cited plan	A plan should be built on hard evidence and sound research, not guesswork or what an entrepreneur “thinks” will happen. The sources for all primary and secondary research should be cited.
Defining the market size too broadly	Defining the market for a new venture too broadly shows that the true target market has not been clearly identified. For example, saying that a new venture will target the music industry isn’t helpful. The market opportunity needs to be better defined. Obviously, the new venture will target a segment or a specific market within the industry.
Overly aggressive financials	Many investors skip directly to this portion of the plan. Projections that are poorly reasoned or unrealistically optimistic lose credibility. In contrast, sober, well-reasoned statements backed by sound research and judgment gain credibility quickly.
Sloppiness in any area	It is never a good idea to make a reader wade through typos, balance sheets that don’t balance, or sloppiness in any area. These types of mistakes are seen as inattention to detail and hurt the entrepreneur’s credibility.

it is in an unusual place or just isn't there, he or she might simply give up and move on to the next plan.[13]

Many software packages are available that employ an interactive, menu-driven approach to assist in the writing of a business plan. Some of these programs are very helpful.[14] However, entrepreneurs should avoid a boilerplate plan that looks as though it came from a "canned" source. The software package may be helpful in providing structure and saving time, but the information in the plan should still be tailored to the individual business. Some businesses hire consultants or outside advisers to write their business plans. Although there is nothing wrong with getting advice or making sure that a plan looks as professional as possible, a consultant or outside adviser shouldn't be the primary author of the plan. Along with facts and figures, a business plan needs to project a sense of anticipation and excitement about the possibilities that surround a new venture—a task best accomplished by those who created the business.[15]

Content of the Business Plan

The business plan should give clear and concise information on all the important aspects of the proposed new venture. It must be long enough to provide sufficient information, yet short enough to maintain reader interest. For most plans, 25 to 35 pages (and typically closer to 25 than 35 pages) are sufficient. Supporting information, such as the résumés of the founding entrepreneurs, can appear in an appendix.

After a business plan is completed, it should be reviewed for spelling, grammar, and to make sure that no critical information has been omitted. There are numerous stories about business plans sent to investors that left out important information, such as significant industry trends, how much money the company needed, or how the money was going to be used. One investor even told the authors of this book that he once received a business plan that didn't include any contact information for the entrepreneur. This was a shame, because the investor was interested in learning more about the business idea.[16]

Style or Format of the Business Plan. The plan's appearance must be carefully thought out. It should look sharp but not give the impression that a lot of money was spent to produce it. Those who read business plans know that entrepreneurs have limited resources and expect them to act accordingly. A plastic spiral binder including a transparent cover sheet and a back sheet to support the plan is a good choice. When writing the plan, avoid getting carried away with the design elements included in word-processing programs, such as boldfaced type, italics, different font sizes and colors, clip art, and so forth. Overuse of these tools makes a business plan look amateurish rather than professional.[17]

One of the most common questions the writers of business plans ask is, "How long and detailed should it be?" The answer to this question depends on the type of business plan that is being written. There are three types of business plans, each of which has a different rule of thumb regarding length and level of detail. Presented in Figure 6.2, the three types of business plans are as follows:

- **Summary plan** A **summary business plan** is 10 to 15 pages and works best for companies that are very early in their development and are not prepared to write a full plan. The authors may be asking for funding to conduct the analysis needed to write a full plan. Ironically, summary business plans are also used by very experienced entrepreneurs who may be thinking about a new venture but don't want to take the time to write a full business plan. For example, if someone such as Drew Houston, the cofounder of Dropbox, was thinking about starting a new business, he might write a summary business plan and send it to selected investors to

FIGURE 6.2
Types of Business Plans

get feedback on his idea. Most investors know about Houston's success with Dropbox, the free file hosting service that was founded in 2007, and don't need detailed information.

- **Full business plan** A **full business plan** is typically 25 to 35 pages long. This type of plan spells out a company's operations and plans in much more detail than a summary business plan, and it is the format that is usually used to prepare a business plan for an investor.
- **Operational business plan** Some established businesses will write an **operational business plan**, which is intended primarily for an internal audience. An operational business plan is a blueprint for a company's operations. Commonly running between 40 and 100 pages in length, these plans can obviously feature a great amount of detail that provides guidance to operational managers.

If an investor asks you for a PowerPoint deck or the executive summary of your business plan rather than the complete plan, don't be alarmed—this is a common occurrence. If the investor's interest is piqued, he or she will ask for more information. Most investors believe the process of writing a full business plan is important, even if they don't ask for one initially. This sentiment is affirmed by Brad Feld, a venture capitalist based in Boulder, CO, who wrote:

> Writing a good business plan is hard. At one point it was an entry point for discussion with most funding sources (angels and VCs). Today, while a formal business plan is less critical to get in the door, the exercise of writing a business plan is incredibly useful. As an entrepreneur, I was involved in writing numerous business plans. It's almost always tedious, time consuming, and difficult but resulted in me having a much better understanding of the business I was trying to create.[18]

A cover letter should accompany a business plan that is sent to an investor or other stakeholders. The cover letter should briefly introduce the entrepreneur and clearly state why the business plan is being sent to the individual receiving it. As discussed in Chapter 10, if a new venture is looking for funding, a poor strategy is to obtain a list of investors and blindly send the plan to everyone on the list. Instead, each person who receives a copy of the plan should be carefully selected on the basis of being a viable investor candidate.

Recognizing the Elements of the Plan May Change A final guideline for writing a business plan is to recognize that the plan will usually change as it is being written and as the business evolves. New insights invariably emerge when entrepreneurs immerse themselves in writing the plan and start receiving feedback from others. This process continues throughout the life of a company, and it behooves entrepreneurs to remain alert and open to new insights and ideas.

Because business plans usually change while being written, there is an emerging school of thought that opposes the idea of writing a business plan and advocates experimentation and trial-and-error learning gleaned through customer feedback over formal planning.[19] This approach, which is associated with the Lean Startup movement, espouses many excellent ideas, particularly in the area of soliciting feedback directly from prospective customers prior to settling on a business idea and business model to execute on the idea. In this book, we take the opposite position, arguing that a business plan, preceded by a feasibility analysis, represents an important starting point for a new venture and serves many useful purposes. In this sense, those developing a business plan should understand that it is not intended to be a static document written in isolation at a desk. Instead, it is anticipated that the research conducted to complete the plan, and the preceding feasibility analysis, will place the founders in touch with potential customers, suppliers, business partners, and others, and that the feedback obtained from these key people will cause the plan to change as it is being written.[20] It's also anticipated that the business itself will iterate and change after it is launched, based on additional feedback. Some businesses will change more than others, based on the quality of their initial feasibility analysis and the newness and volatility of their industry. These issues and related ones are considered in the nearby "Savvy Entrepreneurial Firm" feature.

Outline of the Business Plan

LEARNING OBJECTIVE

4. Identify and describe a suggested outline of a business plan.

A suggested outline of the full business plan appears in Table 6.2. Specific plans may vary, depending on the nature of the business and the personalities of the founding entrepreneurs. Most business plans do not include all the elements introduced in Table 6.2; we include them here for the purpose of completeness.

Exploring Each Section of the Plan

Cover Page and Table of Contents The cover page should include the company's name, address, and phone number; the date; the contact information for the lead entrepreneur; and the company's website address if it has one. The company's Facebook page and Twitter and Instagram names can also be included. The contact information should include an e-mail address, a smartphone number, and a landline number if you have one. This information should be centered at the top of the page. Because the cover letter and the business plan could get separated, it is wise to include contact information in both places. The bottom of the cover page should include information alerting the reader to the confidential nature of the plan. If the company already has a distinctive trademark, it should be placed somewhere near the center of the page. A table of contents should follow the cover letter. It should list the sections and page numbers of the business plan and the appendices.

Executive Summary The **executive summary** is a short overview of the entire business plan; it provides a busy reader with everything she needs to know about the new venture's distinctive nature.[21] As mentioned earlier, in many instances an investor will first ask for a copy of a firm's PowerPoint deck or executive summary and will request a copy of the full business plan only if the PowerPoint deck or executive summary is sufficiently convincing. Thus, certainly when requested, the executive summary arguably becomes the most important section of the business plan.[22] The most critical point to remember when writing an executive summary is that it is not an introduction or preface to the business plan; instead, it is meant to be a summary of the plan itself.

An executive summary shouldn't exceed two single-spaced pages. The cleanest format for an executive summary is to provide an overview of the business

SAVVY ENTREPRENEURIAL FIRM

Know When to Hold Them, Know When to Fold Them

Songkick: • Web: www.songkick.com • Facebook: Songkick • Twitter: @songkick
GrubHub: • Web: www.grubhub.com • Facebook: GrubHub • Twitter: @Grubhub
Instagram: • Web: www.instagram.com • Facebook: Instagram • Twitter: @instagram

One of the challenges business owners have is determining how closely to stick to their business plan once the business is launched and they start receiving customer feedback. In almost all cases, some changes will need to be made to the firm's plan. But the degree to which business plans pan out as their founders envisioned varies. In some cases, a business plan is spot-on and the worst thing a founder could do is vary from the plan. In other cases, a plan needs to be significantly tweaked, and in still other cases it needs to be thrown out the window and the business needs to start over. The following are brief descriptions of businesses that have experienced these various outcomes.

Songkick—No Changes Needed

Songkick was founded in 2007 by Pete Smith, Michelle You, and Ian Hogarth. The problem the company solves is music lovers missing out on seeing their favorite bands because they didn't know they were in their area. Concertgoers try to avoid this problem by subscribing to venue e-mail lists, checking band websites, and surfing through generic concert newsletters. This is a clumsy process and does not ensure that music fans won't miss a concert they would like to see. To solve this problem, Songkick indexes a large number of ticket vendors, venue websites, and local newspapers to create the most comprehensive database of upcoming concerts available. Its mission is to know about every concert that's happening in every location—from an indie band playing at a local nightclub to Beyoncé playing at Madison Square Garden. Users can track the performers they like, and Songkick will send them a personalized concert alert when those performers announce a tour date in their area. Songkick makes money by selling concert tickets on its website. While Songkick has enhanced its service offerings over the years, its business plan has remained unchanged. It now has millions of subscribers and is the largest business of its kind in the world.

GrubHub—Minor Change Needed

GrubHub began in 2004 as a simple restaurant listing website. The idea was to set up a website that listed all the restaurants that deliver to a particular user's home or office address. The initial business plan was based on a "freemium" pricing model. GrubHub would list restaurants for free and make money by charging a subscription fee for restaurants that wanted to be placed in a premium position on its website. The idea was that the restaurants placed in a premium position would get more orders from existing customers and would have a better chance of being "discovered" by new customers.

As time went on, GrubHub's founders realized that restaurants loved what they were doing, but weren't comfortable with paying up front for sales that might or might not happen. Its customers were clear that they only wanted to pay GrubHub when a GrubHub user placed an order. These insights prompted GrubHub to revise its business plan. The company switched from a subscription pricing model, where they charged restaurants for a premium place, to a transactional model where they collected a commission for each order placed. After the change was made, GrubHub saw a dramatic increase in restaurants asking to be placed on its website.

Instagram—Major Changes Needed

Instagram almost wasn't Instagram at all. Before Instagram became the photo-sharing hit that it is, cofounders Kevin Systrom and Mike Krieger were working on a check-in-service called Burbn, which was a location-based service similar to Foursquare. Users could check in to locations, earn points for hanging out with their friends, and share pictures inside the app. Systrom and Krieger worked on Burbn for over a year. It was completely done, had generated buzz, and had $500,000 in funding. The only problem—Systrom and Krieger didn't like it. To them it felt cluttered and overrun with features. They also worried about its competitiveness. Two similar services, Foursquare and Gowalla, already existed. They would have to fight it out with Foursquare and Gowalla for market share. So they stepped back and reconsidered. They concluded that the best approach was to pick a single feature and execute on it extremely well. So, they stripped Burbn down to the one group or feature they liked and felt they could contribute to the most. As it turned out, it was the photo-sharing, comment, and like capabilities. What was left was Instagram. Instagram is now a widely popular online photo-sharing, video-sharing, and social networking service that allows its users to take pictures and videos, and apply digital filters to them. Instagram was acquired by Facebook in 2012 for approximately $1 billion. As of December 2016, Instagram had 600 million active users.

Questions for Critical Thinking

1. Despite all the changes that have happened with the Internet since 2007, when Songkick was founded, why do you think the company has been able to successfully stick with its original business plan?
2. What do you think would have happened to GrubHub if it hadn't changed its business plan?

3. Why do you think some start-ups find it difficult to change their business plan, even when presented with evidence that their current business plan isn't working?
4. Look at the "You Be the VC" features at the end of Chapter 5, which focus on Little Riot and ZUtA Labs, and the "You Be the VC" features at the end of this chapter, which focus on Beyond Meat and Go-Jek. From the information in the features and on each company's website, which company do you think will have the easiest time sticking to its original business plan? Which company do you think will have the hardest time? Explain your selections.

Sources: Songkick Homepage, www.songkick.com (accessed February 21, 2017); GrubHub Homepage, www.grubhub.com, (accessed February 21, 2017); Instagram Homepage, https://instagram (accessed February 21, 2017); B. Barringer and R. D. Ireland, *Entrepreneurship: Successfully Launching New Ventures* 5th edition (Upper Saddle River, NJ: Pearson, 2016).

plan on a section-by-section basis. The topics should be presented in the same order as they appear in the business plan. Two identical versions of the executive summary should be prepared—one that is part of the business plan and one that is a stand-alone document. The stand-alone document should be used to accommodate people who ask to see the executive summary before they decide whether they want to see the full plan.

Even though the executive summary appears at the beginning of the business plan, it should be written last. The plan itself will evolve as it is written,

TABLE 6.2 Business Plan Outline

Cover Page
Table of Contents

I. Executive Summary

II. Industry Analysis
- Industry Size, Growth Rate, and Sales Projections
- Industry Structure
- Nature of Participants
- Key Success Factors
- Industry Trends
- Long-Term Prospects

III. Company Description
- Company History
- Mission Statement
- Products and Services
- Current Status
- Legal Status and Ownership
- Key Partnerships (if any)

IV. Market Analysis
- Market Segmentation and Target Market Selection
- Buyer Behavior
- Competitor Analysis
- Estimates of Annual Sales and Market Share

V. The Economics of the Business
- Revenue Drivers and Profit Margins
- Fixed and Variable Costs
- Operating Leverage and Its Implications
- Start-up Costs
- Break-Even Chart and Calculation

VI. Marketing Plan
- Overall Marketing Strategy
- Product, Price, Promotions, and Distribution
- Sales Process (or Cycle)
- Sales Tactics

VII. Design and Development Plan
- Development Status and Tasks
- Challenges and Risks
- Projected Development Costs
- Proprietary Issues (Patents, Trademarks, Copyrights, Licenses, Brand Names)

VIII. Operations Plan
- General Approach to Operations
- Business Location
- Facilities and Equipment

IX. Management Team and Company Structure
- Management Team (Including a Skills Profile)
- Board of Directors
- Board of Advisors
- Company Structure

X. Overall Schedule

XI. Financial Projections
- Sources and Uses of Funds Statement
- Assumptions Sheet
- Pro Forma Income Statements
- Pro Forma Balance Sheets
- Pro Forma Cash Flows
- Ratio Analysis

Appendices

so not everything is known at the outset. In addition, if you write the executive summary first, you run the risk of trying to write a plan that fits the executive summary rather than thinking through each piece of the plan independently.[23]

Industry Analysis The main body of the business plan begins by describing the industry in which the firm intends to compete. This description should include data and information about various characteristics of the industry, such as its size, growth rate, and sales projections. It is important to focus strictly on the business's industry and not its industry and target market simultaneously. Before a business selects a target market, it should have a good grasp of its industry—including where its industry's promising areas are and its points of vulnerability.

Industry structure refers to how concentrated or fragmented an industry is.[24] Fragmented industries are more receptive to new entrants than industries that are dominated by a handful of large firms. You should also provide your reader a feel for the nature of the participants in your industry. Issues such as whether the major participants in the industry are innovative or conservative and are quick or slow to react to environmental changes are the types of characteristics to convey. You want your reader to visualize how your firm will fit in or see the gap that your firm will fill. The key success factors in an industry are also important to know and convey. Most industries have 6 to 10 key factors in which all participants must establish competence as a foundation for competing successfully. Most participants try to then differentiate themselves by excelling in two or three areas. The key success factors are usually the competitive factors that are listed on the vertical axis of a firm's Competitive Analysis Grid, as explained in Chapter 5.

Industry trends should be discussed, including both environmental and business trends. The most important environmental trends are economic trends, social trends, technological advances, and political and regulatory changes. Business trends include issues such as whether profit margins in the industry are increasing or declining and whether input costs are going up or down. The industry analysis should conclude with a brief statement of your beliefs regarding the long-term prospects for the industry.

Company Description This section begins with a general description of the company. Although at first glance this section may seem less critical than others, it is extremely important in that it demonstrates to your reader that you know how to translate an idea into a business.

The company history section should be brief, but should explain the origin of the idea for the company and the driving force behind its inception. If the idea for the company is heartfelt, tell it. For example, LuminAid is a solar light company that was started by Andrea Sreshta and Anna Stork, two Columbia University students. Sresthta and Stork's product is an inflatable plastic bag, about the size of a small pillow that has a rectangular pouch in the middle. The pouch contains a solar panel, three LEDs, and a rechargeable battery. When inflated, the bag provides LED light, and can easily be recharged in the sun. Because the solar pillow is inflatable, it packs and ships flat. That provides it an advantage, particularly in a disaster situation. For every eight flashlights packed in a box, a total of 50 solar pillows could be placed into the same container. Sreshta and Stork's motivation to design the light was spurred by their concern for people affected by the earthquake that struck Haiti in 2010. They experienced firsthand how a disaster can negatively impact the lives of millions. One thing most disaster victims suffer from is a lack of light. The company's goal is to make the LuminAid light a part of the supplies commonly sent as part of disaster relief efforts.[25]

Sreshta and Stork's story is heartfelt and is one with which anyone can relate. It might even cause one to pause and think, "That is a fantastic idea.

That's just the type of solution that people recovering from a natural disaster like an earthquake need."

A **mission statement** defines why a company exists and what it aspires to become.[26] If carefully written and used properly, a mission statement can define the path a company takes, act as its financial and moral compass, and serve as an anchor around which decisions are made. Some businesses also include a tagline in their business plan. A **tagline** is a phrase that a business plans to use to reinforce its position in the marketplace. For example, Shyp's tagline is "We'll take it from here." Shyp, which is the subject of the "You Be the VC 1.1" feature, is a shipping service that picks up, packages, and ships items for individuals and businesses via the most affordable option available.

The products and services section should include an explanation of your product or service. Include a description of how your product or service is unique and how you plan to position it in the marketplace. A product or service's **position** is how it is situated relative to its rivals. If you plan to open a new type of smoothie shop, for example, you should explain how your smoothie shop differs from others and how it will be positioned in the market in terms of the products it offers and the clientele it attracts. This section is the ideal place for you to start reporting the results of your feasibility analysis. If the concept test, buying intentions survey, and library, Internet, and gumshoe research produced meaningful results, they should be reported here.

The current status section should reveal how far along your company is in its development. A good way to frame this discussion is to think in terms of milestones. A **milestone** is a noteworthy or significant event. If you have selected and registered your company's name, completed a feasibility analysis, developed a business model, and established a legal entity, you have already cleared several important milestones. The legal status and ownership section should indicate who owns the business and how the ownership is split up. You should also indicate what your current form of business ownership is (i.e., LLC, Subchapter S Corp., etc.) if that issue has been decided.We provide a full discussion of the different forms of business ownership in Chapter 7.

Market Analysis The market analysis is distinctly different from the industry analysis. Whereas the industry analysis focuses on the industry in which a firm intends to compete (e.g., toy industry, fitness center industry, men's clothing industry), the **market analysis** breaks the industry into segments and zeroes in on the specific segment (or target market) to which the firm will try to appeal. As mentioned in Chapter 3, most start-ups focus on servicing a specific target market within an industry.

The first task that is generally tackled in a market analysis is to segment the industry the business will be entering and then identify the specific target market on which it will focus. This is done through **market segmentation**, which is the process of dividing the market into distinct segments. Markets can be segmented in many ways, such as by geography (city, state, country), demographic variables (age, gender, income), psychographic variables (personality, lifestyle, values), and so forth. Sometimes a firm segments its market based on more than one dimension in order to drill down to a specific segment that the firm thinks it is uniquely capable of serving. For example, in its market analysis, GreatCall, the cell phone service provided especially for older people, probably segmented the cell phone market by age and by benefits sought. Some start-ups create value by finding a new way to segment an industry. For example, before Tish Ciravolo started Daisy Rock Guitar, a company that makes guitars for women, the guitar industry had not been segmented by gender. Daisy Rock Guitar's competitive advantage is that it makes guitars that accommodate a woman's smaller hands and build.

It's important to include a section in the market analysis that deals directly with the behavior of the consumers in a firm's target market. The more a start-up knows about the consumers in its target market, the more it can gear products or services to accommodate their needs. Many start-ups find it hard to sell products to public schools, for example, because purchase decisions are often made by committees (which draws out the decision-making process), and the funding often has to go through several levels of administrators before it can be approved. This complication was illustrated in the "What Went Wrong?" feature in Chapter 5, which focused on SharpScholar, a failed start-up in the educational technology space. A **competitor analysis**, which is a detailed analysis of a firm's competitors, should be included. We provided a thorough explanation of how to complete a competitor analysis in Chapter 5.

The final section of the market analysis estimates a firm's annual sales and market share. There are four basic ways for a new firm to estimate its initial sales. If possible, more than one method should be used to complete this task. The most important outcome is to develop an estimate that is based on sound assumptions and seems both realistic and attainable. We show the four methods entrepreneurs can use to estimate sales in Table 6.3.

The Economics of the Business This section begins the financial analysis of a business, which is further fleshed out in the financial projections. It addresses the basic logic of how profits are earned in the business and how many units of a business's product or service must be sold for the business to "break even" and then start earning a profit.

The major revenue drivers, which are the ways a business earns money, should be identified. If a business sells a single product and nothing else, it has one revenue driver. If it sells a product plus a service guarantee, it has

TABLE 6.3 The Four Methods for Estimating a New Firm's Initial Sales

Method	Explanation
Utilize the Multiplication Method	There are two approaches that fit this category. Start-ups that plan to sell a product on a national basis normally use a top-down approach. This involves trying to estimate the total number of users of the product, estimate the average price customers pay, and estimate what percentage of the market your business will garner. Start-ups that plan to sell locally normally use more of a bottom-up approach. This approach involves trying to determine how many customers to expect and the average amount each customer will spend.
Find a Comparable Firm	Find a comparable firm and ask for an estimate of annual sales. For example, if you are planning to open a women's clothing boutique, try to find a boutique that is similar to yours (and is not in your trade area) and simply call the owner and ask for a chance to talk to him or her about the business. Once a relationship has been established, you can ask for an estimate of the business' annual sales.
Contact Industry Trade Associations	Contact the premier trade associations in your industry and ask if they track the sales numbers for businesses that are similar to your business. If the trade association doesn't track actual sales numbers for comparable businesses, ask if there are other rules of thumb or metrics that help new companies estimate sales. For example, many industries collect statistics such as "average sales per square foot" or "average sales per employee" for firms in their industry.
Conduct Internet Searches	Internet searches often reveal magazine and newspaper articles as well as blog entries that focus on firms in your industry. On occasion, these articles and blog entries will talk about the sales experiences of a similar early-stage firm. If you know of a firm that is comparable to yours, target that firm first in your search. You may get lucky and find an article or entry that says, "XYZ firm earned gross revenues of $250,000 per year its first three years." If the source of this data is credible and XYZ firm is comparable to your firm, you've just found useful information.

two revenue drivers, and so on. The size of the overall gross margin for each revenue driver should be determined. The gross margin for a revenue driver is the selling price minus the cost of goods sold or variable costs. The **costs of goods sold** are the materials and direct labor needed to produce the revenue driver. So, if a product sells for $100 and the cost of goods sold is $40 (labor and materials), the gross margin is $60 or 60 percent. The $60 is also called the **contribution margin**. This is the amount per unit of sale that's left over and is available to "contribute" to covering the business's fixed costs and producing a profit. If your business has more than one revenue driver, you should figure the contribution margin for each. If you have multiple products in a given revenue driver category, you can calculate the contribution margin for each product and take an average. (For example, if you're opening an office supply store, you may have several different computer printers under the revenue driver "printers.") You can then calculate the weighted average contribution margin for each of the company's revenue drivers by weighing the individual contribution margin of each revenue driver based on the percentage of sales expected to come from that revenue driver.

The next section should provide an analysis of the business's fixed and variable costs. The variable costs (or costs of goods sold) for each revenue driver was figured previously. Add a projection of the business's fixed costs. A firm's **variable costs** vary by sales, while its **fixed costs** are costs a company incurs whether it sells something or not. The company's operating leverage should be discussed next. A firm's **operating leverage** is an analysis of its fixed versus variable costs. Operating leverage is highest in companies that have a high proportion of fixed costs relative to their variable costs. In contrast, operating leverage is lowest in companies that have a low proportion of fixed costs relative to variable costs. The implications of the firm's projected operating leverage should be discussed. For example, a firm with a high operating leverage takes longer to reach break-even; however, once break-even is reached, more of its revenues fall to the bottom line.

The business's one-time start-up costs should be estimated and placed into a table. These costs include legal expenses, fees for business licenses and permits, website design, business logo design, and similar one-time expenses. Normal operating expenses should not be included.

This section should conclude with a break-even analysis, which is an analysis of how many units of its product a business must sell before it breaks even and starts earning a profit. In Chapter 8, we explain how to compute a break-even analysis.

The nearby "What Went Wrong?" feature provides a vivid example of what can happen when the economics of a business are not what they should be. The feature focuses on Move Loot, a start-up that was launched with an ambitious goal—to make the process of buying and selling secondhand furniture seamless and fun—and grew quickly. The business eventually failed largely because the economics of the business were not sound.

Marketing Plan The marketing plan focuses on how the business will market and sell its product or service. It deals with the nuts and bolts of marketing in terms of price, promotion, distribution, and sales. For example, GreatCall, a firm producing cell phones for older users, may have a great product, a well-defined target market, and a good understanding of its customers and competitors, but it still has to find customers and persuade them to buy its product.

The best way to describe a company's marketing plan is to start by articulating its marketing strategy, positioning, and points of differentiation, and then talk about how these overall aspects of the plan will be supported by price, promotional mix and sales process, and distribution strategy. Obviously, it's not possible to include a full-blown marketing plan in the four to five pages

WHAT WENT WRONG?

What Move Loot Learned the Hard Way about the Economics of a Business

Move Loot was started by Jenny Morrill, Bill Bobbitt, Ryan Smith, and Shruti Shah. The founders participated in the prestigious Y Combinator accelerator program in the Silicon Valley. The business idea was to make the process of buying or selling secondhand furniture seamless and fun. Instead of placing an ad on Craigslist and hoping that the person that buys your furniture can pay in cash and has a truck to take it away, Move Loot's solution was to take the furniture off your hands, professionally photograph it, advertise it for sale, store it, and deliver it once the sale is complete. Move Loot would make money by taking a 50 percent commission on the sale. The secondhand furniture market in the United States is worth about $3 billion per year.

Move Loot launched in October 2013 and got off to a fast start. It started in San Francisco. Early on, Move Loot grew by more than 25 percent per week. Unfortunately, in mid-2016 Move Loot shut down. While the company's founders have not weighed in on why Move Loot failed, a look at the economics of the business provides clues as to potential trouble spots.

Move Loot had two revenue drivers—a 50 percent commission on each item sold and a delivery charge for items under $500. On the expense side, Move Loot had to do sufficient marketing to get people to sell secondhand furniture through its service and to attract people to buy secondhand furniture through its service. Like all "two-sided" markets, the service wouldn't work unless there was a large enough critical mass on both sides of the equation. Once Move Loot got a client who wanted to sell a piece of secondhand furniture through its service, think of what it had to do to earn a commission.

1. Send a driver, a truck, and a crew to a customer's house.
2. Pick up the piece of furniture and transport it to a storage facility.
3. Photograph the item, write a description, and list it for sale on its website.
4. Screen offers for the item. If a buyer didn't like the price, he or she could submit a lower bid.
5. Store the item until it sells.
6. Collect the money once it sells.
7. Deliver the item to the customer's house.
8. Pay the original owner of the item.

That's a lot of work to earn a commission on a secondhand piece of furniture. On top of that, if an item didn't sell, unlike a furniture store, Move Loot couldn't discount it until it sold—the furniture belonged to the client. It gave the buyer 60 days for an item to sell. If it didn't sell the buyers could pay to get the furniture returned to them, donate it to charity, or request more time. Move Loot essentially had both high fixed costs and high variable costs. Its fixed costs consisted of its trucks, routing system, storage facilities, and equipment, such as the cameras needed to photograph the secondhand furniture and the servers to support its website. When it closed, it had expanded to several cities beyond San Francisco. Its variable costs consisted of truck drivers, dispatchers, the employees who moved the furniture, the storage facility employees, the employees who managed the sales, and the costs of running the storage facilities. All-in-all, this is a lot of overhead for what was essentially a secondhand online furniture store. Move Loot most likely was caught in a situation where it had narrow margins, high fixed costs, high variable costs, and some inventory that didn't move quickly. This is a hard combination to make work. The "economics of the business" just weren't good.

In the months prior to closing, Move Loot iterated its business model more than once. In November 2015, it broadened its marketplace so that other stores, like a local antique shop, could post their items on Move Loot's website. In March 2016, it switched to a model where anyone could upload their own photos to the site, and then Move Loot would take care of only the pickup and delivery part. Neither of these moves were able to save the company.

The Move Loot story is a good reminder that the fundamental "economics of the business" is an important part of a start-up's business plan.

Questions for Critical Thinking

1. Once a piece of secondhand furniture was listed on Move Loot's website, if a customer didn't like the price, he or she could offer a lower amount. Move Loot's 50 percent commission was based on the final selling price. This must have made it difficult for Move Loot to forecast both its gross margin and its contribution margin on individual sales. To what extent do you believe this was a problem for Move Loot?
2. To what extent do you believe Move Loot's business model was sound?
3. In your judgment, were the "economics of the business" sound for Move Loot from the outset? How could Move Loot establish its business in a manner that the economics of the business made more sense?
4. What can all start–up founders learn from the Move Loot case?

Sources: F. Lardinois. "YC-Backed Move Loot Brings Furniture Consignment Into the 21st Century," TechCrunch, available at https://techcrunch.com/2014/01/28/yc-backed-move-loot-brings-furniture-consignment-into-the-21st-century/ (posted January 28, 2014, accessed February 19, 2017); S. Brown. "S.F. Moving Startup Packs It Up, Closes Doors After Layoffs, Customer Complaints," Bizjournals.com, available at https://www.bizjournals.com/sanfrancisco/blog/techflash/2016/06/move-loot-on-demand-moving-startup-shut-down-handy.html (posted June 30, 2016, accessed February 19, 2017); B. Carson. "The Startup That Wanted to Dethrone Craigslist is Officially Shutting Down," available at https://www.businessinsider.com/moveloot-shuts-down-2016-6 (posted June 29, 2016, accessed February 19, 2017).

permitted in a business plan for the marketing section, but the high points should be presented.

A firm's **marketing strategy** refers to its overall approach for marketing its products and services. A firm's overall approach typically boils down to how it positions itself in its market and how it differentiates itself from competitors. GoldieBlox, for example, is a toy company that has positioned itself as a business that introduces girls to the field of engineering. Only about 10 percent of engineering jobs in the United States are held by women. Beginning with the assumption that storytelling will increase a young girl's connection with the act of building, the company has created a set of toys intended to be used to solve problems while reading about adventures. The ultimate goal is to connect girls with the art of building and encourage young women to pursue careers in engineering.

As we see with GoldieBlox, the marketing strategy sets the tone and provides guidance for how the company should reach its target market via its product, pricing, promotions, and distribution tactics. For example, it will invariably promote and advertise its products in places that young women and their parents are most likely to see. Similarly, it will most likely sell its products through specialty toy stores and its own website, along with mass merchandisers such as Toys "R" Us.

The next section should deal with your company's approach to product, price, promotion, and distribution. If your product has been adequately explained already, you can move directly to price. Price, promotion, and distribution should all be in sync with your positioning and points of differentiation, as described previously. Price is a particularly important issue because it determines how much money a company can make. It also sends an important message to a firm's target market. If GoldieBlox advertised its toys as high-quality toys that are both educationally sound and environmentally friendly but also charged a low price, people in its target market would be confused. They would think, "This doesn't make sense. Are GoldieBlox toys high quality or aren't they?" In addition, the lower price wouldn't generate the profits that GoldieBlox needs to further develop its toys. You should also briefly discuss your plans regarding promotions and distribution.

The final section should describe the company's sales process or cycle and specific sales tactics it will employ. It's surprising how many business plans describe a business's overall marketing strategies, but never comment on how a product or service will actually be sold.

Product (or Service) Design and Development Plan If you are developing a completely new product or service, you need to include a section in your business plan that focuses on the status of your development efforts. Many seemingly promising start-ups never get off the ground because their product development efforts stall or the actual development of the product or service turns out to be more difficult than expected.

The first issue to address is to describe the present stage of the development of your product or service. Most products follow a logical path of development that includes product conception, prototyping, initial production, and full production. You should describe specifically the point that your product or service is at and provide a timeline that describes the remaining steps. If you are in the very early stages of your business and only have an idea, you should carefully explain how a prototype, which is the first physical depiction of a new product or service, will be produced and tested. As explained in Chapter 3, a **product prototype** is the first physical manifestation of a new product, often in a crude or preliminary form. The idea is to solicit feedback and then iterate. A prototype of a product, like one of GoldieBlox's toys, might consist of a preliminary version of the product for users to test and then report their experiences. GoldieBlox would then modify or tweak the toy based on the users' experiences. Similarly, a prototype for a web-based company might consist of a preliminary or beta version of the site, with sufficient functionality built into the site for users to test it and then provide feedback. In some instances a virtual prototype is sufficient. A **virtual prototype** is a computer-generated 3D image of a product or service idea. It displays the idea as a 3D model that can be viewed from all sides and rotated 360 degrees.

A section labeled "Challenges and Risks" should be included and disclose any major anticipated design and development challenges and risks that will be involved in bringing the product or service to market. While you want to remain upbeat, the last thing you want to do is paint an overly rosy picture of how quickly and effortlessly your design and development process will unfold. Experienced readers know that product and service development is an inherently bumpy and challenging process, and they will want insights into the challenges and risks you anticipate with your particular offering.

A final section should describe any patents, trademarks, copyrights, or trade secrets that you have secured or plan to secure relative to the products or services you are developing. If your start-up is still in the early stages and you have not taken action regarding intellectual property issues yet, you should get legal advice so you can, at a minimum, discuss your plans in these areas.We discuss intellectual property in Chapter 12.

Operations Plan The operations plan section of the business plan outlines how your business will be run and how your product or service will be produced. You have to strike a careful balance between adequately describing this topic and providing too much detail. Your readers will want an overall sense of how the business will be run, but they generally will not be looking for detailed explanations. As a result, it is best to keep this section short and crisp.

A useful way to illustrate how your business will be run is to first articulate your general approach to operations in terms of what's most important and what the make-or-break issues are. You can then frame the discussion in terms of "back stage," or behind-the-scenes activities, and "front stage," or what the customer sees and experiences. For example, if you are opening a new fitness center, the back-stage and the front-stage issues might be broken down as follows:

Back Stage (Behind-the-Scenes Activities)	Front Stage (What the Members See)
Staff selection	Member tours
Operations manual	Operating hours
Relationships with suppliers	Staff assistance
Relationships with city government	Fitness classes and programs
Development of marketing materials	Fitness machines
Employee orientation and training	Workshops
Emergency plans	Monthly newsletter

Obviously you can't comment on each issue in the three to four pages you have for your operations plan, but you can lay out the key back-stage and front-stage activities and address the most critical ones.

The next section of the operations plan should describe the geographic location of your business. In some instances location is an extremely important issue, and in other instances it isn't. For example, one of the reasons Jeff Bezos decided to locate Amazon.com in Seattle is that this city is a major distribution hub for several large book publishers. By locating near these distribution facilities, Amazon.com has enjoyed a cost advantage that it wouldn't have had otherwise. On a more fine-grained level, for restaurants and retail businesses, the specific location within a mall or shopping center, or a certain side of a busy street, may make a dramatic difference.

This section should also describe a firm's facilities and equipment. You should list your most important facilities and equipment and briefly describe how they will be (or have been) acquired, in terms of whether they will be purchased, leased, or acquired through some other means. If you will be producing a product and will contract or outsource your production, you should comment on how that will be accomplished. If your facilities are nondescript, such as a generic workspace for computer programmers, it isn't necessary to provide a detailed explanation.

Management Team and Company Structure Many investors and others who read business plans look first at the executive summary and then go directly to the management team section to assess the strength of the people starting the firm. Investors read more business plans with interesting ideas and exciting markets than they are able to finance. As a result, it's often not the idea or market that wins funding among competing plans, but the perception that one management team is better prepared to execute its idea than the others.

The management team of a new firm typically consists of the founder or founders and a handful of key management personnel. A brief profile of each member of the management team should be provided, starting with the firm's founder or founders. Each profile should include the following information:

- Title of the position
- Duties and responsibilities of the position
- Previous industry and related experience
- Previous successes
- Educational background

Although they should be kept brief, the profiles should illustrate why each individual is qualified and will uniquely contribute to the firm's success. Certain attributes of a management team should be highlighted if they apply in your case. For example, investors and others tend to prefer team members who have worked together before. The thinking here is that if people have worked together before and have decided to partner to start a new firm, it usually means that they get along personally and trust one another.[27] You should also identify the gaps that exist in the management team and your plans and timetable for filling them. The complete résumés of key management team personnel can be placed in an appendix to the business plan.

If a start-up has a board of directors and/or a board of advisors, their qualifications and the roles they play should be explained and they should be included as part of your management team. A **board of directors** is a panel of individuals elected by a corporation's shareholders to oversee the management of the firm, as explained in more detail in Chapter 9. A **board of advisors** is a panel of experts asked by a firm's management to provide counsel and advice on an ongoing basis. Unlike a board of directors, a board of advisors possesses no legal responsibility for the firm and gives nonbinding advice.[28] Many start-ups ask people who have specific skills or expertise to serve on their board of advisors to help plug competency gaps until the firm can afford to hire additional personnel. For example, if a firm is started by two web designers and doesn't have anyone on staff with marketing expertise, the firm might place one or two people on its board of advisors with marketing expertise to provide guidance and advice.

The final portion of this section of your business plan focuses on how your company will be structured. Even if you are a start-up, you should outline how the company is currently structured and how it will be structured as it grows. It is important that the internal structure of a company makes sense and that the lines of communication and accountability are clear. Including a description of your company's structure also reassures the people who read the plan that you know how to translate your business idea into a functioning firm.

The most effective way to illustrate how a company will be structured and the lines of authority and accountability that will be in place is to include an organizational chart in the plan. An **organizational chart** is a representation of how authority and responsibility are distributed within the company. The organizational chart should be presented in graphical format if possible.

Overall Schedule A schedule should be prepared that shows the major events required to launch the business. The schedule should be in the format of milestones critical to the business's success, such as incorporating the venture, completion of prototypes, rental of facilities, obtaining critical financing, starting the production of operations, obtaining the first sale, and so forth. An effectively prepared and presented schedule can be extremely valuable in convincing potential investors that the management team is aware of what needs to take place to launch the venture and has a plan in place to get there.

Financial Projections The final section of a business plan presents a firm's pro forma (or projected) financial projections. Having completed the previous sections of the plan, it's easy to see why the financial projections come last. They take the plans you have developed and express them in financial terms.

The first thing to include is a **sources and uses of funds statement**, which is a document that lays out specifically how much money a firm needs (if the intention of the business plan is to raise money), where the money will come from, and how the money will be used. The next item to include is an **assumptions sheet**, which is an explanation of the most critical assumptions on which the financial statements are based. Some assumptions will be based on general information, and no specific sources will be cited to substantiate the assumption. For example, if you believe that the U.S. economy will gain strength over the next three to five years, and that's an underlying assumption driving your sales projections, then you should state that assumption. In this instance, you wouldn't cite a specific source—you're reflecting a consensus view. (It's then up to your reader to agree or disagree.) Other assumptions will be based on very specific information, and you should cite the source for your assumptions. For example, if GoldieBlox has credible data showing that the educational segment of the children's toy industry is expected to grow at a certain percentage each year for the foreseeable future, and this figure plays a large role in its belief that it can increase its sales every year, then it should cite the sources of its information.

The **pro forma (or projected) financial statements** are the heart of the financial section of a business plan. Although at first glance preparing financial statements appears to be a tedious exercise, it's a fairly straightforward process if the preceding sections of your plan are thorough. The financial statements also represent the finale of the entire plan. As a result, it's interesting to see how they turn out.

A firm's pro forma financial statements are similar to the historical statements an established firm prepares, except they look forward rather than track the past. Pro forma financial statements include the pro forma income statement, the pro forma balance sheet, and the pro forma cash flow statement. They are usually prepared in this order because information flows logically from one to the next. Most experts recommend three to five years of pro forma statements. If the company you are writing your plan for already exists, you should also include three years of historical financial statements. Most business plan writers interpret or make sense of a firm's historical or pro forma financial statements through **ratio analysis**. Ratios, such as return on assets and return on sales, are computed by taking numbers out of financial statements and forming ratios with them. Each ratio has a particular meaning in regard to the potential of the business.

We present a complete explanation of how to complete pro forma financial statements and ratio analysis in Chapter 8.

Appendix Any material that does not easily fit into the body of a business plan should appear in an appendix—résumés of the top management team, photos or diagrams of product or product prototypes, certain financial data, and market research projections. The appendix should not be bulky and add significant length to the business plan. It should include only the additional information vital to the plan but not appropriate for the body of the plan itself.

Putting It All Together In evaluating and reviewing the completed business plan, the writers should put themselves in the reader's shoes to determine if the most important questions about the viability of their business venture have been answered. Table 6.4 lists the 10 most important questions a business plan should answer. It's a good checklist for any business plan writer.

One more thought. The feasibility analysis and business plan writing stage of a start-up's journey is the ideal time to start establishing a community of true believers and early evangelists. These are people who care enough about a new business to provide assistance and start spreading the word. The nearby "Partnering for Success" feature provides tips for how to establish a community of true believers and early evangelists. To varying degrees, a start-up's true believers become partners in a start-up's success.

Presenting the Business Plan to Investors

LEARNING OBJECTIVE

5. Explain how to effectively present a business plan to potential investors.

If the business plan successfully elicits the interest of a potential investor, the next step is to meet with the investor and present the plan in person. The investor will typically want to meet with the firm's founders. Because investors ultimately fund only a few ventures, the founders of a new firm should make as positive an impression on the investor as possible.

TABLE 6.4 The 10 Most Important Questions a Business Plan Should Answer

1. Is the business just an idea, or is it an opportunity with real potential?
2. Is the product or service viable? Does it add significant value to the customer? Has a feasibility analysis been completed? If so, what are the results?
3. Is the business entering an exciting, growing industry, and has the firm identified an attractive position within the industry?
4. Does the business have a well-defined target market?
5. Does the business have points of differentiation that truly separate it from its competitors? Are these points of differentiation sustainable?
6. Does the business have a sound marketing plan?
7. Is the management team experienced, skilled, and up to the task of launching the new firm?
8. Is the business's operations plan appropriate and sound?
9. Are the assumptions that the firm is basing its financial projections on realistic?
10. Are the financial projections completed correctly, and do they project a bright future for the firm?

PARTNERING FOR SUCCESS

Establishing a Community of True Believers and Early Evangelists

An important practice for start-ups is to involve others in what they're doing, partly because that's what it takes to conduct a proper feasibility analysis and to do the research necessary to write a business plan, and partly to develop a community of people who believe in what they are doing. These people—called true believers, product champions, or early evangelists—spread awareness about your product or service, not because they're paid to do it but because they believe in what you're doing. Here are some tips for establishing a community of early evangelists. Note that the circle of early evangelists starts small and then widens out.

Tip #1: Reach Out to Family and Friends

Reach out to family and friends to get them involved with what you're doing and to ask them to spread the word. The only caveat is to make sure that if you're asking for feedback, you get candid feedback, not simply what you want to hear. Several of the start-ups featured in this book reached out to family and friends early on. For example, to test its first prototype, the founders of Owlet Baby Care needed to find homes with newborn babies to ask the parents to test their device. To gain access they reached out to family and friends, among others, to help identify households with new babies. Casper, the online mattress company, conducted beta tests of its product. In the final stages of testing the company relied on a small group of family and friends, presumably because they wanted to keep the circle small and only show their product to people they trusted. When you ask people to help—particularly people who care about you—they'll more than likely take an interest in what you're doing. Ask them if they'd like regular updates. They may become your first customers and your most fervent evangelists.

Tip #2: Engage Your Personal Networks

Engaging your personal network is the second source of true believers and early evangelists. We've seen examples of this in the features in the book. For instance, to get their first customers, the founders of SoulCycle went door to door in their neighborhood and "worked their personal network" according to Case 1.1. When they opened SoulCycle studios in new cities, the first thing they did was contact people they knew in those cities to provide them coupons for workouts and to ask them to spread the word. Similarly, when the founders of Rent the Runway set out to test their business idea with potential customers, they ran their first test at Harvard, the university they were attending. Later, they sent PDF files of dresses that were offered for rent to a mailing list of 1,000 to 2,000 people to see how many dresses would be rented. The list was comprised of "friends, family, and anyone else they knew," according to Case 4.1.

Similar to friends and family, when you engage your network, you get people invested in what you're doing. Sometimes this can result in big payoffs. Recall, in the Rent the Runway case the day the company launched they were featured on the front cover of the business section of *The New York Times*. Someone in their network had recommended them to the paper and it ran the story.

Tip #3: Keep In Touch with Other Early Testers

Other early testers, who test prototypes of your business idea and/or give you feedback in other ways, can also become early true believers and evangelists. Send them updates and ask them to follow you on social media. Recall, Casper's sales took off during the firm's first month of operation. According to the case, "a large number of people were involved in Casper's initial testing. These people were serious about sleep, and many became Casper evangelists, posting positive comments on social media or speaking out in other ways."

Also, identify the influencers among your family and friends, personal network, and early testers, and reach out to them individually. Keep them abreast of what you're doing and why you're excited about it. Find additional ways for them to engage with your product or service.

Tip #4: Form a Community of Early Adopters

Your true believers and early evangelists will help form a community of early adopters. Communities typically form around interests, practices (for example, hobbies or professions) or location. SoulCycle, for instance, gained participants primarily by word-of-mouth. Its early evangelists told their friends, who told their friends, who told their friends, and fairly quickly a group of people who had a shared interest—an intense workout in a boutique type of setting—were going to SoulCycle. You can also form a community of early adopters by participating in online or offline groups. Follow people on Twitter in your space. They'll often follow you in return, and if you post interesting material, they'll become familiar with you and what you're doing. Similarly, if you post on blogs, often you'll be picked up by other blogs. For example, the founders of Wild Friends Foods, the firm examined in the "Opening Profile" in Chapter 9, caught a huge break early on when a popular food blogger wrote a short piece about their products. That piece led to hundreds of online orders which helped kickstart the business. A month later they got an even bigger break when they were featured in *The Oprah Magazine.*

Questions for Critical Thinking

1. What are ways to get people to care about your product or service? Why is it important to establish a community of true believers and early evangelists? Wouldn't it be easier to acquire customers via traditional advertising?

2. Why are the people who are asked to test a prototype of a product or provide feedback in some other way ideal candidates to become true believers and earlier evangelists?
3. On a scale of 1–10 (10 is high), how prominent a role do you think social media typically plays in helping companies gain early adopters for their product or service?
4. Brainstorm other ways to establish a community of true believers and evangelists not mentioned in the feature.

The first meeting with an investor is generally very short, about one hour.[29] The investor will typically ask the firm to make a 15- to 20-minute presentation using PowerPoint slides and use the rest of the time to ask questions. If the investor is impressed and wants to learn more about the venture, the presenters will be asked back for a second meeting to meet with the investor and his or her partners. This meeting will typically last longer and will require a more thorough presentation.

The Oral Presentation of a Business Plan

When asked to meet with an investor, the founders of a new venture should prepare a set of PowerPoint slides that will fill the time slot allowed for the presentation portion of the meeting. The same format applies to most business plan competitions. The first rule in making an oral presentation is to follow instructions. If an investor tells an entrepreneur that he or she has one hour and that the hour will consist of a 20-minute presentation and a 40-minute question-and-answer period, the presentation shouldn't last more than 20 minutes. The presentation should be smooth and well-rehearsed. The slides should be sharp and not cluttered with material.

The entrepreneur should arrive at the appointment on time and be well prepared. If any audiovisual equipment is needed, the entrepreneur should be prepared to supply the equipment if the investor doesn't have it. These

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It's important to practice the oral presentation of a business plan before pitching it to investors. Here, a young entrepreneur is in the midst of a practice pitch to a group of people at his university.

arrangements should be made prior to the meeting. The presentation should consist of plain talk and should avoid technical jargon. Start-up entrepreneurs may mistakenly spend too much time talking about the technology that will go into a new product or service and not enough time talking about the business itself. The most important issues to cover in the presentation and how to present them are shown in Table 6.5. This presentation format calls for the use of 12 slides. A common mistake entrepreneurs make is to prepare too many slides and then try to rush through them during a 20-minute presentation.

TABLE 6.5 Twelve PowerPoint Slides to Include in an Investor Presentation

Topic	Explanation
1. Title slide	Introduce the presentation with your company's name, the names of the founders, and the company logo if available.
2. Problem	Briefly state the problem to be solved or the need to be filled.
3. Solution	Explain how your firm will solve the problem or how it will satisfy the need to be filled.
4. Opportunity and target market	Articulate your specific target market. Talk about business and environmental trends that are providing your target market momentum.
5. Technology	This slide is optional but is normally included. Talk about your technology or any unusual aspects of your product or service. Don't talk in an overly technical manner. Make your descriptions easy to understand and interesting.
6. Competition	Explain specifically the firm's competitive advantage in the marketplace and how it will compete against more established competitors.
7. Marketing and sales	Describe your overall marketing strategy. Talk about your sales process. If you've conducted primary research regarding how people feel about your product, report the results here.
8. Management team	Describe your existing management team. Explain how the team came together and how their backgrounds and expertise are keys to the success of your firm. If you have a board of advisors or board of directors, briefly mention the key individuals involved. If you have gaps in your team, explain how and when they will be filled.
9. Financial projections	Briefly discuss the financials. Stress when the firm will achieve profitability, how much capital it will take to get there, and when its cash flow will break even. Use additional slides if needed to properly display your information, but don't go overboard.
10. Current status	Describe the current status of your firm in the context of the milestones you've achieved to date. Don't diminish the value of your accomplishments.
11. Financing sought	Lay out specifically how much financing you're seeking and how you'll use the money.
12. Summary	Bring the presentation to a close. Summarize the strongest points of your venture and your team. Solicit feedback from your audience.

Source: B. Barringer, *Preparing Effective Business Plans: An Entrepreneurial Approach*, 2nd Edition, © 2015, 247–259. Adapted by permission of Pearson Education, Inc., Upper Saddle River, NJ.

Questions and Feedback to Expect from Investors

Whether in the initial meeting or on subsequent occasions, an entrepreneur will be asked a host of questions by potential investors. The smart entrepreneur has a solid idea of what to expect and is prepared for these queries. Because investors often come across as being very critical,[30] it is easy for an entrepreneur to become discouraged, particularly if the investor seems to be poking holes in every aspect of the business plan. The same dynamic typifies the question-and-answer sessions that follow presentations in business plan competitions. In fact, an investor who is able to identify weaknesses in a business plan or presentation does a favor for the entrepreneur. This is because the entrepreneur can take the investor's feedback to heart and use it to improve the business plan and/or the presentation.

In the first meeting, investors typically focus on whether a real opportunity exists and whether the management team has the experience and skills to pull off the venture. The investor will also try to sense whether the managers are highly confident in their own venture. The question-and-answer period is extremely important. Here investors are typically looking for how well entrepreneurs think on their feet and how knowledgeable they are about the business venture. Michael Rovner, a partner of Rob Adam's at AV Labs, put it this way: "We ask a lot of peripheral questions. We might not want answers—we just want to evaluate the entrepreneur's thought process."[31]

Chapter Summary

LO1. A business plan is a written narrative that describes what a new business intends to accomplish and how it plans to achieve its goals. For most new businesses, the business plan is a dual-purpose document that is used both inside and outside the firm. Inside the firm, it helps the company develop a road map to follow in executing its strategies. Outside the firm, it acquaints potential investors and other stakeholders with the business opportunity the firm is pursuing and describes how the business will pursue that opportunity.

LO2. The two primary audiences for a firm's business plan are its employees and potential investors and other external stakeholders. There are different kinds of business plans. For example, a summary business plan is 10 to 15 pages and works best for companies in the early stages of development. These companies lack the information needed for a full business plan but are able to develop a summary business plan to see if potential investors are interested in their idea. A full business plan, typically 25 to 35 pages, spells out a company's operations and plans in much more detail than a summary business plan and is the usual format for a business plan prepared for an investor. An operational business plan is usually prepared for an internal audience. It is 40 to 100 pages long and provides a blueprint for a company's operations.

LO3. Guidelines are available for those writing a business plan to follow. Adhering to these guidelines increases the probability that an entrepreneur will develop an effective business plan. The structure of the plan is the first guideline to consider. The advice here is that a conventional structure should be used to develop a business plan. Doing this allows business investors to focus on the parts of a plan that are critical to their decision-making process. Second, a business plan should be concise and clear in its development. All important aspects of the proposed venture should be included in the plan. Once written, the plan should be checked for grammar errors, spelling mistakes, and to verify that all vital information is in fact included. The plan's style and format are the issues around which the third guideline is framed. The plan's appearance should be carefully evaluated; however, it should be consistent with a conventional structure (as noted earlier) and should not suggest to the potential investor that a great deal of money was spent to prepare the plan itself.

LO4. A business plan has multiple parts, the first of which is the executive summary. The executive summary is a quick overview of the entire business plan and provides busy readers with everything they need to know about the distinctive nature of the new venture. In many instances, an investor will ask for a copy of a firm's executive summary and will request a copy of the full business plan only when the executive summary is sufficiently convincing. The industry analysis, which is another part of the business plan, describes the industry a business will enter. The market analysis part of the plan breaks the industry analysis into segments and zeros in on the specific segments (or target markets) to which the firm will seek to appeal. The management team and company structure section of a business plan is critical. Many investors and others who read business plans look first at the executive summary and then go directly to the management team section to assess the strength of the people starting the firm. The sources and uses of funds statement is a document that lays out specifically how much money a firm needs (if it is raising money), where the money will come from, and what it will be used for. An assumptions sheet is an explanation of the most critical assumptions that a business's financial analysis is based on.

LO5. After writing the business plan, the entrepreneur must prepare to present it effectively to potential investors and possibly others as well. The oral presentation of a business plan typically consists of 20 minutes of formal remarks, accompanied by approximately 12 PowerPoint slides, and 40 minutes of questions and answers. The presentation should be smooth and well-rehearsed. The slides should be sharp and not cluttered with material.

Key Terms

assumptions sheet, **241**
board of advisors, **240**
board of directors, **240**
business plan, **222**
competitor analysis, **235**
contribution margin, **236**
costs of goods sold, **236**
executive summary, **230**
fixed costs, **236**
full business plan, **229**
market analysis, **234**
market segmentation, **234**
marketing strategy, **238**
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tagline, **234**
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MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

6-1. What is a business plan?
6-2. What are the advantages of preparing a business plan for a new venture?
6-3. When is the appropriate time to write a business plan?
6-4. What are the two primary reasons for those starting a new venture to write a business plan?
✪ 6-5. Why is writing a business plan the last activity to be completed in the entrepreneurial process?
6-6. Who reads the business plan and what are they looking for when doing so?
6-7. How will investors typically react if they think a business plan is based on

estimates and predictions rather than on careful analysis and facts?

6-8. Why is it important for a business plan to follow a conventional structure rather than be highly innovative and creative?

6-9. What are the differences among a summary business plan, a full business plan, and an operational business plan?

6-10. Why should the executive summary, which is one of the first things that appears in a business plan, be written last?

6-11. What is the difference between the industry analysis section and the market analysis section of a business plan?

6-12. What is the difference between a concentrated and a fragmented industry?

6-13. What is the purpose of "The Economics of the Business" section of a business plan?

6-14. If you are developing a completely new product or service, what type of information should you include in your business plan regarding the status of the development efforts?

6-15. What is the purpose of the "Operations Plan" section of a business plan?

6-16. Why is the "Management Team and Company Structure" section of a business plan often touted as one of the most important sections?

6-17. What is the purpose of an executive summary?

6-18. What is the purpose of a mission statement?

6-19. What is the difference between a product prototype and a virtual prototype?

6-20. What is the number-one rule in making an investor presentation?

Application Questions

6-21. Travis Ryan is one of four cofounders of a skateboard company. The cofounders have decided to write a business plan to obtain funding for their venture. During a recent meeting, Travis said, "I know that we're all really busy, so I'd like to volunteer to write our business plan. A friend of mine has a house on a lake near where we are going to school. If the three of you agree, I'll take my laptop to my friend's house for a couple of days and knock out our business plan. Any objections?" If you were one of Travis' cofounders, what would you say? What alternative approaches to writing a business plan would you propose and why?

6-22. A good friend of yours, Andrew Waters, has decided to leave his corporate job in order to launch a private SEO (search engine optimization) consulting firm. He is putting together a business plan for this venture and says the following to you: "I've read several books and articles about how to write a business plan, and there is a point about which I am still a bit confused. Is a business plan written more for learning and discovering or is it written more for pitching and selling?" What would you say to Andrew in response to his question?

6-23. Josh White has a brilliant idea—an e-payment business using online payment kiosks. He is looking for investors to fund his business, and he has called on you for advice on writing a good business plan to do so. He needs a structured plan detailing how the potential of his ideas may be achieved and is anxious that it might look hastily put together. Advise Josh on some of the pitfalls that he should avoid while preparing the plan.

6-24. Ginny Welch is proposing to start a wellness center and needs to prepare a market analysis for her business plan for a loan provider. The analysis is due in the next two weeks, but she does not know what to write and who her target market is—all she knows is that her potential customers are those who seek a healthy lifestyle. She has completed her industry analysis but only recently learned the difference between market analysis and industry analysis. What is the next step she should take to complete the market analysis?

6-25. The entrepreneurship class you are taking meets for four hours once per week. A break of 10 minutes or so takes place after the first two hours of each class. During a recent break, you overhead one of your classmates say to another person that in her opinion, the teacher is overselling the importance to potential investors of a start-up's management team. "After all," the classmate says, "A good product outweighs any deficiency a firm may have in terms of managers and their abilities." Given what you have learned about business plans, what would you say to your classmate to convince her that she needs to rethink her view regarding potential investors' views about the quality of a proposed venture's management team?

6-26. d.light, which operates as a for-profit social enterprise, is the focus of Case 6.2. What, if any, special factors should be kept in mind when writing a business plan for a for-profit social enterprise?

6-27. Michael Graves and Jill Simpson just left their jobs with Microsoft to launch a business that will sell a new type of fax machine. They wrote a full business plan that they've asked you to review. When reading the plan, you noticed that several key sections begin with the phrase "We believe . . . ." Is any knowledgable person who reads this business plan going to know what "We believe . . . " really means? What is the problem with including the phrase "We believe . . . ." to introduce key sections of a business plan?

6-28. Two co-founders have $100,000 each that they are prepared to invest in a new business venture. A third potential co-founder actually came up with the business idea but has no funds to invest in the business. How would you divide the equity in this instance when two of the partners have money to invest and the third has the idea and will actually be doing most of the work? Is this an issue that can make or break a new venture?

6-29. Janine Morris has prepared a business plan for her online shoe business. She has approached an angel investor to support her business financially. As you are a close friend, she has shown you her business plan and asked for your opinion. After reading through it, you noticed that it did not include important elements that the investor would look for. Moreover, her business plan was very vague and did not clearly state the real intention of starting the business. Advise Janine.

YOU BE THE VC 6.1 COMPANY: Beyond Meat

• **Web: www.beyondmeat.com** • **Facebook: Beyond Meat** • **Twitter: @BeyondMeat**

Business Idea: Provide consumers with plant-based protein foods that take the animal out of meat—without sacrificing the taste, chew, or satisfaction.

Pitch: A number of factors motivate people to seek out meat substitutes. Health benefits, animal welfare, lowering greenhouse gas emissions, and bad press about the poor conditions under which some animals are raised for slaughter are some of these factors. Many of the most common meat substitutes—tofu, bean burgers, vegetable cutlets, and so on—lack bite, chew, juiciness, and flavor. As a result, people try them for a while and then return to traditional meat products. A parallel problem exists regarding the demand for meat. Global demand for meat has tripled in the last 40 years, driven by population growth and an upward trend in per-capita consumption of meat. Producing meat has significant environmental implications. Animal agriculture is said to be responsible for about 14.5 percent of human-induced greenhouse gas emissions, more than the transportation sector. All of these factors suggest that there is a huge opportunity for a company that can produce a tasty and affordable plant-based substitute for meat, and can do it in a way that is friendlier to the environment than traditional meat production.

Beyond Meat is positioning itself to be that company. On the taste and healthfulness side, the company's first product line, Chicken-Free Strips, is made with plant-based proteins that legitimately replicate the sensory experience of eating meat. Because the product is also gluten-free and is free of trans and saturated fat, cholesterol, dairy, eggs, hormones, and antibiotics, it's better for us than actual chicken. On the cost and environmental side, Beyond Meat's Chicken-Free Strips require less land and water to raise than real chickens and, when produced at a sufficient scale, cost less to make.

Beyond Meat's products are the result of more than 15 years of research conducted by two scientists at the University of Missouri-Columbia, Fu-Hung Hsieh and Harold Huff. The company's Chicken-Free Strips have been precisely engineered to look like chicken, taste like chicken, and especially to feel like chicken when you take a bite. The company is presently working on a Beyond Meat substitute for ground beef that can be worked into tacos, lasagna, or any other meal in which beef is included. Beyond Meat's Chicken-Free Strips are being introduced to the marketplace through Whole Foods Markets and similar health-conscious food stores.

6-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

6-31. If you had to make your decision on just the information provided in the pitch and on the website, would you fund this company? Why or why not?

YOU BE THE VC 6.2 Company: Go-Jek

• **Web: www.go-jek.co** • **Twitter: @gojekindonesia**

Business Idea: A moped-based transport and delivery service operating in several cities across Indonesia.

The Pitch: Go-Jek is a motorcycle ride-hailing phone service in Indonesia established in 2010. Since then, it has developed into an on-demand service using a mobile platform and app and has expanded its operations from the city of Jakarta to over 25 cities across Indonesia. It has also expanded its services to incorporate transportation and logistics, food delivery, and other delivery services.

Go-Jek prides itself on speed and innovation and is determined to make a lasting contribution to the lives of those who work for the business. Their drivers are referred to as partners, not employees, but they do have access to health and accident insurance and other benefits.

Indonesian cities are famous for their traffic congestion, and government initiatives have failed to deal with the issue. The solution to getting around quickly is the motorcycle taxi, or ojek. The problem is that motorcycle private taxis are unsafe, unregulated, and insanitary (thousands have worn that old crash helmet before you!) Go-Jek solves all these problems with real-time tracking and control as well as free head covers and face masks for customers.

Go-Jek has thus become the motorcycle equivalent of Uber. In cities like Jakarta, due to the heavy traffic, Go-Jek actually has a significant advantage over Uber. Users register when they open the app for the first time, and all they need to do is to fill out the pickup address, the delivery address, and when they need the service. The app will then show the price. Payment can be made in cash, Go-Jek credits, or corporate pin number. Go-Jek also features a referral promotion code system. When a new user keys in an existing customer's promo code, they receive $2 credit, as does the customer whose promo code they used. This way, there is a direct incentive for word-of-mouth referrals.

Go-Jek is estimated to have over 200,000 drivers across some 25 cities. It has recently expanded to create the GoCar private car service and has formed a partnership with the Indonesian taxi company Blue Bird. In 2017, both Uber and Grab introduced motorbike taxi services in Indonesia. The competition is set to be extremely tough in the coming years.

Go-Jek is actively looking to expand into other markets and considering India and Sri Lanka as likely destinations for their new operations. Go-Jek is also committed to fighting for its market share in Indonesia. Indonesia has a population of some 250 million and is considered the largest Internet market in Southeast Asia.

6-32. Based on the material covered in this chapter, what questions would you ask the firm's founder before making your funding decision? What answers would satisfy you?

6-33. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 6.1

Birchbox: Leveraging the College Experience to Write a Business Plan and Launch a Growing Start-up

• Web: www.birchbox.com • Facebook: Birchbox • Twitter: @birchbox

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Katie Beauchamp and Hayley Barna met on their first day at Harvard Business School. They volunteered to co-coordinate a spring holiday for themselves and 50 of their classmates. Through the experience they realized that they worked well together as a team, but at that time, they had no thought of cofounding a business. That all changed just over a year later, when Beauchamp and Barna launched Birchbox, a beauty samples subscription service that now has over one million monthly subscribers in five countries.

The College Experience

Beauchamp and Barna quickly became friends. They were also in the same MBA cohort and took many of their classes together. The idea for Birchbox emerged gradually. One class was particularly instrumental, a class on disruptive innovation taught by Harvard professor Clayton Christensen. The class challenged the students to think of a big idea that's an industry game changer. Beauchamp and Barna's first idea concerned the beauty industry, which hadn't experienced significant innovation for many years. A personal

Birchbox

Birchbox cofounders Hayley Barna and Katie Beauchamp dynamic also nudged them toward a business idea in the beauty industry. Barna's best friend, Mollie Chen, was a beauty editor. Beauchamp would notice that Barna always had the best beauty products, and when asked where she got them, she would always say that Chen (the beauty editor) had recommended them. It got Beauchamp and Barna thinking—wouldn't every woman like to have a best friend that was a beauty editor and could recommend beauty products to them?

Beauchamp and Barna's thoughts coalesced in the last semester of their two-year MBA program. For the first time, they were thinking about starting a business together. They saw a void in the marketplace ripe to be filled. Companies had come up with great ways to sell many products online, including fashion, but not beauty products. Beauty products are tough to sell online because they have a touch, try, and feel element to them. To capitalize on the opportunity of selling beauty products online, and get around the hesitation that people have for buying beauty products without touching and seeing them first, Beauchamp and Barna's idea was an online monthly subscription service that consisted of a small box of beauty product samples that qualified customers could try out. They would then offer full-sized versions of the samples on their website for sale. The major brands were already making samples that they handed out in stores. Beauchamp and Barna decided to call their business Birchbox.

Last Semester at Harvard—A Testing Ground for Birchbox

Rather than let the clock run out on their college experience and then try to launch Birchbox, Beauchamp and Barna did everything they could to leverage their college status. They negotiated with their professors so their final project in each class would be Birchbox. They also used their student status as a way of getting their foot in the door with suppliers and customers. For Birchbox to work, Beauchamp and Barna had to answer three fundamental questions. First, would beauty brands work with them, in regard to providing samples? Second, would women pay for curated boxes of samples? And third, would samples drive full-sized purchases? The only way, they figured, to answer these questions was to go straight to the sources. First, they built a prototype of the box in which they would send the monthly samples and determined how the samples would be presented in the box. They then thought through the rest of the business. Each month, the box would contain five beauty product samples. Information would be put on the firm's website and YouTube channel about each product, so the customer could learn more about them. They would then offer full-sized versions of the products for sale. To get buy-in, they "cold-called" beauty and cosmetics companies. They never hid the fact that they were still in college. Instead, they framed it as an advantage (they had a readymade audience of their target market right in their classes). Incredibly, several of the companies, including Benefits, Nars, and Keihl's signed on. Second, they created a beta version of their website and incented 200 subscribers to pay them $20 a month to test their concept. They used feedback from the users to improve the original Birchbox in several key areas. At this point, Beauchamp and Barna had more than an idea. They had suppliers, a preliminary list of potential customers, results, and data.

After completing these steps, Beauchamp and Barna entered Birchbox into the HBS business plan competition. They won second place, which further bolstered their confidence. The competition provided tremendous exposure for Birchbox and for Beauchamp and Barna as nascent entrepreneurs. They met people who became advisers and mentors. The competition was judged by venture capitalists, and several of them offered the pair money. They passed on the offers, thinking it would be best to keep Birchbox lean.

Birchbox officially launched in September 2010. At the outset, it remained lean and reflected a college student's lifestyle. After graduation, Beauchamp and Barna moved Birchbox to Brooklyn to be closer to their suppliers. Their first office was unpretentious and had

Christopher Hall/Shutterstock

Each monthly Birchbox for Women includes a small collection of high-quality beauty, grooming, and lifestyle product samples. The product samples are similar to the ones shown here.

IKEA furniture. Beauchamp and Barna learned many lessons the hard, and sometimes fun, way. For example, when they made their first product video they tried to recruit volunteers in Union Square (a popular area in Manhattan). They soon found that it's impossible to get busy New Yorkers to volunteer, so they, along with a couple of early employees, dressed up and starred in the video themselves. By the end of 2010, Birchbox had 10,000 subscribers.

Need to Pivot

Birchbox grew rapidly from 2010 to 2016. While it continued gaining subscribers, it was not showing a profit. In an effort to cut costs, in 2016, the firm laid off 15 percent of its staff in January and another 12 percent in June. The cost cutting measures were precipitated by an inability to raise fresh capital on favorable terms. In late summer of 2016, Birchbox raised $15 million in a convertible note—a type of loan that eventually converts to an equity stake—from its current investors. Its new business plan focused on becoming profitable while maintaining its momentum in the marketplace.

Birchbox has also shifted its business model and has broadened its reach beyond e-commerce. In mid-2014, it opened its first brick-and-mortar store. If you are in New York City and would like to make a visit, it's located in the SoHo district of Manhattan at 433 West Broadway. The store is packed with fun ways to try new products. A customer can BYOB (Build Your Own Birchbox) by picking a box and five samples from across categories. The store has been a success. Birchbox has found that the lifetime value of a customer is three times as high when they visit the store as opposed to shopping strictly on birchbox.com. Birchbox has also developed two lines of its own makeup. The first is a line of lipstick and eyeshadow, launched in 2015, created by a team of in-house product development experts, under the brand name LOC (Love of Color). The second is ARROW, launched in 2016, a makeup, skincare, and body products brand designed to enhance natural beauty during (and after) physical activity.

Challenges and Opportunities Ahead

Despite the need to pivot their business plan in 2016, the founders of Birchbox remain optimistic. The company has over 1 million monthly subscribers. The success of its first physical location, and its ability to increase the lifetime value of a customer via the in-store experience, opens the possibility of additional locations. Current plans are to open "pop-up" stores in select cities to gauge demand before opening permanent locations. Birchbox is also exploring the possibility of opening stores within the stores of retail partners. The addition of in-house expertise to develop its own beauty brands presents new opportunities. Birchbox is also considering an upscale women's monthly subscription box at a higher price-point than the staple $10 a month box it has featured from the beginning.

There are also challenges. Ipsy, GlossyBox, and BeautyArmy have similar subscription plans as Birchbox. Ipsy, in particular, is a formidable competitor. Started by YouTube makeup and skincare celebrity Michelle Phan, Ipsy reportedly has as many monthly subscribers as Birchbox. There is also a concern, shared by all participants in the market, that at some point the industry may plateau in terms of subscribers for its staple women's subscription service. New markets may be difficult to grow. For example, the number of products and product samples made for men's grooming and lifestyle supplies is much lower than those made for women. This factor may limit the growth of Birchbox Man.

Discussion Questions

6-34. How effectively do you think Katie Beauchamp and Hayley Barna used their time in college to advance their business idea?

6-35. In what ways is Birchbox's business approach a win-win for both its suppliers and its customers?

6-36. How was writing a business plan and preparing for a business plan competition helpful to Katie Beauchamp and Hayley Barna while Birchbox was still in the planning, testing, and prototyping stage?

6-37. Going forward, what are the most serious challenges facing Birchbox? Which of these challenges do you believe is the most threatening to the firm's success? Do you think Birchbox will have to pivot its business plan again? If so, what factors do you think will precipitate the next pivot?

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CASE 6.2

d.light: How Bringing Its Business Plan to Life Helped a Social Enterprise Get Off to a Strong Start

• *Web: dlightdesign.com* • *Facebook: D.lightDesign* • *Twitter: @dlightdesign*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Imagine the following. You are in the audience of a business plan competition. The next team up to present is d.light, a for-profit social enterprise that plans to bring light to people without access to reliable electricity. Two young men introduce themselves as the founders of d.light, and say they're going to start their presentation with a demonstration. The lights go out. In a few seconds, you see a dim light at the front of the room, and smell smoke and burning kerosene. After about 30 seconds, your eyes start to water and it becomes slightly uncomfortable to breathe. The lights switch back on and the smoke clears. The young men apologize for the lack of light and the smoke, but say the demonstration was staged to illustrate a point. Around 1.2 billion people, or more than one fifth of the world's population, have no access to electricity, and about a billion more have an unreliable or intermittent supply. An estimated 500 million households must burn some sort of fuel, such as kerosene, for cooking or lighting. Kerosene fuel is expensive, dangerous, and toxic to both people and the environment. In fact, the United Nations estimates that kerosene fumes kill 1.5 million people per year, and cause countless health complications for others.

Sam Goldman and the Origins of d.light

The scene described here actually took place—several times. It's the way Sam Goldman and Ned Tozun, the cofounders of d.light, introduced the company at business plan competitions and when they pitched investors. d.light is an international consumer products company serving "base of the pyramid" consumers who lack access to reliable electricity. Although d.light technically started in a class at Stanford University, its beginning can be traced to Sam Goldman's youth and early adulthood. Growing up, Goldman's parents worked for the United States Agency for International Development (USAID), a government agency that provides economic and humanitarian assistance in countries across the globe. Goldman lived in Pakistan, Peru, India, Canada, and several other countries. As a young adult, while working for the Peace Corps, he lived for four years in a West African village that had no electricity. A neighbor boy was badly burned in a kerosene fire, an event that deeply impacted Goldman. At one point during his time in the village, Goldman was given a battery-powered LED headlamp, and was struck by the dramatic difference that simply having light at night can make in a person's life. He could now cook, read, and do things at night that were unimaginable without the benefits reliable lighting provides.

Impacted by this experience, Goldman sought out a graduate program that would provide him the opportunity to start thinking about creating a business to take light to people without access to reliable electricity. He landed at Stanford, which was starting a program in social enterprise. A pivotal class was Jim Patelli's 2006–2007 Entrepreneurial Design course. The class was divided into teams, and each team was challenged to address a significant issue in the developing world. Goldman was teamed up with Ned Tozun, a business classmate, and two engineering students, Erica Estrade and Xian Wu. The team tackled the problem of light for people without access to reliable electricity, and developed a rough prototype of a portable LED light that could be recharged via solar power. That spring, the team traveled to Burma for the purpose of going into villages that didn't have access to electricity to introduce their device. Villagers told them they spent up to 40 percent of their income on kerosene. When shown how their crude prototype could provide light at night and be recharged during the day simply by deploying small solar panels on their homes, the villagers were so taken that one woman actually wept. According to one account of the team's trip, in one village the local police confiscated the prototypes. They, too, needed light at night.

Design and Distribution

After completing the Entrepreneurial Design course, the teammates headed in their separate directions for the summer. In the fall, they reunited, determined to continue to work on their business concept. The concept of using solar power to recharge portable lights in poor rural areas wasn't new. In fact, it had been tried many times. The problem, in Goldman and his team's estimation, was a combination of design and distribution. Previous models relied either on

NGOs and governments “giving” fairly expensive lights to people without access to electricity, which they couldn’t afford to replace when used up or if broken, or commercial enterprises buying extremely inexpensive lights in China and exporting them to Africa and elsewhere, where they performed poorly. It was clear to Goldman that neither of these models was sustainable.

So Goldman and his team, driven by the possibility of changing literally millions of people’s lives throughout the world, recruited talented engineers and distribution experts, who worked on a near pro bono basis, to help with the project. The goal was to produce a solar-powered portable LED light that was exactly what rural villagers needed—nothing more and nothing less. It also had to be cheap enough that villagers could afford it yet capable of being produced in a way that yielded sufficient margins for d.light to be profitable. The decision was made early on that d.light would be a for-profit company. The company’s goal was not to impact 100,000 people or a million people but to impact hundreds of millions of people. Goldman and his team knew that their lofty ambitions would take cash and additional R&D efforts, which would require private-sector investment capital.

During this period, which covered the summer of 2007 until early 2008, Goldman and his cofounders continued traveling to remote areas for the purpose of obtaining feedback about their prototype. During Christmas break, instead of traveling home to see his family, Goldman was in the middle of Myanmar doing research. The team thinned some in early 2008, with Goldman, Tozan, and Wu continuing. d.light was now up and running and opened its first international offices in India, China, and Tanzania.

Mark Boulton/NHPA/Photoshot/Newscom

d.light solar lantern

Business Plan Competitions and Investor Presentations

One thing Goldman stresses during talks about d.light is the instrumental role that the company’s business plan played in helping the company take shape and in raising investment capital. Early on, d.light entered several business plan competitions. In the spring of 2007, it took second place in the University of California, Berkley’s Social Venture Competition and won first prize at Stanford’s Social E-Challenge. A big breakthrough happened in May 2007, when the team claimed the $250,000 first prize in the prestigious Draper Fisher Jurvetson Venture Challenge competition. This money provided seed funding for much of the work that was completed during the summer and fall of 2007.

What’s particularly interesting is Goldman’s reflections about why d.light was so successful in business plan competitions and eventually with investor presentations. These reflections are instructive for entrepreneurs as they think about how to design and then successfully launch their ventures. As shown in the nearby table, there are six reasons that account for d.light’s success, specifically with business plan competitions. Collectively, the attributes shown in the table present d.light as an organization with a compelling idea, a strong management team, large markets to serve, an intense product focus, and a coherent, resolute, and extremely admirable vision for the future.

d.light Today

Today, d.light is having the impact that its founders envisioned it could. Its stated goal is to impact the lives of at least 100 million people by 2020. The company says it’s on track to reach its goal three years early. The nearby chart shows the numbers on d.light’s social impact dashboard, which is updated frequently and is posted on the company’s website. These numbers reflect the impact of the availability of light, produced by d.light solar lanterns, for people who didn’t previously have access to reliable electricity and light. The numbers are remarkable, particularly in terms of lives empowered, school-aged children reached with solar lighting, and savings in energy-related expenses. The numbers reflect the good that a well-managed social enterprise can create.

Six Key Reasons d.light Was Successful in Business Plan Competitions

Told Stories and Showed Pictures	While many teams enter business plan competitions with impressive PowerPoint slides and bullet points, d.light focused on telling stories and showing pictures. The company's founders showed photographs of rural villagers using their device, and shared their testimonials. In one interview, Goldman remarked that no matter how many plans or pitches a group of judges or investors heard during a day, he was confident they remembered d.light's presentation.
All In	The founders were fully committed to d.light. They passed on corporate jobs and focused on d.light full time. Along with "talking the talk," they also "walked the walk." Instead of saying that they planned to travel to remote villages to test their device, they just went out and did it. Some of the trips came before the business plan presentations.
Right Team	d.light put together a strong team, with a balance of business and engineering expertise. The team was well-suited for launching a global initiative. Goldman had lived overseas the majority of his life, in places like India and Pakistan. Other team members had demonstrated that they had no inhibitions about traveling to remote villages to talk about their device.
Big Market	d.light was tackling a large market, which investors like. To make their financials work, the team would have to scale the business and sell millions of units. While the challenge was great, so was the potential payoff.
Product Focus	The company iterated its device multiple times before settling on its first solar-powered portable LED light, called the Nova. The Nova sold for the U.S. equivalent of around $25. Early feedback indicated that the price was still too high, so more iterations took place.
Strong Vision	Although d.light was a social enterprise, it unashamedly presented itself as a for-profit venture. The team was resolute that getting to scale could only be accomplished via private-sector capital. d.light also measured its success by the number of families it positively impacted. This sense of purpose and vision permeated the organization.

d.light's Social Impact Dashboard

Number	Category
75 million	Lives empowered
20 million	School-aged children reached with solar lighting
$5.9 billion	Saved in energy-related expenses
41 billion	Productive hours created for working and studying
26 million	Tons of CO_2, offset
148 GWH	Generated from renewable energy source

d.light sells its product through a number of channels in more than 62 countries. One strategy that has worked well is to employ "rural entrepreneurs" to sell the product. d.light likes to employ indigenous personnel, who know the local customs, people, and language, to sell its product on a commission basis. It also has partnerships with NGOs, microfinance organizations, and social enterprise start-ups that are producing solar lanterns to achieve the same goals it is striving toward. In 2013, d.light entered into a major partnership with Total, a French oil and gas company that sells d.light's products as part of the "Access to Energy Program" throughout Africa. As a result of the Total partnership, and its initiatives across the world, d.light now makes more than 500,000 of its solar lanterns per month. For the first few years of its existence, d.light's production was more in the neighborhood of 20,000 to 30,000 units per month.

d.light has funded its operations and growth through both investment capital and earnings. d.light is also continually updating its products. For example, its newest design incorporates a smartphone charger, knowing smartphones are the lifeline of many small business owners and others in developing countries.

Looking Ahead

As it continues to grow, d.light faces both opportunities and challenges. In terms of opportunities, the problem it's trying to solve, to provide reliable sources of light to people without access to electricity, is as large as ever. Incredibly, according to United Nations reports, the number of people worldwide who do not have access to reliable electricity is actually larger today than it was when d.light started. The charge to continue doing what it's currently doing, and find ways to increase its impact, represents its biggest opportunity. Currently, d.light has a family of solar products instead of the single solar lantern with which it started. Its products include a single function solar lantern (similar to the one it started with), a multifunction lantern, which acts as a smartphone charger during the day and a lantern at night, and a solar home system that acts as a personal power grid for a home or family. The system includes a solar panel, mobile-charging battery pack, two solar lights, two light switches, and a portable lantern. d.light will continue to innovate and add new products.

In terms of challenges, not everyone agrees that distributing solar lanterns is the best way to bring power to people without access to reliable electricity. For example, one of the world's largest private coal companies, Peabody

Energy, has a campaign called Advanced Energy for Life, which advocates building coal-powered electrical grids in Africa as the solution to meeting the needs of people without power. The deterrent to this approach is cost. Other schools of thought argue that while what companies like d.light are doing is admirable, they provide only a partial solution. d.light's counter to both arguments is that the people it serves don't have a choice between solar energy and traditional alternatives. Their choice is between solar energy and kerosene lanterns, with the former being much safer, cleaner, and cost-effective.

Another challenge is defending its for-profit status. Some observers believe that companies like d.light should be nonprofits and give their lanterns away. d.light's counter to this argument is that the only way to effectively tackle the worldwide shortage of reliable lighting is to stimulate business activity through the private sector. How can an entrepreneur in Kenya, the company argues, make a living selling solar lights if a nearby NGO is giving them away for free?

d.light's efforts have clearly made a difference in the lives of millions of people. The firm has received numerous awards to recognize what it has accomplished. One particularly nice distinction is its place in the British Museum's History of the World in 100 Objects. d.light's basic lantern, the S250, is object number 100 in the collection.

Discussion Questions

6-38. Why is the problem of bringing light to people who don't have access to reliable electricity not being tackled in a meaningful way by a large lighting company, such as GE (General Electric) or Philips?

6-39. What qualities do Sam Goldman and his team have that will help them solve the problem of providing light to the billions of people in the world who lack access to reliable electricity?

6-40. Why does Sam Goldman go out of his way to talk about the importance of d.light's business plan? In what ways do you think having a meticulously created business helped d.light in its launch efforts?

6-41. If you were one of d.light's founders, what would your marketing strategy be? How would you go about educating people in remote areas of the world about your product and the benefits associated with purchasing it?

Sources: d.light Homepage, www.dlightdesign.com (accessed February 21, 2017); M. Lavelle, "D.light Attacks a Big Energy Problem with Small Solar," *Daily Climate*, April 21, 2015; J. Wiener, "d.light's Lofty Goals Meet Practical Challenges in India," *Stanford Business Magazine*, May 24, 2010; S. Sethuraman and S. Goldman, "Lighting the Way to Economic Development," *Social Innovation Conversations Podcast*, available at https://ssir.org/podcasts/entry/sam_goldman_-_lighting_the_way_to_economic_development (posted October 26, 2009, accessed February 21, 2017).

ESSAY QUESTIONS

1. Assume that because you have always enjoyed preparing brisket, you now desire to open a restaurant in your mid-size hometown. In discussing doing this with your family, you mention that if they will provide seed capital, you'll go about buying some land in order to then build a small restaurant. While supportive of your desire to launch your entrepreneurial venture, family members tell you that they would be much more comfortable if you wrote a business plan because such a plan provides important insights to potential employees and investors and other stakeholders as well. Write a paragraph or two to explain the benefits that a well-written business plan could provide to the parties and stakeholders identified by some of your family members.

2. Go-Jek is the subject of the You Be the VC 6.2 feature. After re-reading this feature, discuss trends in the taxi industry that this company should know about as it continues operations. Given today's trends as well as those you anticipate will exist in the future, what is the firm's target market today, and what might its target market be in the future? Write a few paragraphs to present the results of your analysis.

Endnotes

1. F. J. Greene and C. Hopp, "Are Formal Planners More Likely to Achieve New Venture Viability? A Counterfactual Model and Analysis," *Strategic Entrepreneurship Journal* 11, no. 1 (2017): 36–60.
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PART 3 Moving from an Idea to an Entrepreneurial Firm

Owlet Baby Care, Inc.

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Getting Personal with BILLY GOAT ICE CREAM

Billy Goat Ice Cream Co./Photo Credit: RaShaun Robinson

Cofounders

RASHAUN ROBINSON

Master's in Entrepreneurship, Spears School of Business, Oklahoma State University, 2015

CALEB NEIL

Master's in Entrepreneurship, Spears School of Business, Oklahoma State University, 2015

Dialogue with RaShaun Robinson

WHAT I DO WHEN I'M NOT WORKING
Binge watching House of Cards, golfing, and hanging with friends

MY BIGGEST WORRY AS AN ENTREPRENEUR
Not looking far enough ahead to avoid the potholes and pitfalls

MY ADVICE FOR NEW ENTREPRENEURS
Conduct a feasibility analysis before starting any new venture

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
Things don't come as fast as you want them

BEST ADVICE I'VE RECEIVED
Do what you love and it'll feel like you've never worked a day in your life

BEST PART OF BEING A STUDENT
You have the safety net of the school to make mistakes

CHAPTER 7

Preparing the Proper *Ethical and Legal* Foundation

MyLab Entrepreneurship

Improve Your Grade!

If your instructor is using MyLab Entrepreneurship, visit **www.pearson.com/mylab/entrepreneurship** for videos, simulations, and writing exercises.

OPENING PROFILE

BILLY GOAT ICE CREAM

Proceeding on a Firm Legal Foundation

• *Web: www.bgicecream.com* • *Facebook: www.facebook.com/billygoaticecream* • *Twitter: @BGIceCreamCo*

If you are among the 33 percent of Americans who are lactose intolerant, you've probably been missing out on eating ice cream. The majority of ice cream is made from cow's milk—which lactose intolerant people can't consume. But now, because of a new approach to making ice cream developed by RaShaun Robinson and Caleb Neil, two former Oklahoma State University entrepreneurship students, lactose intolerant people can again enjoy ice cream. Billy Goat Ice Cream, the company Robinson and Neil started, makes ice cream from goat's milk rather than cow's milk. Goat's milk not only tastes good and is nutritious, but is something that lactose intolerant people can consume.

It all started in 2012 while Robinson was a student at Langston University in North Central Oklahoma. He took an entrepreneurship class; students in the class were challenged to come up with a business idea that would advance agriculture in Oklahoma. Robinson was familiar with the American Institute for Goat Research, which is located at Langston, and came up with the idea of goat's milk ice cream. He wrote a business plan based on the idea, entered it into a university competition, and won first place. He called the business Billy Goat Ice Cream. His buddies kidded him because a Billy Goat is a male goat—goat's milk comes from female nannie goats. Robinson stuck with the name, saying it was kind of quirky and different just like he envisioned Billy Goat Ice Cream becoming.

After graduating from Langston, Robinson enrolled in the Master's in Entrepreneurship program at Oklahoma State. During his first semester, he was encouraged to enter a Pitch & Poster competition. He asked Caleb Neil, a classmate, to partner with him and their entry focused on Billy Goat Ice Cream. Up until now, Billy Goat Ice Cream was just a concept. To make it real, Robinson and Neil made a pint of goat's milk ice cream in Robinson's apartment. They experimented with different recipes before settling on a recipe of their own with which they were satisfied. They handed out samples during the competition and won first place. The results of the competition, along with the unanimous positive feedback they received, motivated them to think of Billy Goat Ice Cream as a real business.

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Discuss the actions founders can take to establish a strong ethical culture in their entrepreneurial ventures.
2. Describe actions taken in new firms to effectively deal with legal issues.
3. Provide an overview of the business licenses and permits that a start-up must obtain before it begins operating.
4. Identify and describe the different forms of organization available to new firms.

Robinson and Neil applied for and were accepted into Student Startup Central, the student new business incubator at Oklahoma State. They spent the next several months fleshing out their concept. Eventually, they decided to partner and make Billy Goat Ice Cream a legal business. To get off to a good start legally, they connected with an attorney in Stillwater, the town in which Oklahoma State University is located, who specializes in business start-ups. The attorney helped them draft a Founders' Agreement and registered Billy Goat Ice Cream as a limited liability corporation. Later, when Billy Goat Ice Cream got its first investors, he helped them hammer out an operating agreement, which defined the relationship among all involved parties. Along with providing legal services, Robinson and Neil's attorney worked out favorable terms for payment. He realized Billy Goat Ice Cream was a start-up and was strapped for cash. Both Robinson and Neil have mentioned that his willingness to be flexible with payments was helpful to Billy Goat Ice Cream in the early going.

In the summer of 2014, Robinson and Neil moved Billy Goat Ice Cream into the Meridian Technology Incubator west of Stillwater. About this time they got two big breaks. The first was a REI Oklahoma grant for rural development. Because Robinson and Neil planned to rely on Oklahoma goat farmers as their source for goat's milk, REI had a vested interest in the firm's success given the agency's focus on expanded economic opportunities for Oklahoma's residents and entrepreneurs. They helped by providing flexible financing and development services to Billy Goat Ice Cream. The grant enabled Robinson and Neil to buy equipment and set up a commercial kitchen. The second big break was meeting Rhonda Hooper, the president of Jordan & Associates, an advertising firm in Oklahoma City. Hooper served on the Advisory Board for the Oklahoma State University School of Entrepreneurship, of which Student Startup Central is a part. Hooper took an interest in what Robinson and Neil were doing, and Jordan & Associates entered into a partnership with Billy Goat Ice Cream, exchanging their expertise in branding, promotions, and website development for a small equity stake in the company. If you look at Billy Goat Ice Cream's website (www.bgicecream.com), the beautiful presentations you see in terms of Billy Goat's logo and its Web design is Jordan & Associates' work.

After setting up shop at the Meridian Technology Incubator, Billy Goat Ice Cream started pitching local businesses to carry their product. Their first customer was a local Hampton Inn. They had met the manager at a Chamber of Commerce event. Their second customer was a Food Pyramid grocery store. One thing Robinson and Neil did that has worked out well is set up an advisory board. They picked people who filled their knowledge gaps. The board consisted of a food engineer, a culinary arts instructor, a staff member at Meridian, a representative from REI, the manager of the local Food Pyramid store, and their accountant. It was through their relationship with the local Food Pyramid manager that they got into their first grocery store.

Billy Goat Ice Cream has experienced several legal issues that are common for food start-ups. They've learned to comply and adhere with all licensing and permitting requirements for food companies in Oklahoma. Their kitchen is inspected and their product is tested regularly by the Oklahoma Department of Agriculture Food & Forestry division. They've purchased general liability insurance to protect themselves in the event of a lawsuit. They meet with their attorney annually, and more often if a need arises. Recently, their attorney put them in contact with a trademark attorney who assisted them. They got a cease and desist letter from a restaurant/tavern in another city that has Billy Goat in its name. The trademark attorney they hired helped them make the argument that it is unlikely that a consumer would confuse their product, goat's milk ice cream, with a restaurant/tavern.

Billy Goat Ice Cream is moving forward on a firm legal foundation. They're now in over 100 stores, including a small number of Whole Foods Markets. They just inked an agreement with Walmart to be in 67 Walmart stores in Oklahoma and parts of Missouri and Kansas. If they are fortunate enough to go nationwide with Walmart, their business will progress to an entirely new level.

We begin this chapter with a discussion of the most important initial ethical and legal issues facing a new firm, including establishing a strong ethical organizational culture, choosing a lawyer, drafting a founders' agreement, and avoiding litigation. Next, we talk through the process of obtaining the proper licenses and permits to operate a business. We conclude with a discussion of the different forms of business organization that are available to entrepreneurs, including sole proprietorships, partnerships, corporations, and limited liability companies.

In Chapter 12, we discuss the protection of intellectual property through patents, trademarks, copyrights, and trade secrets. This topic, which is also a legal issue, is becoming increasingly important as entrepreneurs rely more on intellectual property rather than physical property as a source of a competitive advantage. Chapter 15 discusses legal issues pertaining to franchising.

As the opening profile about Billy Goat Ice Cream suggests, new ventures must deal with important ethical and legal issues at the time of their launching. As a company grows, the legal environment becomes more complex. A re-evaluation of a company's ownership structure usually takes place when investors become involved. In addition, companies that go public in the United States are required to comply with a host of Securities and Exchange Commission (SEC) regulations. Of course, firms established in nations throughout the world must comply with regulations that are specific to those countries.

Against this backdrop, the following sections discuss several of the most important ethical and legal issues facing the founders of new firms.

Establishing a Strong Ethical Culture for a Firm

LEARNING OBJECTIVE

1. Discuss the actions founders can take to establish a strong ethical culture in their entrepreneurial ventures.

One of the most important things the founders of an entrepreneurial venture can do is establish a strong ethical culture for their firms. As suggested by information we report here, the data regarding business ethics are both encouraging and discouraging. The 2016 Global Business Ethics Survey (GBES) is a rigorous, multicountry inquiry into worker conduct and workplace integrity, which provides insight into workplace ethics in both public and private sector organizations. The 2016 GBES survey found that four key metrics provide insight into the ethics environment of an organization:

- *Pressure to compromise organizational standards.* This factor is an important warning sign of future workplace misconduct.
- *Observed misconduct.* Misconduct is the most basic indicator of the state of integrity in an organization. To what extent do employees follow the rules and live out the core values of organization?
- *Report observed misconduct.* This refers to whether employees report misconduct when they observe it, rather than remaining silent.
- *Experience retaliation for reporting misconduct.* This refers to whether employees who report misconduct are retaliated against, such as by getting the silent treatment or being exposed to verbal harassment, demotions, undesirable assignments, or even violence.[1]

Table 7.1 provides a summary of the GBES findings.

As we noted earlier, these percentages are both encouraging and discouraging. While 22 percent of employees feel pressured to compromise, that means that 78 percent do not. It is striking that 30 percent of U.S. employees report observing misconduct. While it is heartening that 76 percent report misconduct when they see it, it is equally disheartening that 53 percent are retaliated against after reporting misconduct they've observed.

In regard to observed misconduct, in the United States, the three highest incidents of observed misconduct were: Abusive or intimidating behavior among employees; lying to employees, customers, vendors, or the public; and decisions made or actions taken to benefit the employees (or friends or family of the employee) over the interests of the employees' organization.

The takeaway from the survey is that establishing an ethical culture is not something that should be taken for granted. Indeed, establishing an ethical culture is something that must be prioritized and worked on at all stages during the development of a business. Next, we discuss three specific steps that an entrepreneurial start-up can take to build a strong ethical culture.

Lead by Example

Leading by example is the most important thing any entrepreneur, manager, or supervisor can do to build a strong ethical culture in her or his organization. In strong ethical cultures, entrepreneurs, managers, and supervisors:

- Communicate ethics as a priority
- Set a good example of ethical conduct
- Keep commitments
- Provide information about what is going on
- Support following organizational standards

Employees also have responsibilities. The most important things employees can do to support a strong ethical culture in an organization are to:

- Consider ethics in making decisions
- Talk about ethics while completing their work
- Set a good example of ethical conduct
- Support following organizational standards

In companies where these attributes are present, a stronger ethical culture exists. This reality demonstrates the important role that everyone involved with a start-up plays in developing a strong ethical culture for their firm.

TABLE 7.1 Findings from the 2016 Global Business Ethics Survey

Criteria	Global (13 countries included in study)	United States only
Pressure to compromise organizational standards	22%	22%
Observed misconduct	33%	30%
Report observed misconduct	59%	76%
Retaliation against reporters of misconduct	36%	53%

Note: Percentages are based on medians rather than averages.
Source: 2016 Global Business Ethics Survey, Ethics Research Center, United States of America, Ethics & Compliance Initiative, 2016.

Establish a Code of Conduct

A **code of conduct** (or code of ethics) is a formal statement of an organization's values regarding certain ethical and social issues.[2] The advantage of having a code of conduct is that it provides specific guidance to entrepreneurs, managers, and employees regarding expectations of them in terms of ethical behavior. Consider what Facebook has done in this area. The company has a formal Code of Conduct, posted on its website, which has 13 sections. Each section includes detailed information that explains how the topic covered by that section governs the behavior of not only Facebook employees, but any of its affiliates or subsidiaries and others performing work on behalf of Facebook. The Table of Contents of Facebook's Code of Conduct is shown in Table 7.2. You can see Facebook's Code of Conduct along with the full explanations of each section at https://investor.fb.com/corporate-governance/code-of-conduct/.

In practice, some codes of conduct are very specific, like Facebook's. Other codes of conduct set out more general principles about an organization's beliefs on issues such as product quality, respect for customers and employees, and social responsibility. In all cases though, codes of conduct are intended to influence people to behave in ways that are consistent with a firm's ethical orientation.

Implement an Ethics Training Program

Firms also use ethics training programs to promote ethical behavior. **Ethics training programs** teach business ethics to help employees deal with ethical dilemmas and improve their overall ethical conduct. An **ethical dilemma** is a situation that involves doing something that is beneficial to oneself or the organization, but may be unethical. Most employees confront ethical dilemmas at some point during their careers.

Ethics training programs can be provided by outside vendors or can be developed in-house. For example, one organization, Global Learning Systems (GLS) provides ethical training programs for businesses of all sizes. It provides

TABLE 7.2 Table of Contents of Facebook's Code of Conduct

1. Introduction
2. Conflicts of Interest
3. Harassment
4. Communications
5. Public Disclosures
6. Financial Integrity and Responsibility
7. Confidential Information
8. Protection of User Data
9. Protection of Facebook Assets
10. Compliance with Law
11. Reporting Violations
12. Policy Prohibiting Retaliation
13. Amendment and Waivers

Source: Facebook website, https://investor.fb.com/corporate-governance/code-of-conduct/

business ethics training along with training on related topics such as workplace antiharassment, sexual harassment prevention, and HIPAA compliance. GLS offers both off-the-shelf and customized learning programs. For example, its off-the-shelf business ethics course is web-based and requires about 45 minutes to complete. In the course, employees learn to recognize common business ethics issues along with techniques to avoid acting in an unethical manner and bringing harm to oneself and the employee's employer. Similarly, GLS's menu of workplace antiharassment courses helps employees understand what workplace harassment is, the appropriate steps to take if unlawful harassment takes place, and how harassment affects both the individuals involved and the organization as a whole. The courses provide real-life examples and hypothetical scenarios that teach participants how to recognize and prevent workplace harassment. Specific courses are offered on preventing unlawful harassment, preventing sexual harassment, preventing workplace bullying, and several other related topics.[3]

Along with maintaining a strong ethical culture, it is also important that a firm is willing to say "We're sorry" when it makes a mistake in that doing so is an important part of operating in a fair, trustworthy, and savvy manner. The nearby "Savvy Entrepreneurial Firm" feature focuses on a public relations crisis that Zendesk, a firm that helps other companies manage their customer relationships, experienced in 2010. Zendesk implemented a price increase to which its customers vocally objected. As you'll see when you read the feature, on reflection, the founders of Zendesk felt that they had acted hastily and issued a sincere apology to their customers. At the time, Zendesk was only three years old and the incident could have badly damaged the firm if it had responded differently to the concerns its customers articulated. Zendesk is now one of the largest and most successful firms in its industry.

Dealing Effectively with Legal Issues

LEARNING OBJECTIVE

2. Describe actions taken in new firms to effectively deal with legal issues.

Those leading entrepreneurial ventures can also expect to encounter a number of important legal issues when launching and then, at least initially, operating their firm. We discuss a number of these issues next.

Choosing an Attorney for a Firm

It is important for an entrepreneur to select an attorney as early as possible when developing a business venture.[4] Selecting an attorney was instrumental in helping Billy Goat Ice Cream, the company discussed in this chapter's "Opening Profile," establish a firm legal foundation.

Table 7.3 provides guidelines to consider when selecting an attorney. It is critically important that the attorney be familiar with start-up issues and that he or she has successfully shepherded entrepreneurs through the start-up process before. It is not wise to select an attorney just because she is a friend or because you were pleased with the way she prepared your will. For issues dealing with intellectual property protection, it is essential to use an attorney who specializes in this field, such as a patent attorney, when filing a patent application.[5]

While hiring an attorney is advisable, it is not the only option available for researching, preparing, and filing the necessary forms to get a business up and running legally. Most business owners can do much of the preliminary work on their own, and they rely on an attorney for guidance and advice. If you're particularly tight on money and feel as though you can handle portions of the legal process on your own (which is not generally recommended but may apply in some cases), there are online companies that can help you with the necessary forms and filings. Examples include LegalZoom (www.legalzoom.com), Rocket Lawyer (www.rocketlawyer.com), and Nolo (www.nolo.com). All three companies

SAVVY ENTREPRENEURIAL FIRM

Don't Hesitate to Say "We're Sorry"

• Web: www.zendesk.com • Facebook: Zendesk • Twitter: @Zendesk

Zendesk helps its clients manage their customer relationships. It sells a suite of cloud-based software products including Zendesk Support, which is a system for tracking, prioritizing, and solving customer support tickets. The company was founded in a loft in Copenhagen, Denmark by Mikkel Svane, Alexander Aghassipour, and Morten Primdahl. The three made their way to San Francisco, where Zendesk grew quickly.

In 2010, three years after Zendesk was founded, things were going well. The company was growing and was transitioning from building a product to building a firm. In May of 2010, at the same time the company was preparing to release a major product update with new innovative capabilities, it decided to raise prices for some of its customers. The price hike was designed in a way that the customers that were the most expensive to serve would pay more, while customers that caused less strain on the firm's operations got a cheaper option and could pay less. The timing seemed right. The price adjustment would come at the same time that a slew of new features and capabilities were introduced.

Its price hike didn't go over well. In fact, a large number of customers were outraged and didn't hesitate to show their anger. They flooded the Zendesk forums with complaints. Angry phone calls poured in. Competitors piled on. An article in a major tech publication accused Zendesk of using a "bait and switch" tactic. To try to calm things down, Zendesk cofounder and CEO Mikkel Svane posted a message on the company's website, essentially justifying the price jump. It didn't help. It wasn't about the facts anymore. At this point, customers were upset and that was that.

Zendesk prided itself on transparency, fairness, and honesty, and this was its first major customer service issue. For some customers the price increase made sense, but for many it didn't. Zendesk, Svane concluded, had taken its customers for granted and had screwed up. Svane posted another message on Zendesk's website, this time with a different tone. The following is an excerpt from the message published in *Startupland*, a book that Mikkel Svane and Carlye Adler later wrote about Zendesk:

> We've spent the last two and a half years building this company by putting our customers first and meeting their needs. When we decided to make a change to the Zendesk pricing structure for our existing customers, we tried to be as thoughtful, transparent, and straightforward as possible. We failed. We let you down. And we apologize.

The message on the firm's website went on to say that the price increase would only apply to new customers—all existing customers would be grandfathered to their existing prices without a time limit. Svane said that although he wishes Zendesk hadn't made its customers angry, he's glad they spoke up. He said Zendesk will always listen. After noting in the message that customers are the reason Zendesk exists, Svane ended the post on the website by saying that he was flying to New York that day and would be at the SoHo Park Café (in Manhattan) that evening. He said "I'll be there with a few others from Zendesk, and we would love to discuss all of this with you. It would be great to see you there."

In his book, Svane reflected on the experience. He said that relationships are not about reasoning—they are about how people feel. It's about spending time listening and respecting each other's viewpoint even when you think the other person is wrong. Svane also said that he learned that you don't raise your price for an existing product for existing customers. That's the advantage (from the customer's perspective) of a subscription service.

Zendesk survived. It acknowledged its mistake and fixed it. It now serves 87,000 customers in 150 countries and territories worldwide. Its customers range from one person businesses to tech giants such as Dropbox and Twitter.

Questions for Critical Thinking

1. On a scale of 1–10 (10 is high), how important is transparency, fairness, and honesty for a firm such as Zendesk? What does a firm have to lose if its customers feel it is subpar on these qualities?
2. Why do you think Svane's first message to Zendesk's customers didn't work? Why do you think the second message did?
3. In the end, to what degree do you think Zendesk handled its crisis appropriately?
4. What can entrepreneurial firms learn from Zendesk's experience? What did you learn from it?

Sources: M. Svane and C. Adler. *Startupland*, San Francisco, CA: Jossey-Bass, 2015; Wikipedia, Zendesk, www.wikipedia.com (accessed February 22, 2017).

TABLE 7.3 How to Select an Attorney

1. Contact the local bar association and ask for a list of attorneys in your area who specialize in business start-ups.
2. Interview several attorneys. Check references. Ask your prospective attorney whom he or she has guided through the start-up process before and talk to the attorney's clients. If an attorney is reluctant to give you the names of past or present clients, select another attorney.
3. Select an attorney who is familiar with the start-up process. Make sure that the attorney is more than just a legal technician. Most entrepreneurs need an attorney who is patient and is willing to guide them through the start-up process.
4. Select an attorney who can assist you in raising money for your venture. This is a challenging issue for most entrepreneurs, and help in this area can be invaluable.
5. Make sure your attorney has a track record of completing work on time. It can be very frustrating to be prepared to move forward with a business venture, only to be stymied by delays on the part of an attorney.
6. Talk about fees. If your attorney won't give you a good idea of what the start-up process will cost, keep looking.
7. Trust your intuition. Select an attorney who you think understands your business and with whom you will be comfortable spending time and having open discussions about the dreams you have for your entrepreneurial venture.
8. Learn as much about the process of starting a business yourself as possible. It will help you identify any problems that may exist or any aspect that may have been overlooked. Remember, it is your business start-up, not your attorney's. Stay in control.

provide a comprehensive menu of legal services for business owners, including the ability to ask a lawyer questions either for free or for a modest fee. It's a judgment call as to whether to hire a lawyer to do your legal work, utilize a service such as LegalZoom, RocketLawyer, or Nolo, or pursue a blended approach. A blended approach might involve hiring an attorney to obtain legal advice (such as determining your form of business ownership) and then utilizing one of the online services to prepare the documents and file them with the appropriate governmental agencies on your behalf.

Kzenon/Shutterstock

It is important to select an attorney as soon as possible when forming a new business. Here, an attorney experienced with start-up issues is discussing the importance of a founders' agreement with two entrepreneurs.

Drafting a Founders' Agreement

If two or more people start a business, it is important that they have a founders' (or shareholders') agreement. A **founders' agreement** is a written document that deals with issues such as the relative split of the equity among the firm's founders, how individual founders will be compensated for the cash or the "sweat equity" they put into the firm, and how long the founders will have to remain with the firm for their shares to fully vest.[6]

The items typically included in a founders' agreement are shown in Table 7.4.

An important issue addressed by most founders' agreements is what happens to a founder's equity if she or he dies or decides to leave the firm. Most founders' agreements include a **buyback clause**, which legally obligates departing founders to sell to the remaining founders their interest in the firm if the remaining founders are interested.[7] In most cases, the agreement also specifies the formula for computing the dollar value to be paid. The presence of a buyback clause is important for at least two reasons. First, if a founder leaves the firm, the remaining founders may need the shares to offer to a replacement person. Second, if founders leave because they are disgruntled, the buyback clause provides the remaining founders a mechanism to keep the shares of the firm in the hands of people who are fully committed to a positive future for the venture.

Vesting ownership in company stock is another topic most founders' agreements address. The idea behind vesting is that when a firm is launched, instead of issuing stock outright to the founder or founders, it is distributed over a period of time, typically three to four years, as the founder or founders "earn" the stock. Vesting keeps employees motivated and engaged and also solves a host of potential problems that can result if employees are given their stock all at once. More on the concept of vesting ownership in company stock is provided in the nearby "Partnering for Success" feature. While reading the feature, imagine how people receiving ownership in a company as part of their compensation would see themselves as partners.

Avoiding Legal Disputes

Most legal disputes are the result of misunderstandings, sloppiness, or a simple lack of knowledge of the law. Getting bogged down in legal disputes is something

TABLE 7.4 Items Included in a Founders' (or Shareholders') Agreement

- Nature of the prospective business
- Identity and proposed titles of the founders
- Legal form of business ownership
- Apportionment of stock (or division of ownership)
- Consideration paid for stock or ownership share of each of the founders (may be cash or "sweat equity")
- Identification of any intellectual property signed over to the business by any of the founders
- Description of how the founders will be compensated and how the profits of the business will be divided
- Basic description of how the business will be operated and who will be responsible for what
- Description of the outside business activities that the founders will not be allowed to engage in (e.g., you wouldn't want a founder to engage in an outside business that competes directly with your business)
- Provisions for resolving disputes (many founders' agreements include a stipulation that disputes will be resolved via mediation or arbitration rather than through the courts)
- Buyback clause, which explains how a founder's shares will be disposed of if she or he dies, wants to sell, or is forced to sell by a court order

PARTNERING FOR SUCCESS

Vesting Ownership in Company Stock: A Sound Strategy for Start-Ups

The core idea associated with the vesting of stock is that when a firm is launched, instead of issuing stock outright to the founders, the stock is distributed over a period of time, typically three to four years, as the founder or cofounders "earn" the stock. The same practice is followed with employees who join the firm later.

The reason vesting is a smart move is that although everyone is normally healthy and on the same page when launching an entrepreneurial venture, you never know what might happen. You want everyone involved with the venture to remain engaged with it. You also want a way of determining the price of a departing employee's stock, if the firm has a "buyback" clause in its corporate bylaws and wants to repurchase a departing employee's shares. Vesting provides a mechanism for accomplishing both of these objectives. A typical start-up's vesting schedule lasts 36 to 48 months and includes a 12-month cliff, which is the period of time a person must work for the company in order to leave with any ownership interest. Thus, if a firm has a 48-month vesting schedule and offers 1,000 shares of stock to an employee, if the employee leaves after 10 months, that person does not retain an equity ownership position in the firm. If the employee leaves after 28 months, she or he will retain 28/48 of the promised equity, or 583 of the original granting of 1,000 shares. The shares will be issued to the employee at a specific price. If an employee leaves and the company is entitled to buy back the person's shares, the buyback clause typically allows the firm to repurchase the shares at their original issuance price.

Vesting and the partnering among employees it brings about avoids three problems. First, it helps keep employees motivated and engaged. If the employee in the example mentioned in the previous paragraph received his or her entire allotment of 1,000 shares on day one, the employee could walk away from the firm at any point and retain all issued shares while doing so. Second, if an employee's departure is acrimonious for whatever reason, there isn't any squabbling about how many shares the person will leave the firm with because the answer to this question is spelled out in the vesting schedule. Additionally, if a buyback clause is in place and it stipulates the formula for determining the value of the departing employee's stock, the firm can repurchase the shares without an argument. It is never a good outcome to have a former employee, particularly one who left under less than ideal circumstances, remain as a partial owner of the firm. Third and finally, investors are generally reluctant to invest in a firm if a block of stock is owned by former employees. Such a situation simply spells trouble, which, of course, investors seek to avoid.

Questions for Critical Thinking

1. Investors are often criticized for insisting that a vesting schedule be put in place for stock that is issued to employees. After reading this feature, do you think this criticism is justified? If a company anticipated that it will never take money from investors, is it still a good idea to establish a vesting schedule? Explain your answer.
2. Why do you think start-ups launch and distribute stock to founders and other members of their new-venture team without vesting schedules?
3. Is it typically necessary to hire an attorney to establish a vesting schedule for an entrepreneurial venture or can the new firm do it on its own?
4. Given your reading of this feature, explain how you think employees who own shares of a newly-launched firm would view themselves as partners in such a situation?

that an entrepreneur should work hard to avoid. It is important early in the life of a new business to establish practices and procedures to help avoid legal disputes. Legal snafus, particularly if they are coupled with management mistakes, can be extremely damaging to a new firm.

There are several steps entrepreneurs can take to avoid legal disputes and complications, as discussed next.

Meet All Contractual Obligations. It is important to meet all contractual obligations on time. This includes paying vendors, contractors, and employees as agreed and delivering goods or services as promised. If an obligation cannot be met on time, the problem should be communicated to the affected parties as soon as possible. It is irritating for vendors, for example, when they are not paid on time, largely because of the other problems the lack of prompt payments creates. The following comments dealing with construction companies demonstrate this situation: "Not getting paid on time can be devastating to construction companies that have costs to (their) vendors and

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One of the simplest ways to avoid misunderstandings and ultimately legal disputes is to get everything in writing.

employees that sometimes require payment weekly. Cash flow problems can send a company into a hole from which they will often not recover."[8] Being forthright with vendors or creditors if an obligation cannot be met and providing the affected party or parties a realistic plan for repaying the money is an appropriate path to take and tends to maintain productive relationships between suppliers and vendors.

Avoid Undercapitalization. If a new business is starved for money, it is much more likely to experience financial problems that will lead to litigation.[9] A new business should raise the money it needs to effectively conduct business or should stem its growth to conserve cash. Many entrepreneurs face a dilemma regarding this issue. Most entrepreneurs have a goal of retaining as much of the equity in their firms as possible, but equity must often be shared with investors to obtain sufficient investment capital to support the firm's growth.This issue is discussed in more detail in Chapter 10.

Get Everything in Writing. Many business disputes arise because of the lack of a written agreement or because poorly prepared written agreements do not anticipate potential areas of dispute.[10] Although it is tempting to try to show business partners or employees that they are "trusted" by downplaying the need for a written agreement, this approach is usually a mistake. Disputes are much easier to resolve if the rights and obligations of the parties involved are in writing. For example, what if a new business agreed to pay a web design firm $5,000 to design its website? The new business should know what it is getting for its money, and the web design firm should know when the project is due and when it will receive payment for its services. In this case, a dispute could easily arise if the parties simply shook hands on the deal and the web design firm promised to have a "good-looking website" done "as soon as possible." The two parties could easily later disagree over the quality and functionality of the finished website and the project's completion date.

The experiences and perspectives of Maxine Clark, the founder of Build-A-Bear Workshop, provide a solid illustration of the practical benefits of putting things in writing, even when dealing with a trusted partner:

> While I prefer only the necessary contracts (and certainly as few pages as possible), once you find a good partner you can trust, written up-front agreements are often a clean way to be sure all discussed terms are acceptable to all parties. It's also a good idea after a meeting to be sure someone records the facts and agree-to points, and distributes them to all participants in writing. E-mail is a good method for doing this. Steps like this will make your life easier. After all, the bigger a business gets, the harder it is to remember all details about every vendor, contract, and meeting. Written records give you good notes for doing follow-up, too.[11]

There are also two important written agreements that the majority of firms ask their employees to sign. A **nondisclosure agreement** binds an employee or another party (such as a supplier) to not disclose a company's trade secrets. A **noncompete agreement** prevents an individual from competing against a former employer for a specific period of time. A sample nondisclosure and noncompete agreement is shown in Figure 7.1.

Set Standards. Organizations should also set standards that govern employees' behavior beyond what can be expressed via a code of conduct. For example, four of the most common ethical problem areas that occur in an organization are human resource ethical problems, conflicts of interest, customer confidence, and inappropriate use of corporate resources. Policies and procedures should be established to deal with these issues. In addition, as reflected in the "Partnering for Success" features throughout this book, firms are increasingly partnering with others to achieve their objectives. Because of this, entrepreneurial ventures should be vigilant when selecting their alliance partners. A firm falls short in terms of establishing high ethical standards if it is willing to partner with companies that behave in a contrary manner.

When legal disputes do occur, they can often be settled through negotiation or mediation, rather than more expensive and potentially damaging litigation. **Mediation** is a process in which an impartial third party (usually a professional mediator) helps those involved in a dispute reach an agreement. At times, legal disputes can also be avoided by a simple apology and a sincere pledge on the

FIGURE 7.1
Sample Nondisclosure and Noncompete Agreement

Nondisclosure and Noncompetition. (a) At all times while this agreement is in force and after its expiration or termination, [employee name] agrees to refrain from disclosing [company name]'s customer lists, trade secrets, or other confidential material. [Employee name] agrees to take reasonable security measures to prevent accidental disclosure and industrial espionage.

(b) While this agreement is in force, the employee agrees to use [his/her] best efforts to [describe job] and to abide by the nondisclosure and noncompetition terms of this agreement; the employer agrees to compensate the employee as follows: [describe compensation]. After expiration or termination of this agreement, [employee name] agrees not to compete with [company name] for a period of [number] years within a [number] mile radius of [company name and location]. This prohibition will not apply if this agreement is terminated because [company] violated the terms of this agreement.

Competition means owning or working for a business of the following type: [specify type of business employee may not engage in].

(c) [Employee name] agrees to pay liquidated damages in the amount of $[dollar amount] for any violation of the covenant not to compete contained in subparagraph (b) of this paragraph.

IN WITNESS WHEREOF, [company name] and [employee name] have signed this agreement.

____

[company name]

____

[employee's name]

Date: ______________________________

part of the offending party to make amends. Yale professor Constance E. Bagley illustrates this point.[12] Specifically, in regard to the role a simple apology plays in resolving legal disputes, Professor Bagley refers to a *Wall Street Journal* article in which the writer commented about a jury awarding $2.7 million to a woman who spilled scalding hot McDonald's coffee on her lap. *The Wall Street Journal* writer noted that "A jury awarded $2.7 million to a woman who spilled scalding hot McDonald's coffee on her lap. Although this case is often cited as an example of a tort (legal) system run amok, *The Wall Street Journal* faulted McDonald's for not only failing to respond to prior scalding incidents but also for mishandling the injured woman's complaints by not apologizing."[13]

A final issue important in promoting business ethics involves the manner in which entrepreneurs and managers demonstrate accountability to their investors and shareholders. This issue, which we discuss in greater detail in Chapter 10, is particularly important in light of the corporate scandals observed during the early 2000s, as well as scandals that may surface in future years.

Obtaining Business Licenses and Permits

LEARNING OBJECTIVE

3. Provide an overview of the business licenses and permits that a start-up must obtain before it begins operating.

Many businesses require licenses and permits to operate. Depending on the nature of the business, licenses and permits may be required at the federal, state, and/or local levels. There are three ways for those leading a business to determine the licenses and permits that are necessary. The first is to ask someone who is running a similar business, and they will usually be able to point you in the right direction. The second is to contact the secretary of state's office in the state where the business will be launched. In most cases, they'll be able to help you identify the federal, state, and local licenses that you'll need. The third is to use one of the search tools available online. An example is the SBA's *Permit Me* search tool, available at www.sba.gov/licenses-and-permits. This very useful search tool allows you to search by zip code and type of business for the licenses and permits that are needed to open a particular business.

The number-one rule is that if you are uncertain, ask. Severe penalties can be levied if you start running a business without the proper licenses in place. The following is an overview of the licenses and permits that are required in the United States at the federal, state, and local levels for business organizations.

Federal Licenses and Permits

Most businesses do not require a federal license to operate, although some do. Table 7.5 contains a partial list of the business activities that require a federal license or permit, along with the federal agency to contact and its website address. Seemingly simple businesses sometimes require more licenses and permits than one might think. For example, if you prepare tax returns for others you are required by the IRS to register and obtain a tax preparer tax identification number (PTIN). Similarly, if you make beer that is sold, you'll need a federal permit and a state liquor license. You do not need a federal permit or a state liquor license if you make beer strictly for personal consumption.

State Licenses and Permits

In most states, there are three different categories of licenses and permits that you may need to operate a business. Most states have start-up guides that walk you through the steps of setting up a business in the state. For example, the guide for starting a business in Oregon, called the Startup Toolkit, is available at www.oregon.gov/business/Pages/toolkit.aspx. It provides step-by-step instructions for starting a business in Oregon.

TABLE 7.5 Partial List of Businesses That Require a Federal License or Permit to Operate

Business Activity	Federal Agency
Agriculture—Transporting Animals, Animal Products, Biologics, Biotechnology, or Plants across State Lines	U.S. Department of Agriculture (USDA)
Alcoholic Beverages—Manufacture, Wholesale, or Sell Alcoholic Beverages at a Retail Location	U.S. Treasury's Alcohol and Tobacco Tax and Trade Bureau (TTB)
Aviation—Operation of an Aircraft, the Transportation of Goods or People via Air, or Aircraft Maintenance	Federal Aviation Administration (FAA)
Commercial Fisheries	National Oceanic and Atmospheric Administration (NOAA)
Drug Manufacturing	Food and Drug Administration (FDA)
Firearms, Ammunition, and Explosives	Bureau of Alcohol, Tobacco, Firearms and Explosives (ATF)
Fish and Wildlife—Any Wildlife Activity, Including the Import/Export of Wildlife and Derivative Products	U.S. Fish and Wildlife Service
Ground Transportation	Department of Transportation (DOT)
Income Tax Preparation	IRS
Investment Advising	Security & Exchange Commission (SEC)
Maritime Transportation—Ocean Transportation or the Facilitation of the Shipment of Cargo by Sea	Federal Maritime Commission (FMC)
Mining and Drilling—Businesses Involved in the Drilling for Natural Gas, Oil, or Other Mineral Resources on Federal Lands	Bureau of Safety and Environmental Enforcement (BSEE)
Preparation of Meat Products	Food and Drug Administration (FDA)
Radio or Television Broadcasting	Federal Communications Commission (FCC)

Business Registration Requirements. Some states require all new businesses to register with the state. For example, the State of Oklahoma requires new businesses to complete a document titled "Oklahoma Business Registration Application" prior to commencing business. The purposes of the document are to (1) register the business, (2) place the business on the radar screen of the tax authorities, and (3) make sure the business is aware of and complies with certain regulations, such as the need to withhold state and federal taxes from employees' paychecks. The best way to determine if your state has a similar document is to ask a business owner or contact your secretary of state's office.

Sales Tax Permits. Most states and communities require businesses that sell goods, and in some cases services, to collect sales tax and submit the tax to the proper state authorities. If you're obligated to collect sales tax, you must get a permit from your state. Most states have online portals that make it easy to obtain a sales tax permit. For example, if you are opening a business in Texas, you can obtain your Texas Sales Tax Permit at www.window.state.tx.us/taxpermit/.

Professional and Occupational Licenses and Permits. In all states, there are laws that require people in certain professions to pass a state examination and maintain a professional license to conduct business. Examples include barbers, chiropractors, nurses, tattoo artists, land surveyors, and real estate agents. There are also certain businesses that require a state occupational license or permit to operate. Examples include plumbers, daycare centers, trucking companies, and insurance agencies.

Local Licenses and Permits

On the local level, there are two categories of licenses and permits that may be needed. The first is a permit to operate a certain type of business. Examples include child care, barber shops and salons, automotive repair, and hotels and motels. Many cities have quirky requirements, so it is important to check, prior to launching a business, if a specific permit is required. For example, in Atlanta you need a permit to operate a business that involves billiard or pool rooms. In Baltimore, you need a permit to operate a dance academy.

The second category is permits for engaging in certain types of activities. Examples include the following:

- Building permit: Typically required if you are constructing or modifying your place of business
- Health permit: Normally required if you are involved in preparing or selling food
- Signage permit: May be required to erect a sign
- Street vendor permit: May be required for anyone wanting to sell food products or merchandise on a city street
- Sidewalk café permit: May be required if tables and chairs are placed in a city right-of-way
- Alarm permit: Sometimes required if you have installed a burglar or fire alarm
- Fire permit: May be required if a business sells or stores highly flammable material or handles hazardous substances

In addition to obtaining the proper licenses and permits, if you plan to use a fictitious name for your business, you'll need to obtain a fictitious business name permit (regulations vary depending on location). A **fictitious business name permit** allows a business to legally operate under a fictitious name, like Gold Coast Sea Food or Red Rock Bakery. Selecting a name for a business and obtaining a fictitious business name permit if needed is an important task, not only to comply with the law but because a business's name is a critical part of its identity and its branding strategy. It is also one of the first things that people associate with a business. Appendix 7.1 contains a set of guidelines and suggestions for picking a business name. As illustrated in the appendix, it is important that a business choose a name that facilitates rather than hinders how it wants to differentiate itself in the marketplace.

Finally, all businesses, other than sole proprietorships that do not have employees, are required to obtain a **Federal Employee Identification Number** (normally called the Employer Identification Number or EIN). The easiest and quickest way to obtain an EIN is to go to www.irs.com and click on Apply for an EIN Online. A business' EIN is similar to an individual's social security number. It is used by the IRS to track the business for tax compliance purposes.

Along with obtaining the proper business licenses and permits, businesses are also required to comply with the government regulations that administer their activity. Noncompliance can lead to serious consequences. The nearby "What Went Wrong?" feature provides an example of an entrepreneurial start-up, Flytenow, that was shut down because of a Federal Aviation Administration regulation. The feature is also a colorful example of the wrangling that sometimes takes place between entrepreneurial firms and government agencies regarding how a certain regulation should be applied.

WHAT WENT WRONG?

How Flytenow Got Grounded by Government Regulations

Along with obtaining the proper licenses and permits, start-ups are also obligated to comply with any federal, state, and/or local government regulations that govern their activity. If they don't, they can be shut down. There are two challenges that start-ups face in this area. First, they may not be familiar with all the regulations that govern their business. The onus to know the rules and regulations is on the start-up. Second, a start-up and the government may disagree with how a regulation applies. If this happens, then a start-up has the option to take the matter to court, and hope the court sides with its point of view. This exact situation played out for Flytenow, except the court ruled in favor of the government and Flytenow was forced to shut down.

Flytenow was an airplane ride-sharing service that four founders launched in 2013. The company ran an Internet site where private pilots posted their flight plans and flight "enthusiasts," as Flytenow's website called them, could ride along and share the expenses. Flytenow made money by taking a commission on the funds that exchanged hands. According to the company, during the short time it was in service it attracted 25,000 members, including private pilots, travelers, and aviation enthusiasts. Most of the pilots on Flytenow's service operated single-engine, propeller-driven, four-seat planes.

The FAA challenged Flytenow's service citing a regulation that prohibits a pilot from accepting payment from passengers unless he or she possesses a commercial license. Applying that rule would ruin Flytenow's business model, because it is impractical for a private pilot to obtain a commercial license. Flytenow fought back, arguing that flight sharing is nothing new. Pilots have always posted notes on bulletin boards that read something like "Flying from Minneapolis to Chicago on Friday—looking for someone to ride along and share the costs." The FAA acknowledged that that practice is okay. They argued that what Flytenow was doing was different. By operating an Internet site that made ride-sharing widely available, Flytenow was operating as a common carrier (like Delta or Southwest). Pilots for common carriers need a commercial license. Flytenow didn't accept that they were acting as a common carrier. The company argued that flights arranged through its service were not indiscriminately available but only available to "enthusiasts" that demonstrated a common interest in the specific date, route, and adventure that the flight would entail.

The case went to court, and the U.S. Court of Appeals for the District of Columbia upheld the FAA's ruling. The founders of Flytenow reacted in a blog post by saying, "Unfortunately, we are left with no choice but to shut down Flytenow. However, we are still fighting as pilots to make this happen. Our amazing legal team at The Goldwater Institute is looking into options to appeal and help introduce a bill in Congress. Thanks to all of our supporters, mentors, and investors who helped us along the way."

Flytenow's experience is a reminder of the complicated legal environment in which start-ups may find themselves.

Questions for Critical Thinking

1. Which side do you agree with in this case—Flytenow or the FAA? Explain your answer.
2. If you started a business in an industry you weren't intimately familiar with, how would you go about determining the proper licenses and permits to obtain, and whether there are additional government regulations that affect the product or service you plan to offer?
3. If you were starting an aviation-related company, how would you go about locating an attorney that specialized in aviation law?
4. Do you think the founders of Flytenow will find a way to resurrect the service, or do you think the company is permanently out of business? Explain your answer.

Sources: Flytenow Blog, "The Beginning of the End," available at https://blog.flytenow.com (posted on an unknown date, accessed February 21, 2017); D. Weikel. "California-Based Flight-Sharing Company Must Remain Closed, Federal Court Rules," *L.A. Times*, December 21, 2015; D. Weiss, "Uber-Type Flight App Shuts Down After DC Circuit Decision," ABA Journal, available at https://www.abajournal.com/news/article/uber_type_flight_sharing_app_shuts_down_after_dc_circuit_decision (posted December 28, 2015, accessed February 21, 2017).

Choosing a Form of Business Organization

LEARNING OBJECTIVE

4. Identify and describe the different forms of organization available to new firms.

When a business is launched, a form of legal entity must be chosen. Sole proprietorships, partnerships, corporations, and limited liability companies are the most common legal entities from which entrepreneurs make a choice. Choosing a legal entity is not a one-time event. As a business grows and matures, it is necessary to periodically review whether the current form of business organization remains appropriate.

There is no single form of business organization that works best in all situations. It is up to a firm's owners and their attorney to select the legal entity that best meets their needs. The decision typically hinges on several factors, which are shown in Figure 7.2. It is important to be careful in selecting a legal entity for a new firm because each form of business organization involves trade-offs among these factors and because an entrepreneur wants to be sure to achieve the founders' specific objectives.

This section describes the four forms of business organization and discusses the advantages and disadvantages of each. A comparison of the four legal entities, based on the factors that are typically the most important in making a selection, is provided in Table 7.6.

Sole Proprietorship

The simplest form of business entity is the sole proprietorship. A **sole proprietorship** is a form of business organization involving one person, and the person and the business are essentially the same. Sole proprietorships are the most prevalent form of business organization. The two most important advantages of a sole proprietorship are that the owner maintains complete control over the business and that business losses can be deducted against the owner's personal tax return.[14]

Setting up a sole proprietorship is cheap and relatively easy compared to the other forms of business ownership. The only legal requirement, in most states, is to obtain the appropriate license and permits to do business, as described in the previous section.

If the business will be operated under a trade name (e.g., West Coast Graphic Design) instead of the name of the owner (e.g., Sam Ryan), the owner will have to file an assumed or fictitious name certificate with the appropriate local government agency, as mentioned earlier. This step is required to ensure that there is only one business in an area using the same name and provides a public record of the owner's name and contact information.

A sole proprietorship is not a separate legal entity. For tax purposes, the profit or loss of the business flows through to the owner's personal tax return document and the business ends at the owner's death or loss of interest in the business. The sole proprietor is responsible for all the liabilities of the business, and this is a significant drawback. If a sole proprietor's business is sued, the owner could theoretically lose all the business's assets along with personal assets. The liquidity of an owner's investment in a sole proprietorship is typically low. **Liquidity** is the ability to sell a business or other asset quickly at a price that is close to its market value.[15] It is usually difficult for a sole proprietorship to raise investment capital because the ownership of the business cannot be shared. Unlimited liability and difficulty raising investment capital are the primary reasons entrepreneurs typically form corporations or limited liability companies as opposed to sole proprietorships. Most sole proprietorships are salary-substitute or lifestyle firms (as described in Chapter 1) and are typically a poor choice for an aggressive entrepreneurial firm.

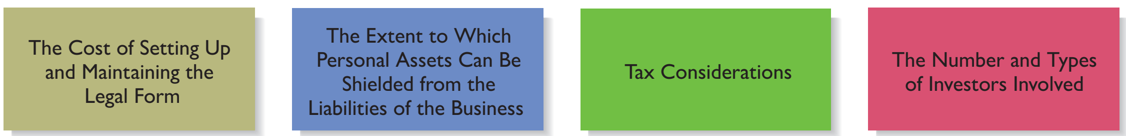

FIGURE 7.2
Factors Critical in Selecting a Form of Business Organization

TABLE 7.6 Comparison of Forms of Business Ownership

		Partnership		*Corporation*		
Factor	**Sole Proprietorship**	**General**	**Limited**	**C Corporation**	**S Corporation**	**Limited Liability Company**
Number of owners allowed	1	Unlimited number of general partners allowed	Unlimited number of general and limited partners allowed	Unlimited	Up to 100	Unlimited number of "members" allowed
Cost of setting up and maintaining	Low	Moderate	Moderate	High	High	High
Personal liability of owners	Unlimited	Unlimited for all partners	Unlimited for general partners; limited partners only to extent of investment	Limited to amount of investment	Limited to amount of investment	Limited to amount of investment
Continuity of business	Ends at death of owner	Death or withdrawal of one partner unless otherwise specified	Death or withdrawal of general partner	Perpetual	Perpetual	Typically limited to a fixed amount of time
Taxation	Not a taxable entity; sole proprietor pays all taxes	Not a taxable entity; each partner pays taxes on his or her share of income and can deduct losses against other sources of income	Not a taxable entity; each partner pays taxes on his or her share of income and can deduct losses against other sources of income	Separate taxable entity	No tax at entity level; income/loss is passed through to the shareholders	No tax at entity level if properly structured; income/loss is passed through to the members
Management control	Sole proprietor is in full control	All partners share control equally, unless otherwise specified	Only general partners have control	Board of directors elected by the shareholders	Board of directors elected by the shareholders	Members share control or appoint managers
Method of raising capital	Must be raised by sole proprietor	Must be raised by general partners	Sale of limited partnerships, depending on terms of operating agreement	Sell shares of stock to the public	Sell shares of stock to the public	It's possible to sell interests, depending on the terms of the operating agreement
Liquidity of investment	Low	Low	Low	High, if publicly traded	Low	Low
Subject to double taxation	No	No	No	Yes	No	No

To summarize, the primary advantages and disadvantages of a sole proprietorship are as follows:

Advantages of a Sole Proprietorship

- Creating one is easy and inexpensive.
- The owner maintains complete control of the business and retains all the profits.
- Business losses can be deducted against the sole proprietor's other sources of income.
- It is not subject to double taxation (explained later).
- The business is easy to dissolve.

Disadvantages of a Sole Proprietorship

- Liability on the owner's part is unlimited.
- The business relies on the skills and abilities of a single owner to be successful. Of course, the owner can hire employees who have additional skills and abilities.
- Raising capital can be difficult.
- The business ends at the owner's death or loss of interest in the business.
- The liquidity of the owner's investment is low.

Partnerships

If two or more people start a business, they must organize as a partnership, corporation, or limited liability company. Partnerships are organized as either general or limited partnerships.

General Partnerships. A **general partnership** is a form of business organization in which two or more people pool their skills, abilities, and resources to run a business. The primary advantage of a general partnership over a sole proprietorship is that the business isn't dependent on a single person for its survival and success. In fact, in most cases, the partners have equal say in how the business is run. Most partnerships have a partnership agreement, which is a legal document that is similar to a founders' agreement. A **partnership agreement** details the responsibilities and the ownership shares of the partners involved with an organization. The business created by a partnership ends at the death or withdrawal of a partner, unless otherwise stated in the partnership agreement. General partnerships are typically found in service industries. In many states, a general partnership must file a certificate of partnership or similar document as evidence of its existence. Similar to a sole proprietorship, the profit or loss of a general partnership flows through to the partner's personal tax returns. If a business has four general partners and they all have equal ownership in the business, then one-fourth of the profits or losses would flow through to each partner's individual tax return.[16] The partnership files an informational tax return only.

The primary disadvantage of a general partnership is that the individual partners are liable for all of the partnership's debts and obligations. If one partner is negligent while conducting business on behalf of the partnership, all the partners may be liable for damages. Although the non-negligent partners may later try to recover their losses from the negligent one, the joint liability of all partners to the injured party remains. It is typically easier for a general partnership to raise money than a sole proprietorship simply because more than one person is willing to assume liability for a loan. One way a general partnership can raise investment capital is by adding more partners. Investors are typically reluctant to sign on as general partners, however, because of the unlimited liability that follows each one.

In summary, the primary advantages and disadvantages of a general partnership are as follows:

Advantages of a General Partnership

- Creating one is relatively easy and inexpensive compared to a corporation or limited liability company.
- The skills and abilities of more than one individual are available to the firm.
- Having more than one owner may make it easier to raise funds.
- Business losses can be deducted against the partners' other sources of income.
- It is not subject to double taxation (explained later).

Disadvantages of a General Partnership

- Liability on the part of each general partner is unlimited.
- The business relies on the skills and abilities of a fixed number of partners. Of course, similar to a sole proprietorship, the partners can hire employees who have additional skills and abilities.
- Raising capital can be difficult.
- Because decision making among the partners is shared, disagreements can occur.
- The business ends at the death or withdrawal of one partner unless otherwise stated in the partnership agreement.
- The liquidity of each partner's investment is low.

Limited Partnerships A **limited partnership** is a modified form of a general partnership. The major difference between the two is that a limited partnership includes two classes of owners: general partners and limited partners. There are no limits on the number of general or limited partners permitted in a limited partnership. Similar to a general partnership, the general partners are liable for the debts and obligations of the partnership, but the limited partners are liable only up to the amount of their investment. The limited partners may not exercise any significant control over the organization without jeopardizing their limited liability status.[17] Similar to general partnerships, most limited partnerships have partnership agreements. A **limited partnership agreement** sets forth the rights and duties of the general and limited partners, along with the details of how the partnership will be managed and eventually dissolved.

A limited partnership is usually formed to raise money or to spread out the risk of a venture without forming a corporation. Limited partnerships are common in real estate development, oil and gas exploration, and motion picture ventures.[18]

Corporations

A **corporation** is a separate legal entity organized under the authority of a state. Corporations are organized as either C corporations or subchapter S corporations. The following description pertains to C corporations, which are what most people think of when they hear the word *corporation.* Subchapter S corporations are explained later.

C Corporations. A **C corporation** is a legal entity that, in the eyes of the law, is separate from its owners. In most cases, the corporation shields its owners, who are called **shareholders**, from personal liability for the debts and obligations of the corporation. A corporation is governed by a board of directors, which is elected by the shareholders (more about this in Chapter 9). In most instances, the board hires officers to oversee the day-to-day management of the organization. It is usually easier for a corporation to raise investment capital than a sole proprietorship or a partnership because the shareholders are not liable beyond their investment in the firm. It is also easier to allocate partial ownership interests in a corporation through the distribution of stock. Most C corporations have two classes of stock: common and preferred. **Preferred stock** is typically issued to conservative investors who have preferential rights over common stockholders in regard to dividends and to the assets of the corporation in the event of liquidation. **Common stock** is issued more broadly than preferred stock. The common stockholders have voting rights and elect the firm's board of directors. The common stockholders are typically the last to get paid in the event of the liquidation of the corporation; that is, after the creditors and the preferred stockholders.[19]

Establishing a corporation is more complicated than a sole proprietorship or a partnership. A corporation is formed by filing **articles of incorporation** with the secretary of state's office in the state of incorporation. The articles of incorporation typically include the corporation's name, purpose, authorized number of stock shares, classes of stock, and other conditions of operation.[20] In most states, corporations must file papers annually, and state agencies impose annual fees. It is important that a corporation's owners fully comply with these regulations. If the owners of a corporation don't file their annual paperwork, neglect to pay their annual fees, or commit fraud, a court could ignore the fact that a corporation has been established and the owners could be held personally liable for actions of the corporation. This chain of effects is referred to as "**piercing the corporate veil**."[21]

A corporation is taxed as a separate legal entity. In fact, the "C" in the title "C corporation" comes from the fact that regular corporations are taxed under subchapter C of the Internal Revenue Code. A disadvantage of corporations is that they are subject to **double taxation**, which means that a corporation is taxed on its net income and, when the same income is distributed to shareholders in the form of dividends, is taxed again on shareholders' personal income tax returns. This complication is one of the reasons that entrepreneurial firms often retain their earnings rather than paying dividends to their shareholders. The firm can use the earnings to fuel future growth and at the same time avoid double taxation. The hope is that the shareholders will ultimately be rewarded by an appreciation in the value of the company's stock.

The ease of transferring stock is another advantage of corporations. It is often difficult for a sole proprietor to sell a business and even more awkward for a partner to sell a partial interest in a general partnership. If a corporation is listed on a major stock exchange, such as the New York Stock Exchange or the NASDAQ, an owner can sell shares at almost a moment's notice. This advantage of incorporating, however, does not extend to corporations that are not listed on a major stock exchange. There are approximately 2,800 companies listed on the New York Stock Exchange (with a market capitalization of approximately $18.2 trillion dollars) and 3,100 on the NASDAQ. These firms are **public corporations**. The stockholders of these 5,900 companies enjoy a **liquid market** for their stock, meaning that the stock can be bought and sold fairly easily through an organized marketplace. It is much more difficult to sell stock in closely held or private corporations. In a **closely held corporation**, the voting stock is held by a small number of individuals and is very thinly or infrequently traded.[22] A **private corporation** is one in which all the shares are held by a few shareholders, such as management or family members, and are not publicly traded.[23] The vast majority of the corporations in the United States are private corporations. The stock in both closely held and private corporations is fairly **illiquid**, meaning that it typically isn't easy to find a buyer for the stock.

A final advantage of organizing as a C corporation is the ability to share stock with employees as part of an employee incentive plan. Because it is easy to distribute stock in small amounts, many corporations, both public and private, distribute stock as part of their employee bonus or profit-sharing plans. Such incentive plans are intended to help firms attract, motivate, and retain high-quality employees.[24] **Stock options** are a special form of incentive compensation. These plans provide employees the option or right to buy a certain number of shares of their company's stock at a stated price over a certain period of time. The most compelling advantage of stock options is the potential rewards to participants when (and if) the stock price increases.[25] Many employees receive stock options at the time they are hired and then periodically receive additional options. As employees accumulate stock options, the link between their potential reward and their company's stock price becomes increasingly clear. This link provides a powerful inducement for employees to exert extra effort on behalf of their firm in hopes of positively affecting the stock price.[26]

To summarize, the advantages and disadvantages of a C corporation are as follows:

Advantages of a C Corporation

- Owners are liable only for the debts and obligations of the corporation up to the amount of their investment.
- The mechanics of raising capital is easier.
- No restrictions exist on the number of shareholders, which differs from subchapter S corporations.
- Stock is liquid if traded on a major stock exchange.
- The ability to share stock with employees through stock options or other incentive plans can be a powerful form of employee motivation.

Disadvantages of a C Corporation

- Setting up and maintaining one is more difficult than for a sole proprietorship or a partnership.
- Business losses cannot be deducted against the shareholders' other income.
- Income is subject to double taxation, meaning that it is taxed at the corporate and the shareholder levels.
- Small shareholders typically have little voice in the management of the firm.

Subchapter S Corporation. A **subchapter S corporation** combines the advantages of a partnership and a C corporation. It is similar to a partnership in that the profits and losses of the business are not subject to double taxation. The subchapter S corporation does not pay taxes; instead, the profits or losses of the business are passed through to the individual tax returns of the owners. The S corporation must file an informational tax return. An S corporation is similar to a C corporation in that the owners are not subject to personal liability for the behavior of the business. An additional advantage of the subchapter S corporation pertains to self-employment tax. By electing the subchapter S corporate status, only the earnings actually paid out as salary are subject to payroll taxes. The ordinary income that is disbursed by the business to the shareholders is not subject to payroll taxes or self-employment tax.

Because of these advantages, many entrepreneurial firms start as subchapter S corporations. There are strict standards that a business must meet to qualify for status as a subchapter S corporation:

- The business cannot be a subsidiary of another corporation.
- The shareholders must be U.S. citizens. Partnerships and C corporations may not own shares in a subchapter S corporation. Certain types of trusts and estates are eligible to own shares in a subchapter S corporation.
- It can have only one class of stock issued and outstanding (either preferred stock or common stock).
- It can have no more than 100 members. Husbands and wives count as one member, even if they own separate shares of stock. In some instances, family members count as one member.
- All shareholders must agree to have the corporation formed as a subchapter S corporation.

The primary disadvantages of a subchapter S corporation are restrictions in qualifying, expenses involved with setting up and maintaining the subchapter S status, and the fact that a subchapter S corporation is limited to 100 shareholders.[27] If a subchapter S corporation wants to include more than 100 shareholders, it must convert to a C corporation or a limited liability company.

Limited Liability Company

The **limited liability company (LLC)** is a form of business organization that is rapidly gaining popularity in the United States. The concept originated in Germany and was first introduced in the United States in the state of Wyoming in 1978. Along with the subchapter S corporation, it is a popular choice for start-up firms. As with partnerships and corporations, the profits of an LLC flow through to the tax returns of the owners and are not subject to double taxation. The main advantage of the LLC is that all partners enjoy limited liability.

Iakov Filimonov/Shutterstock

This young man just opened a bicycle shop. Before he opened, he obtained the necessary licenses and permits and organized as a limited liability company.

This differs from regular and limited partnerships, where at least one partner is liable for the debts of the partnership. The LLC combines the limited liability advantage of the corporation with the tax advantages of the partnership.[28]

Some of the terminology used for an LLC differs from the other forms of business ownership. For example, the shareholders of an LLC are called "members," and instead of owning stock, the members have "interests." The LLC is more flexible than a subchapter S corporation in terms of number of owners and tax-related issues. An LLC must be a private business—it cannot be publicly traded. If at some point the members want to take the business public and be listed on one of the major stock exchanges, it must be converted to a C corporation.

The LLC is rather complex to set up and maintain, and in some states the rules governing the LLC vary. Members may elect to manage the LLC themselves or may designate one or more managers (who may or may not be members) to run the business on a day-to-day basis. The profits and losses of the business may be allocated to the members any way they choose. For example, if two people owned an LLC, they could split the yearly profits 50–50, 75–25, 90–10, or any other way they chose.[29]

In summary, the advantages and disadvantages of an LLC are as follows:

Advantages of a Limited Liability Company

- Members are liable for the debts and obligations of the business only up to the amount of their investment.
- The number of shareholders is unlimited.
- An LLC can elect to be taxed as a sole proprietor, partnership, S corporation, or corporation, providing a great deal of flexibility.
- Because profits are taxed only at the shareholder level, there is no double taxation.

Disadvantages of a Limited Liability Company

- Setting up and maintaining one is more difficult and expensive.
- Tax accounting can be complicated.
- Some of the regulations governing LLCs vary by state.
- Because LLCs are a relatively new type of business entity, there is not as much legal precedent available for owners to anticipate how legal disputes might affect their businesses.
- Some states levy a franchise tax on LLCs—which is essentially a fee the LLC pays the state for the benefit of limited liability.

Chapter Summary

LO1. Establishing a strong ethical culture in their firms is the single most important thing the founders of an entrepreneurial venture can do. Three important ways to do this are (1) lead by example, (2) establish a code of conduct (also known as a code of ethics), and (3) implement an ethics training program. In the context of "leading by example," three keys to building a strong ethical culture in a firm are (1) having leaders who intentionally make ethics a part of their daily conversations and decision making, (2) supervisors who emphasize integrity when working with their direct reports, and (3) peers who encourage each other to act ethically. A code of conduct and an ethics training program are two techniques entrepreneurs use to promote high standards of business ethics in their firms. A code of conduct describes the general value system, moral principles, and specific ethical rules that govern a firm. An ethics training program provides employees with instructions for how to deal with ethical dilemmas when they occur.

LO2. We show the criteria that are important for selecting an attorney for a new firm in Table 7.3. Critical issues include selecting an attorney familiar with the start-up process, selecting an attorney who can assist you in raising money, and making certain that the attorney has a track record of completing work on time. It is important to ensure that a venture's founders agree on their relative interests in the venture and their commitment to its future. A founders' (or shareholders') agreement is a written document dealing with issues such as the split of equity between or among the firm's founders, how individual founders will be compensated for the cash or the "sweat equity" they put into the firm, and how long the founders will have to remain with the firm for their shares to fully vest. Suggestions for how new firms can avoid litigation include meeting all contractual obligations, avoiding undercapitalization, getting everything in writing, and promoting business ethics in the firm. A nondisclosure agreement is a promise made by an employee or another party (such as a supplier) not to disclose a company's trade secrets. A noncompete agreement prevents an individual from competing against a former employer for a specified period of time.

LO3. Before a business is launched, a number of licenses and permits are typically needed. The required licenses and permits vary by city, county, and state, as well as by type of business, so it is important to study local regulations carefully. In most communities, a business needs a license to operate. Along with obtaining the appropriate licenses, some businesses may need to obtain one or more permits.

LO4. The major differences among sole proprietorships, partnerships, corporations, and limited liability companies are shown in Table 7.6. These forms of business organization differ in terms of the number of owners allowed, cost of set up and maintenance, personal liability of owners, continuity of the business, methods of taxation, degree of management control, ease of raising capital, and ease of liquidating investments. Fast-growth firms tend to organize as corporations or limited liability companies for two main reasons: to shield the owners from personal liability for the firm's behavior and to make it easier to raise capital.

Key Terms

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MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

7-1. When should your friend, who is considering launching a consulting firm to provide financial services to small businesses, think about the ethical climate she wants to establish in her venture?

7-2. Based on the information included in this chapter, in general, do entrepreneurs tend to overestimate or underestimate their knowledge of the laws that pertain to starting a new firm, and why?

7-3. What are the prerequisites for building a strong ethical culture in a firm?

7-4. What are some of the specific steps that can be taken in an entrepreneurial venture for the purpose of building a strong ethical culture?

7-5. What is the purpose of a *code of conduct*?

✪ 7-6. What is the purpose of establishing and using an *ethics training program* in an entrepreneurial firm?

7-7. What are some of the more important criteria to consider when selecting an attorney for a new firm?

7-8. What is a founders' agreement and why is it important for a team of entrepreneurs to have one in place when launching a venture?

7-9. What is the purpose of a nondisclosure agreement and the purpose of a noncompete agreement?

7-10. How can entrepreneurial ventures avoid legal disputes?

7-11. What is mediation and how do entrepreneurs use it to resolve disputes?

7-12. At what point, during the process of starting a firm, does a business need to focus on the business licenses and permits that it needs, and why at that point?

✪ 7-13. Why is it important for a firm's founders to think carefully about the name they pick for their company?

7-14. Why isn't choosing a legal entity a one-time event?

7-15. What might trigger a firm's decision to change how it is legally organized?

7-16. What are the advantages and disadvantages of organizing a new firm as a sole proprietorship?

7-17. Is a sole proprietorship a separate legal entity? Why or why not?

7-18. What are the differences between a general partnership and a limited partnership?

7-19. What are the major advantages and disadvantages of a C corporation?

7-20. How is a C corporation subject to double taxation?

7-21. How is a subchapter S corporation similar to a partnership arrangement?

7-22. What is meant by the term *piercing the corporate veil* and what are the implications for the owners of a corporation if the corporate veil is pierced?

7-23. What are the differences among a public corporation, a closely held corporation, and a private corporation?

7-24. How can a limited liability company be made public and listed on a major stock exchange?

7-25. What are the advantages and disadvantages of a limited liability company?

7-26. Is a limited liability company an appropriate form of ownership for an aggressive entrepreneurial firm, why or why not?

Application Questions

7-27. Under what conditions should ethical considerations be part of a company's business plan? Should a company periodically measure its ethical performance? If so, what are the best ways for a firm to do this?

7-28. Tom Andersen owns an electronics firm in Wichita, Kansas. He has told you that he has been suffering some cash flow problems recently, but has avoided having to borrow money by letting some of his firm's bills run late. When you raised your eyebrows in response to hearing these comments from Tom, he said, "Don't worry. I'm really not nervous about this situation in that I have some large orders coming in soon. I'll use the cash from these orders to catch up on my bills." Does what Tom has told you seem to be a sound strategy for him to follow? What are the downsides associated with how Tom is approaching his cash flow issues?

7-29. Martha Young has recently developed a business in laundry services. She has done her homework and is very confident of her business plan. You recently met her over lunch, during which she happily discussed her business and the steps she had taken to ensure the success of her new venture. When asked about her attorney, she mentioned that she is considering her sister Stella, a fresh graduate from law school, to be her legal advisor. Do you think that Martha has made the right choice by appointing her sister, especially since she is new to this industry?

7-30. DipJar is the focus of the "You Be the VC 7.2" feature. Assume that this firm's founders have asked you to help them write a code of conduct for their firm. Given your understanding of how DipJar operates as an entrepreneurial venture, put together a table of contents for the firm's code of conduct.

7-31. Apple has been involved in a series of patent disputes with Nokia and Samsung. To avoid a protracted argument with Nokia, Apple paid out $2 billion. In June 2017, U.S. courts ordered Apple to pay $506 million for infringing a University of Wisconsin patent. When it comes to patent and legal disputes between companies, is it ever worth the expense and publicity of going to court? Is this a lesson for start-ups?

7-32. You have been approached by a close family friend who is putting together a limited liability company to purchase a condominium complex near Cocoa Beach in Florida. He is asking you, along with a number of family members, to invest $10,000 each in his company. The condominium complex is selling for $5 million. Your friend hopes to convince 50 people to invest $10,000 each, which will raise $500,000; he intends to borrow the remaining $4.5 million to close the deal. "I don't mind investing the $10,000 but I'm really nervous about being on the hook for a $4.5 million loan if the deal goes bad," you note to your friend. In response, he insists that all you would have at risk is $10,000 and that you would not be liable for anything else. Is your friend right or wrong about this?

7-33. Sam Anderson wants to start a Mexican food restaurant in your neighborhood, but he is unsure about the types of permits and licenses that are necessary for his business. His restaurant is scheduled to start operating within the next three months. As you are associated with the local municipal council, he has sought your advice on the two categories of licenses and permits that may be needed for his business. Help Sam.

7-34. Stephen Martin and James Canton came up with the idea of starting a bicycle rental business. They found a good location in the town center and decided to open a shop where people can park their car and rent a bicycle to travel around town. The idea came from their own experiences in a town where the roads were always congested with traffic. As Stephen and James have been the best of friends for over two decades, they have decided not to sully their bond by having a founders' agreement. Do you think this is a good idea? Why?

YOU BE THE VC 7.1 COMPANY: Vélib'

• Web: www.velib.paris.fr • Facebook: Vélib' • Twitter: @Velib

Business Idea: Reduce traffic congestion, air pollution, and wear and tear on the nation's highways by introducing an easy-to-use, self-service, bike-for-hire system.

Pitch: Traffic congestion is stressful; it causes air pollution and costs millions in tax revenue spent on keeping roads in good repair. Now one company is encouraging people to give up their cars in favor of pedal power. Vélib', located in Paris, France, is pioneering the concept of a public bicycle rental program. On July 15, 2007, 10,000 bicycles were introduced to the city along with 750 automated rental stations holding 15 bicycles each. Customers pay a deposit of $200 for an unlimited number of rentals and are then given a charge card that detaches the bikes from the cycle racks. The rental is $1.80 for unlimited access 24 hours a day or $8.50 for a seven-day pass. The bike does not need to be returned to the same pick-up point; customers can pick up one of the distinctive gray bicycles from a rack near the Eiffel Tower, cycle to the Pantheon, and leave it at the nearest Vélib' stand there. Twenty trucks are used each night to redistribute the machines to high-demand stations.

Theft is kept to a minimum thanks to the heavy design of the bikes. The parking facilities are also secure, and the credit-card deposit system deters users from "forgetting" to return the bikes, because fines can then be collected directly from the card. The service is primarily aimed at people making short journeys. Each bicycle is used 30 times a day on average, and the average trip time is just 18 minutes. To date, nearly 200 million journeys have been made, with an average of 90,000 per day. Visitors to the city can take out short-term subscriptions simply by using their credit cards directly at the cycle-rack terminals.

The service is financed by family-controlled advertising company JCDecaux, which provides the bikes in return for an exclusive contract to sell outdoor advertising in prime locations around Paris. JCDecaux paid start-up costs of around $115 million, and the Paris City Council pays the $500 replacement cycle costs, estimated at around $2 million per year.

Since its launch, the number of bicycles available for hire has doubled to 20,000, and the number of rental stations has increased to 1,800. City officials say traffic has been reduced by 5 percent in the French capital.

7-35. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

7-36. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this firm? Why, or why not?

YOU BE THE VC 7.2 COMPANY: DipJar

• Web: www.dipjar.com • Facebook: DipJar • Twitter: @dipjar

Business Idea: Create a hardware device that makes it easy for people to use credit or debit cards to leave tips for service workers or to donate to a nonprofit organization, such as the Salvation Army or the public library.

Pitch: Most people don't carry much cash anymore. Instead, the majority of Americans rely on credit and debit cards to make purchases. This change makes it harder for people to spontaneously tip service providers or make donations. This is a problem in the restaurant industry in that the move away from cash has caused tips to go down. In some settings, it's nearly impossible to tip without cash. For example, most people tip the bell staff of a hotel if they hail them a cab. It's impossible to do that if you don't have cash. Similarly, it's hard to make small donations if a person isn't carrying cash.

Think of Salvation Army volunteers who stand in front of stores during the Christmas season collecting donations in their iconic red buckets. What do you do if you want to make a donation, but either don't have any cash on you, or only have bills in denominations larger than you want to give? There are also organizations to which people might give small donations, like a public library, but there are no tasteful ways for the organization to collect small amounts of money.

DipJar has solved these problems. It has created a small hardware product called the DipJar. Here's how it works. An organization buys a DipJar. DipJar will customize the color of the device to fit the organization's brand, and will screen print the organization's logo on the front of the device. The DipJar is accompanied by an online dashboard. The dashboard allows the organization to program in its banking information (so it can get paid) and the amount of the desired tip or donation (say $5.00). The DipJar will then display the $5.00 requested amount. All a patron has to do is "dip" his or her credit or debit card into the device, and a $5.00 donation is made. The dashboard records the amount of money that is collected daily, weekly, and monthly. The amount requested can be changed at any time. The DipJar is tastefully designed, and is about the size of a telephone. For a restaurant or café, the dashboard can track the amount of tips collected during a specific shift. That feature allows the owners of the restaurant to pass along the correct dollar amount of tips to the wait staff that was working during that shift. DipJar has various pricing models depending on the usage. It charges a competitive processing fee for each transaction.

A number of organizations have experienced success utilizing their DipJars. For example, the Salvation Army was looking for a credit card solution to supplement its red kettles, as well as a tool to enable collections in retail settings where the red kettle wouldn't be appropriate. A total of 90 DipJars were deployed in three states. The result: Over $3,700 in annualized donations at one Denver thrift shop with no previous collections. Similarly, visitors to the New York Public library's main branch are offered a free audio tour guide and are asked for a donation in exchange. The library was missing out on contributions from visitors who didn't have cash. The result: The library now collects $150–$200 a month in $5.00 donations processed via DipJar. Cash donations have also gone up, as the DipJar has helped set a $5.00 norm.

7-37. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

7-38. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 7.1

Preparing a Proper Legal Foundation: A Start-Up Fable

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Jack Peterson and Sarah Jones are planning to start a business. Their plan is to locate and operate 10 kiosks in malls and other high-traffic areas to sell accessories for Apple iPhones and iPads. To complement their accessory sales, the two have created a series of short videos that help users learn how to make better use of their iPhones and iPads. The videos will be available on Jack and Sarah's website for a one-time fee of $5.99 or on an app they are developing for a $5.99 one-time download fee. Both the website and the mobile app will include promotions to buy additional iPhone and iPad accessories via Jack and Sarah's kiosks or through their online store.

iUser Accessories is the tentative name for the business. Jack and Sarah like to use the word *tentative* because they aren't completely sold on the name. The Internet domain name, www.iuseraccessories.com, was available, so they registered it on www.godaddy.com. Part of their start-up funding will be used to hire a trademark attorney to do a formal trademark search before they use the name or do any advertising.

Jack and Sarah met in an introduction to entrepreneurship course at their local university. They hit it off while working on the initial business plan for iUser Accessories, which they completed as an assignment for the class. Their senior year, they refined the plan by working on it during a business planning class. They took first place in a university-wide business plan competition just before graduation. The win netted them $10,000 in cash and $10,000 in "in-kind" services for the business. Their plan was to use the money to establish a relationship with an accountant affiliated with the university.

Feasibility Analysis and Business Plan

As part of their business plan, Jack and Sarah completed a product feasibility analysis for iUser Accessories. They first developed a concept statement and distributed it to a total of 25 people, including professors; electronic store owners; iPhone and iPad users; and the parents of young iPhone and iPad users. The responses were both positive and instructive. The idea to distribute videos dealing with how to better use your iPhone and iPad via streaming video over the Internet or via the mobile app came directly from one of the concept-statement participants. Jack and Sarah's original idea was to distribute this material in a more conventional manner. The person who came up with the idea wrote on the bottom of the concept statement, "Not only will this approach save you money (by not having to distribute actual DVDs) but it will drive traffic to your website and your app and provide you with additional e-commerce opportunities."

Following the concept statement, Jack and Sarah surveyed 410 people in their target market, which is 15- to 35-year-olds. They did this by approaching people wherever they could and politely asking them to complete the survey. They persuaded one of their marketing professors to help them with the survey's design, to make sure it generalized to a larger population. They learned that 62 percent of the people in their target market own an iPhone or iPad or plan to buy one soon. The survey also listed a total of 36 iPhone and iPad accessories, which are available through vendors to which Jack and Sarah have access. The results affirmed Jack and Sarah's notion that the vast majority of people in their target market don't realize the number of iPhone and iPad accessories that exist, let alone know where to get them. They also were pleased with the high degree of interest expressed by the survey participants in learning more about many of the accessories.

Start-Up Capital

As part of their business plan, Jack and Sarah completed one- and three-year pro forma financial statements, which demonstrate the potential viability of their business. They have commitments for $66,000 of funding from friends and family. According to their projections, they should be cash-flow positive within four months and will not need any additional infusions of cash, unless they expand the business beyond the scope of their original business plan. The projections include salaries of $45,000 per year for both Jack and Sarah, who will both work more than 40 hours a week manning the kiosks and running the business.

Jack and Sarah are fortunate in that they are able to each contribute $3,000 to the business personally and were able to gain commitments of $30,000 each from their respective groups of friends and family. A year or so ago they participated in a class offered by their local Small Business Development Center (SBDC) about how to start a business and remembered an attorney saying that it is all right to talk to people about funding prior to talking to an attorney, but don't actually accept any money until you have your legal ducks in order. As a result, other than their own money, Jack and Sarah don't actually have the $66,000 yet. They can accumulate it within 30 days once they are confident that the business is a go.

wavebreakmedia/Shutterstock

Jack and Sarah preparing for the meeting with the attorney.

Preparing for the Meeting with the Attorney

Jack and Sarah plan to launch their business on September 15, just a couple of months prior to the start of the busy Christmas season. They spent some time asking around the business school and the technology incubator attached to their university to identify the name of a good small-business attorney. They identified an attorney and made the appointment. The appointment was scheduled for 2:15 pm on July 16 at the attorney's office.

Another takeaway that Jack and Sarah gleaned from the SBDC class was to plan carefully the time you spend with an attorney, in order to make best use of your time and minimize expenses. As a result, prior to the meeting, Jack and Sarah planned to spend several evenings at a local Barnes & Noble bookstore, looking at books that deal with forms of business ownership and other legal issues and making a concise list of issues to discuss with the attorney. They had also gone over this material in preparing their business plan. In the meeting with the attorney, they want to be as well informed as possible and actually lead the discussion and make recommendations. Sarah's dad is a real estate agent and had dealt with many attorneys during his career. One thing he told her, in helping her prepare for this meeting, is that attorneys are helpful and necessary but shouldn't make your decisions for you. Sarah shared this insight with Jack, and they were both determined to follow that advice in their upcoming meeting.

Jack and Sarah's Recommendations

To put their list on paper and get started, Jack created a document (shown nearby) for the purposing of listing issues they wanted to discuss with the attorney.

Jack and Sarah spent the next several evenings completing this list and talking about their business. When they made the call to set up the meeting with the attorney, the attorney told them that she wasn't an intellectual property lawyer, and if it looked like the business was a go after their meeting, she could arrange for them to talk to one of her partners who specialized in patent and trademark law. As a result, Jack and Sarah knew that this meeting would focus more on forms of business ownership and general legal issues, and they would address their intellectual property questions at another meeting.

Jack Peterson and Sarah Jones

Founders, iUser Accessories

List of Legal Issues to Discuss with Attorney

Issue	Jack and Sarah's Recommendation

The Day Arrives

The day for the meeting arrived, and Jack and Sarah met at the attorney's office at 2:15 pm. They had e-mailed the attorney their list of issues along with their recommendations a week prior to the meeting. The attorney greeted them with a firm handshake and opened a file labeled "iUser Accessories, Jack Peterson and Sarah Jones." Seeing their names like that, on an attorney's file, made it seem like their company was already real. The attorney looked at both of them and placed a copy of the list they had e-mailed in front of her. The list already had a number of handwritten notes on it. The attorney smiled and said to Jack and Sarah, "Let's get started."

Discussion Questions

7-39. Complete Jack and Sarah's list for them, including the issues you think they will place on the list along with their recommendations. Which of the issues do you think will stimulate the most discussion with the attorney, and which issues do you think will stimulate the least?

7-40. What are some of the actions Jack and Sarah took prior to meeting with the attorney that are appropriate for them to have taken?

7-41. Is it too early for Jack and Sarah to begin laying an ethical foundation for their proposed venture? If not, what steps could they take now as a foundation for an ethical culture within their firm?

7-42. What advantages do Jack and Sarah have starting iUser Accessories together rather than one of them starting it as a sole entrepreneur?

7-43. Based on information featured in the case, what challenges do you think Jack and Sarah will have keeping their partnership active?

CASE 7.2

Peloton Cycle and DonorsChoose: How For-Profit and Nonprofit Start-Ups Build Credibility and Trust

Peloton: • Web: www.pelotoncycle.com • Facebook: PelotonCycle • Twitter: @ridepeloton
DonorsChoose: • Web: www.donorschoose.org • Facebook: DonorsChoose: Twitter: @DonorsChoose

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Credibility is a vital part of any start-up's persona. Whether a prospective customer in a for-profit context or a prospective donor in a nonprofit context, it's important that the company or organization presents itself in a manner that builds credibility and trust during first encounters. Both consumers and donors have multiple options for allocating their money. As a result, it is essential that a start-up make a favorable first impression and give its patrons reasons to trust it.

How Companies and Organizations Build Credibility and Trust

There are several ways companies and organizations can build credibility, legitimacy, and trust. We present eight techniques that are essential in nearly all cases in the following list.

Techniques for Engendering Credibility, Legitimacy, and Trust

Technique	Explanation
1. Have an attractive logo, corporate e-mail address, and professional looking website.	Prospective customers and donors have a mental image of what *real* companies and organizations look like. If your logo, website, or e-mail address look amateurish or suspect, the game is up. Always have a corporate.com or .org e-mail address. A Gmail or Yahoo! e-mail address makes a company or organization look amateurish.
2. Receive media coverage.	Display prominently on your website the media coverage you've received. If you're new, start by asking bloggers in your industry to cover you. Media coverage is a tacit sign of legitimacy and support.
3. Obtain expert testimonials.	Get expert testimonials and feature them on your website and in your literature. An expert doesn't have to be someone who is famous. If you're selling surgery-related software, ask a surgeon to test it and comment. If you're starting a nonprofit to provide a place for at-risk kids to hang out after school, ask the local police chief or a school principal to comment on your service.
4. Obtain customer testimonials.	Ask customers, donors, or recipients of the good or service you provide to test that good or service and then to comment about their experiences. Include their pictures if possible. Positive quotes from real people are often the most persuasive.
5. Give people a reason to care.	Make sure to convey your start-up's relevance, but don't use buzz words like you're "revolutionary" or "are the industry's best." These terms are too slick. Instead, be genuine. Explain in everyday language why your customers or donors should care.
6. Tell your story.	Why do you care? There is nothing that builds credibility and trust faster than a founder telling the sincere story of why he or she is launching a company or starting a nonprofit. Include your picture and put a real e-mail address next to it.
7. Have a presence on Facebook, Twitter, and Instagram.	Like it or not, people will look for you on Facebook, Twitter, and Instagram. If you're not there, it's a red flag. Establish a presence on all three of these sites and provide frequent updates.
8. Tell people how you'll use and/or protect their money.	If you're a for-profit business, offer a money-back guarantee. If you're a nonprofit, explain in specific terms how your donor's money will be spent.

Presented next are examples of how two organizations—one for-profit and one nonprofit—are building credibility, legitimacy, and trust via these techniques.

Peloton Cycle

Launched in 2012, Peloton Cycle is enabling people to have a unique fitness experience in their homes. The company has built a sleek, innovative stationary bike that is equipped with a 22-inch waterproof, Android touchscreen, which allows the rider to stream live or on-demand cycling classes from the top instructors in New York City. With the Peloton Cycle, for the first time ever, people can obtain an intense, high-energy cardio workout from the convenience of their home.

From the touchscreen, the user can pick from hundreds of archived on-demand rides or participate in one of 12 live classes per day. If you sign up for a live class ahead of time, it can signal to your friends that you'll be in the class and they can join you. You can also post your reservation to Facebook so others can join you if they wish. The on-demand rides include hundreds of options that vary by length, level of difficulty, instructor, and so forth. The live rides allow you to join Peloton riders in the company's New York City studios along with Peloton riders across the world. For both the on-demand and live options, you can check the leader board to see how you're doing relative to other riders, or you can hide the data and immerse yourself in the ride. As you ride, the Peloton Cycle monitors calories burned, power output, distance traveled, and cadence (pedaling rate) and shows it all to you as you go.

Peloton Cycle makes money by selling the bike ($1,995) and the monthly subscription to the live and on-demand rides ($39.00).

That's the product and service that Peloton Cycle offers. Here's how Peloton is building credibility, legitimacy, and trust via the eight techniques described previously.

1. It has a professional logo design, a beautiful website, and a corporate e-mail address.
2. It has attracted considerable press and has been featured in *Fast Company*, *Men'sHealth*, *USA Today*, *Good Housekeeping*, *Vanity Fair*, *The New York Times* and other outlets. The firm also has been reviewed on several television shows (e.g., Fox Business) and has caught the attention of celebrities including Sofia Vergara, Madonna, and Jon Bon Jovi. www.salesforce.com CEO March Benioff tweeted "I am a @RidePeloton convert! Great Product. Visionary experience. Highly recommend."
3. Peloton does not post expert testimonials on its website per se, but the site contains multiple photos of people who have aligned themselves with the company. It also posts quotes from publications that have featured the Peloton Cycle. The company claims to have attracted some of the most talented cycling instructors in the country. Peloton also has product videos on its website (and on YouTube) that allow people to see the Peloton Cycle in action for themselves.
4. Customer testimonials are prominently posted on the company's website.
5. All of Peloton's advertising, promotions, and public relations is geared toward conveying to potential customers the difference that Peloton is making in people's lives. Peloton allows people access to high intensity, interactive workouts from the convenience of their homes. Peloton also stresses the "community' aspect of what it calls the Peloton experience. People become acquainted with one another by taking the same live cycling classes at the same time. They form friendships and develop support networks.
6. The company jumps at the opportunity to tell its story, and is proud of bringing a new approach to fitness to the marketplace. Its founding story along with a nicely crafted summary of the value it provides is posted on its website (under the link "Our Story"). Peloton has a YouTube channel that includes a variety of views of the company, including interviews with its founder, Peloton commercials, and features on Peloton instructors. The company has also run nationwide TV commercials that tell the essence of the Peloton story.
7. The company is active on Facebook, Twitter, and Instagram. As of March 2017, it had 213,975 Facebook likes, 11,500 Twitter followers, and 52,500 Instagram followers.
8. Peloton offers a 30-day return policy. Peloton does not refund the initial shipping fee nor pay for the bike to be shipped back to the company.

DonorsChoose

DonorsChoose is a nonprofit organization that provides a way for people to donate directly to specific projects at public schools. Charles Best, a middle school science teacher at a public school in the Bronx, launched DonorsChoose in 2000. Since then, it has grown to serve public schools across the United States.

DonorsChoose collects proposals from teachers and posts them on its website. A typical project is a request that was posted in February, 2017 by a teacher at Deer Creek Intermediate School of Edmond, OK—a public school. The teacher requested $387.96 to buy six wobble chairs for her classroom. Wobble chairs are ergonomically designed, so they provide proper back and leg support, and allow students a wide range of movement without leaving their seats. The teacher says that she has created a flexible classroom, which allows students to move from activity to activity. She has already seen positive results, and the wobble chairs would provide her students even more flexibility and opportunities to learn. A 15 percent overhead is added by DonorsChoose to fund its operations, and a budget is displayed, which includes shipping charges, sales tax, and so forth, bringing the request to $585. As of the date this case was written, eight people, from two different states, had donated $475 and $110 was still needed. If the project is funded, DonorsChoose will buy the wobble chairs and deliver them to the teacher. A fax or e-mail message will then be sent to the school principal indicating that the gift had been made. In

Rawpixel.com/Shutterstock

Many of the requests funded on DonorsChoose are for hands-on activities that involve and inspire students. Here, a teacher is using a globe, a large world map, and a specially designed curriculum to familiarize students with other countries and cultures in the world.

addition, if any teachers in the same school have raised money through DonorsChoose, those teachers will be notified of the gift. DonorsChoose never sends cash to a teacher to buy the items included in the request. It makes the purchases and delivers the items.

What happens next is heartwarming and special. Anyone who donates $1 or more receives a written thank-you letter from the teacher, photos from the classroom, and a report of how each dollar was spent. DonorsChoose is funded by the administrative overhead it collects from donors and through private funding choices.

That's what DonorsChoose is about. Like any charity, it relies on the trust and support of its donors. Here's how DonorsChoose covers the eight techniques shown previously for building credibility, legitimacy, and trust.

1. It has a professional logo design, a beautiful website, and a .org e-mail address.
2. Despite having been active for more than 15 years, DonorsChoose still draws attention from the press. It has been featured on NPR, NBC Nightly News, CNBC, CBS This Morning, Morning Joe, and other radio and television programs. Articles have been written about DonorsChoose in *Fast Company*, *Vanity Fair*, *The Wall Street Journal*, *USA Today*, and other outlets.
3. DonorsChoose has been endorsed by two organizations that rate nonprofits: BBB Accredited Charity and Charity Navigator. It consistently meets the BBB Wise Giving Alliance's standards for charity accountability, and has received a four-star rating (the highest possible) from Charity Navigator, America's premier independent charity evaluator. It also has a number of corporate partners that affiliate themselves with DonorsChoose and its mission. Its partners include Chevron, Google.org, Sonic, the Bill & Melinda Gates Foundation, Disney, 3M, and TOMS.
4. DonorsChoose does not post customer testimonials per se, but prominently displays the impact that it has had since inception. As of the time this case was written, DonorsChoose had had 2,527,307 supporters, 877,593 projects funded, and 22,082,465 students reached. It also maintains a blog (www.donorschoose.org/blog) where it provides tips for raising money on DonorsChoose and provides heartwarming stories about positive things that are occurring in public school classrooms.
5. The entire premise of DonorsChoose provides people a reason to care. Multiple pictures of children and the projects that are being funded are posted on the charity's website. Its tagline is "Support a classroom. Build a future."
6. The "About Us" tab provides extensive information about why the organization was started and who is behind it.
7. DonorsChoose is active on Facebook, Twitter, and Instagram. It has 180,915 Facebook likes, 234,000 Twitter followers, and 15,300 Instagram followers. Pause for a moment and look at DonorsChoose's

Instagram account (www.instagram.com/donorschoose). The bright, optimistic, vibrant faces of the schoolchildren you'll see will make your day.

8. DonorsChoose prominently displays the impact it makes. Its financial records are audited by a public accounting firm, and its records are available to the public upon request.

Discussion Questions

7-44. Why is building credibility, legitimacy, and trust particularly important for a start-up venture, regardless of whether it is a for-profit or a nonprofit organization?

7-45. How can building credibility, legitimacy, and trust help start-up organizations avoid legal disputes and problems?

7-46. As related to ethics and ethical behavior, what are the characteristics you anticipate are associated with the cultures at Peloton Cycle and DonorsChoose?

7-47. Do some additional research on Peloton Cycle and DonorsChoose, and describe some of the actions its founder or founders have taken (focus on John Foley for Peloton and Charles Best for DonorsChoose) to lead by example in terms of helping their organizations build credibility and trust.

Sources: Peloton Cycle Homepage, www.pelotoncycle.com (accessed February 25, 2017); DonorsChoose Homepage, www.donorschoose.com (accessed February 25, 2017).

ESSAY QUESTIONS

1. The You Be the VC 7.1 on Vélib' illustrates the fact that a new business enterprise can be created with funds from surprising and innovative sources. In the case, JCDecaux's start-up and running costs are offset by their monopoly in 1,600 city-wide billboards across Paris. Despite the high risks and running costs, the media company has enormous earning potential if it can leverage the billboard assets over the ten-year agreement period. In one or two paragraphs, suggest how a similar arrangement might work in your city or capital. What city-wide service or problem could be funded using this kind of business model? What public assets might be available for the city to trade in return for a service run by a private enterprise for profit? In your view, would the system work in most cities? What are the advantages and disadvantages to the city in forming such an agreement?

2. GiveForward is a crowdfunding platform through which people can provide financial and emotional support to individuals who are having difficulty covering their out-of-pocket medical costs. Think about the service GiveForward provides to those having difficulty when it comes to paying for all of their out-of-pocket medical expenses. What type of ethical dilemmas do you anticipate might face those working in this firm? To deal with the dilemmas you identify as well as others that might surface, what type of ethics training program would you recommend be developed by GiveForward and used with its employees? Use a paragraph or two to write your responses to these two questions.

APPENDIX 7.1 What's In a Business Name? A Lot of Trouble If You Aren't Careful

Introduction

While at first glance naming a business may seem like a minor issue, it is an extremely important one. A company's name is one of the first things people associate with a business, and it is a word or phrase that will be said thousands or hundreds of thousands of times during the life of a firm. A company's name is also the most critical aspect of its branding strategy. A company brand is the unique set of attributes that allows consumers to separate it from its competitors. As a result, it is important that a business choose its name carefully so that it will facilitate rather than hinder how the business wants to differentiate itself in the marketplace.

If an entrepreneur isn't careful, the process of naming a business can also result in a peck of trouble. There are a number of legal issues involved in naming a business, which should be taken seriously. If a business selects a name and later finds out that it has already been legally taken, the business may have to (1) amend its articles of incorporation, (2) change its Internet domain name, (3) obtain new listings in telephone and other directories, (4) purchase new stationery and business cards, (5) redo signage and advertising, and (6) incur the expense and potential embarrassment of introducing a new name to its customers. These are complications that no entrepreneur wants to endure. The following case describes the strategies for naming a business, along with the legal issues involved.

Strategies for Naming a Business

The primary consideration in naming a company is that the name should complement the type of business the company plans to be. It is helpful to divide companies into four categories to discuss this issue.

Consumer-Driven Companies

If a company plans to focus on a particular type of customer, its name should reflect the attributes of its clientele. For example, a high-end clothing store that specializes in small sizes for women is called La Petite Femme. Similarly, a company named Local Dirt helps food retailers connect with local producers of produce, meats, and other food products. These companies have names that were chosen to appeal specifically to their target market or clientele.

Product- or Service-Driven Companies

If a company plans to focus on a particular product or service, its name should reflect the advantages that its product or service brings to the marketplace. Examples include Jiffy Print, Anytime Fitness, and 1-800-FLOWERS. These names were chosen to reflect the distinctive attributes of the product or service the company offers, regardless of the clientele.

Industry-Driven Companies

If a company plans to focus on a broad range of products or services in a particular industry, its name should reflect the category in which it participates. Examples include General Motors, Bed Bath & Beyond, and Home Depot. These companies have names that are intentionally broad and are not limiting in regard to target market or product selection.

Personality- or Image-Driven Companies

Some companies are founded by individuals who put such an indelible stamp on the company that it may be smart to name the company after the founder. Examples include Liz Claiborne, Walt Disney, Charles Schwab, and Magic Johnson Enterprises. These companies have names that benefit from a positive association with a popular or distinctive founder. Of course, this strategy can backfire if the founder falls out of favor in the public's eye.

While names come to some business owners easily, for others it's a painstaking process. It was a painstaking process for JetBlue, as described in the book *Blue Streak*, which is a chronology of the early years of JetBlue. According to Barbara Peterson, the book's author, David Neeleman, the founder of JetBlue, and his initial management team agonized over what to name the company and considered literally hundreds of names before settling on JetBlue. JetBlue was launched in 1999. Neeleman felt that a strong brand would surmount the handicap of being a new airline and believed that the company's name was the key to building its brand. A list of some of the alternative names that Neeleman and his management team seriously considered for JetBlue is shown in a nearby table. Today, it's hard to think of JetBlue as anything other than JetBlue, which illustrates the power of branding.

Names That Were Seriously Considered for JetBlue

Air Hop	Egg
Scout Air	It
Competition	Blue
Home	Fair Air
Air Taxi	Scout
Avenues	Hi! Way
Civilization Airways	True Blue

Legal Issues Involved in Naming a Business

The general rule for business names is that they must be unique. In other words, in most instances, there may not be more than one business per name per state. In addition, a business may not have a name that is confusingly similar to another business. This regulation prevents a software company from naming itself Macrosoft, for example, which Microsoft would undoubtedly claim is confusingly similar to its name.

To determine if a name is available in a particular state, the entrepreneur must usually contact the secretary of state's office to see if a particular name is available. The inquiry can typically be accomplished online or over the phone. If the name is available, the next step is to reserve it in the manner recommended by the secretary of state's office. Many attorneys and incorporation services include this step in the fee-based services they offer to entrepreneurs and their ventures.

Once a name that is available has been chosen, it should be trademarked. The process for obtaining a trademark is straightforward and relatively inexpensive, given the protection it provides. A full explanation of how to obtain a trademark is provided in Chapter 12 of this book.

The entire process of naming a business is often very frustrating for entrepreneurs, because it is becoming increasingly difficult to find a name that isn't already taken. For example, if an entrepreneur was planning to open a new quick-printing service, almost every possible permutation of the word *printing* with words like *quick, swift, fast, rapid, speedy, jiffy, express, instant*, and so forth are taken. In addition, sometimes names that work in one culture don't work in another, which is something that should be taken into consideration. The classic example of this is the Chevy Nova. After much advertising and fanfare, the car received a very cool reception in Mexico. It turned out that the phrase *No va* in Spanish means "Doesn't Go." Not surprisingly, the Nova didn't sell well in Mexico.

As a result of these complications, and for other reasons, entrepreneurs use a variety of other strategies when naming their business. Some names are simply made up, because the firm wants a name that is catchy or distinctive, or because it needs to make up a name to get an Internet domain name that isn't already taken (more about this later). Examples of names that were made up include Wello, Verizon, eBay, Google, and Fitbit. Some of these names are made up with the help of marketing research firms that use sophisticated methodologies such as an evaluation of the "linguistic properties" (will a consumer read the name properly?), the "phonetic transparency" (is it spelled as it sounds?), and the "multilingual functionality" (is it as intelligible in Japanese as in English?) of a particular name. All of these issues are potentially important. Several years ago Anderson Consulting changed its name to Accenture. The pronunciation of "Accenture" isn't obvious, which has been a problem for the firm ever since.

Internet Domain Names

A final complicating factor in selecting a name for a company is registering an Internet domain name. A domain name is a company's Internet address (e.g., www.facebook.com). Most companies want their domain name to be the same as their company's name. It is easy to register a domain name through an online registration service such as GoDaddy.com (www.godaddy.com). The standard fee for registering and maintaining a domain name is about $10–$15 per year.

Because no two domain names can be exactly the same, frustrations often arise when a company tries to register its domain name and the name is already taken. There are two reasons that a name may already be taken. First, a company may find that another company with the same name has already registered it. For example, if an entrepreneur started a company called Delta Semiconductor, it would find that the domain name www.delta.com is already taken by Delta Airlines. This scenario plays itself out every day and represents a challenge for new firms that have chosen fairly ordinary names. The firm can either select another domain name (such as www.deltasemiconductor.com) or try to acquire the name from its present owner. However, it is unlikely that Delta Airlines would give up www.delta.com for any price. The second reason that a domain name may already be taken is that it might be in the hands of someone who has registered the name with the intention of using it at a later date or of someone who simply collects domain names in hopes that someone will want to buy the name at a higher price.

Still, a little imagination goes a long way in selecting a company name and an Internet domain name. For example, we (your book's authors) made up the name iUser Accessories for the business described in Case 7.1. The Internet domain name www.iuseraccessories.com was available, which we registered on www.godaddy.com. What might we do with this Internet domain name? We aren't certain. But, another party deciding to launch an entrepreneurial venture with this name will discover that the hoped-for name is already registered.

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Getting Personal with ESSENTIUM MATERIALS

Essentium Materials/Photo Credit: Blake Teipel

Cofounders

BLAKE TEIPEL

PhD, Materials Science and Engineering, Texas A&M University, 2016

ELISA TEIPEL

PhD, Civil Engineering, University of Colorado-Boulder, 2015

RYAN VANO

BS, Mechanical Engineering, Baylor, 2010

GENE BIRDWELL

MBA, University of Texas-Dallas, 2000

Dialogue with Blake Teipel

BEST PART OF BEING A STUDENT

All the free—literally free—wonderful resources and advice available to you. Everyone wants to help a student who's passionate and willing to work hard

FAVORITE BAND ON MY SMARTPHONE MUSIC LIST

The Dave Matthews Band

MY BIGGEST WORRY AS AN ENTREPRENEUR

Being disrupted

FIRST ENTREPRENEURIAL EXPERIENCE

Pitching the first idea for our first venture to our financial backer, his CFO, and his CPA

FAVORITE PERSON I FOLLOW ON INSTAGRAM

My wife

WHAT I DO WHEN I'M NOT WORKING

Play with my little son

CHAPTER 8

Assessing a New Venture's *Financial Strength* and Viability

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OPENING PROFILE

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In June 2013, Blake Teipel was in the midst of a PhD program in Materials Science and Engineering at Texas A&M University. He also had a business idea. Teipel, along with three other engineers and a financial backer, were working on a biomaterials product for the automotive industry. There are a number of plastic parts in cars such as air conditioning vents, cupholders, and fasteners under the dashboard. Teipel and his team were working on a biomaterials compound that could make the parts lighter and more sustainable. A member of the team (Teipel's wife, Elisa) presented the idea at an academic conference and gained interest from Ford Motor Company. Ford awarded the team a research grant to sustain its work on the product, which the team coupled with a National Science Foundation (NSF) grant to continue their investigation. It was also fortuitous that this was the area in which Teipel was writing his PhD dissertation.

From June 2013 to June 2015, the five-person team worked on the idea. Ford was a natural partner because, of all the automakers, it has the highest degree of environmental focus for the materials used in its vehicles. The group wrote a business plan, obtained sufficient funding to continue its work, and set in motion an operating plan to bring their product to market. It was an ideal situation because they knew if their product worked, they would have a customer. Ford, along with the other automakers, was under pressure to meet stringent EPA fuel economy standards. One way to meet the standards was to make the parts in their vehicles lighter and more sustainable.

During this period, Teipel's company, called Essentium Materials, managed its finances carefully. The company didn't yet have a product to sell, so it was particularly attentive to the amount of money it had in the bank compared to its monthly burn rate. A company's burn rate is the rate at which it is spending its capital until it reaches profitability. While Teipel and his team continued to make progress on their product, they couldn't get it to the point of commercial viability that would allow Ford to place a purchase order. That reality caused the team to step back from their original idea. Part of the work they were doing on the biomaterials product idea had crossover into 3D printing. In June 2015, the team pivoted and started working on a 3D printing business idea.

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Learn about the importance of understanding the financial management of an entrepreneurial firm.
2. Identify the four main financial objectives of entrepreneurial ventures.
3. Describe the process of financial management as used in entrepreneurial firms.
4. Explain the difference between historical and pro forma financial statements.
5. Describe the different historical financial statements and their purposes.
6. Discuss the role of forecasts in projecting a firm's future income and expenses.
7. Explain the purpose of pro forma financial statements.

Teipel and his team wrote a new business plan. The idea was to produce and sell the filament that 3D printers use to make parts. The team had most of the equipment needed and felt it could produce a novel, multilayer filament that would enable customers to make parts that would be stronger, tougher, and more resilient than parts made by 3D printers using conventional filament. It was a less difficult technical challenge than the biomaterial products idea. The team also felt that the 3D printer market was a good one to enter, that its product would be globally distinctive, and that they could get to market quickly. In fact, at that time the 3D printing filament market was growing at a three-digit rate per year, and still is.

Essentium Materials is now a vibrant 3D printing filament provider. It is hiring people and is getting good sales traction. It is also a reseller for certain 3D printer manufacturers and adds useful hardware add-ons to the printers it sells. Its customers include NASA along with leading companies in the automotive, aerospace, and biomedical industries. The original team remains together, with the exception of one of the four engineers who left to pursue other opportunities. The team works out of facilities in College Station, TX, the home of Texas A&M University. Essentium Materials has garnered considerable attention in the 3D printing world, and its founders are now seen as thought leaders in the 3D printing community.

When it comes to financial management, Essentium Materials has been fortunate to have Gene Birdwell on its team. Birdwell is an experienced engineer and businessperson who has built several start-ups in various industries. He has managed Essentium Materials' finances from the beginning, and has been instrumental in the company's fundraising efforts. In Teipel's words, he has provided Essentium Materials the type of "patient capital" that the company has needed to get its business plan right and bring multiple products to market. As a result, Essentium Materials has always had sufficient cash in the bank to meet its basic needs. In regard to day-to-day financial management, Essentium Materials uses an enterprise version of Quickbooks to track its finances and inventory. The company monitors its income statement on a daily basis and watches its cash flow carefully. An essential financial metric for Essentium Materials is to grow its monthly revenue faster than its monthly burn rate.

In regard to more long-term financial planning, Essentium Materials prepares financial forecasts once a quarter that project future income and expenses. Teipel and his team feel strongly that it is critical to have a financial plan and compare the plan against actual results continually.

In terms of advice for student entrepreneurs, Teipel's recommendation is to live inexpensively and focus on bringing a product to market and generating sales. If an entrepreneur, particularly early on, is engaging in an activity that doesn't directly relate to product development and/or sales, then it's probably not a good use of scarce resources.

In this chapter, we'll look at how new ventures manage their finances and assess their financial strength and viability. For the purposes of completeness, we'll look at how both existing firms and entrepreneurial ventures accomplish these tasks. First, we'll consider general financial management and discuss the financial objectives of a firm and the steps involved in the financial management process. **Financial management** deals with two activities: raising money and managing a company's finances in a way that achieves the highest rate of return.[1] We cover the process of raising money in Chapter 10. This chapter focuses on how a company manages its finances in an effort to increase its financial strength and earn the highest rate of return. Next, we'll examine how existing firms track their financial progress through preparing, analyzing, and maintaining past financial statements. Finally, we'll discuss how both existing firms and start-up ventures forecast future income and expenses and how the forecasts are used to prepare pro forma (i.e., projected) financial statements. Pro forma financial statements, which include the pro forma income statement, the pro forma balance sheet, and the pro forma statement of cash flows, are extremely helpful to firms in financial planning.

Introduction to Financial Management

LEARNING OBJECTIVE

1. Learn about the importance of understanding the financial management of an entrepreneurial firm.

An entrepreneur's ability to pursue an opportunity and turn the opportunity into a viable entrepreneurial firm hinges largely on the availability of money. Regardless of the quality of a product or service, a company can't be viable in the long run unless it is successful financially. Money either comes from external sources (such as investors or lenders) or is internally generated through earnings. It is important for a firm to have a solid grasp of how it is doing financially. One of the most common mistakes young entrepreneurial firms make is not emphasizing financial management and putting in place appropriate forms of financial controls.[2]

Entrepreneurs and those managing established companies must be aware of how much money they have in the bank and if that amount is sufficient to satisfy their firm's financial obligations. Just because a firm is successful doesn't mean that it doesn't face financial challenges.[3] For example, many of the small firms that sell their products to larger companies such as Apple, General Electric (GE), and The Home Depot aren't paid for 30, 60, or 90 days from the time they make a sale. Think about the difficulty this scenario creates. The small firm must buy parts, pay its employees, pay its routine bills, build and ship its products, and then wait for one, two, or three months for payment. Unless a firm manages its money carefully, it is easy to run out of cash, even if its products or services are selling like hotcakes.[4] Similarly, as a company grows, its cash demands often increase to service a growing clientele. It is important for a firm to accurately anticipate whether it will be able to fund its growth through earnings or if it will need to look for investment capital or borrowing to raise needed cash.

The financial management of a firm deals with questions such as the following on an ongoing basis:

- How are we doing? Are we making or losing money?
- How much cash do we have on hand?
- Do we have enough cash to meet our short-term obligations?
- How efficiently are we utilizing our assets?
- How do our growth and net profits compare to those of our industry peers?
- Where will the funds we need for capital improvements come from?
- Are there ways we can partner with other firms to share risk and reduce the amount of cash we need?
- Overall, are we in good shape financially?

A properly managed firm stays on top of the issues suggested by these questions through the tools and techniques that we'll discuss in this chapter.

Financial Objectives of a Firm

LEARNING OBJECTIVE

2. Identify the four main financial objectives of entrepreneurial ventures.

Most entrepreneurial firms—whether they have been in business for several years or they are start-ups—have four main financial objectives: profitability, liquidity, efficiency, and stability. Understanding these objectives sets a firm on the right financial course and helps it track the answers to the previously posed questions. Figure 8.1 describes each of these objectives.

FIGURE 8.1
Primary Financial Objectives of Entrepreneurial Firms

Profitability	Liquidity	Efficiency	Stability
A company's ability to make a profit	A company's ability to meet its short-term obligations	How productively a firm utilizes its assets	The overall health of the financial structure of the firm, particularly as it relates to its debt-to-equity ratio

Profitability is the ability to earn a profit. Many start-ups are not profitable during their first one to three years, while they are training employees and building their brands, but a firm must become profitable to remain viable and provide a return to its owners.

Liquidity is a company's ability to meet its short-term financial obligations. Even if a firm is profitable, it is often a challenge to keep enough money in the bank to meet its routine obligations in a timely manner. To do so, a firm must keep a close watch on accounts receivable and inventories. A company's **accounts receivable** is money owed to it by its customers. Its **inventory** is its merchandise, raw materials, and products waiting to be sold. If a firm allows the levels of either of these assets to get too high, it may not be able to keep sufficient cash on hand to meet its short-term obligations.[5]

Efficiency is how productively a firm utilizes its assets relative to its revenue and its profits. Southwest Airlines, for example, uses its assets very productively. Its turnaround time, or the time that its airplanes sit on the ground while they are being unloaded and reloaded, is the lowest in the airline industry. As Southwest officials are quick to point out, "Our planes don't make any money sitting on the ground—we have to get them back into the air."[6]

Stability is the strength and vigor of the firm's overall financial posture. For a firm to be stable, it must not only earn a profit and remain liquid but also keep its debt in check. If a firm continues to borrow from its lenders and its **debt-to-equity ratio**, which is calculated by dividing its long-term debt by its shareholders' equity, gets too high, it may have trouble meeting its obligations and securing the level of financing needed to fuel its growth.

An increasingly common way that small companies improve their prospects across several of these areas is to join buying groups or co-ops, where businesses band together to attain volume discounts on products and services. Gaining access to products and services this way facilitates smaller firms' efforts to compete on more of a "level playing field" with larger, more established companies. The way buying groups work, and how they're able to help businesses cut costs without adversely affecting their competitiveness, is described in the nearby "Partnering for Success" feature.

The Process of Financial Management

LEARNING OBJECTIVE

3. Describe the process of financial management as used in entrepreneurial firms.

To assess whether its financial objectives are being met, firms rely heavily on analyses of financial statements, forecasts, and budgets. A **financial statement** is a written report that quantitatively describes a firm's financial health. The income statement, the balance sheet, and the statement of cash flows are the financial statements entrepreneurs use most commonly. **Forecasts** are estimates of a firm's future sales, income, expenses, and capital expenditures, based on its past performance, its current circumstances, and its future plans.[7] New ventures typically base their forecasts on an estimate of sales and then on industry averages or the experiences of similar start-ups regarding the cost of goods sold (based on a percentage of sales) and on other expenses. **Budgets** are itemized forecasts of a company's income, expenses, and capital needs and are also an important tool for financial planning and control.[8]

PARTNERING FOR SUCCESS

Organizing Buying Groups to Cuts Costs and Maintain Competitiveness

One challenge that businesses confront is cutting costs in ways that do not erode their ability to remain competitive. Many cost-cutting techniques, such as scaling back on hiring, lowering marketing expenses, and reducing inventory, may save money but may also decrease a business's chances to remain competitive. One technique that can help to conserve a product-based business's financial assets without adverse side effects is to join or organize a buying group.

A buying group, or buying co-op, is a partnership that bands small businesses and start-up firms together to attain volume discounts on products and services. In the United Kingdom and the Republic of Ireland, the Toymaster Group has been in operation since 1977 and now has around 250 members. They are all small, independent toys and games stores that operate under the name Toymaster, benefiting from the combined buying power of all the members. Some 55 percent of an average toy shop's revenue comes in during the pre-Christmas period and just 15 percent during each of the other three quarters of the year. This means that accounting and money management is tightly controlled, and this is what a buying group offers.

Suma is the UK's largest independent co-operative wholefood wholesaler–distributor. They specialize in vegetarian, organic, ethical, natural products. They provide a unique, niche service as they are 100 percent vegetarian and stock no products derived from animals. They have close relationships with the growers and suppliers and say that they have real commitment to fair trade rather than simply using it as a marketing device.

The beauty of buying groups is that they generally allow businesses to obtain the exact same product for a lower price with no undesirable impact (other than the membership fee) on other parts of their operations. The money that's freed up can go directly to a business's bottom line or be used to invest in customer service or other methods to increase competitiveness. There is no national directory of industry buying groups. The best way to find out whether there are buying groups that service an industry is to conduct research on the Internet and make inquiries among industry participants.

Questions for Critical Thinking

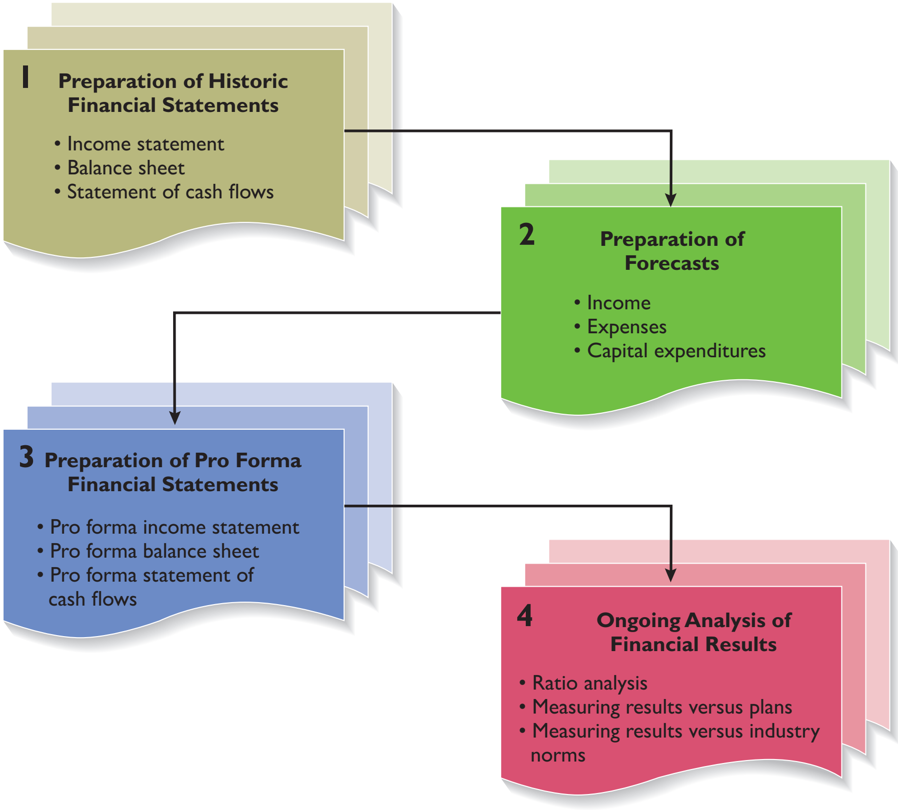
1. Which of the four financial objectives of a firm—profitability, liquidity, efficiency, and stability—does participating in a buying cooperative contribute to the most?
2. Do some Internet or library research to determine whether there is a small business buying group or groups that New Venture Fitness Drinks, the fictitious company introduced in Chapter 3 and used as an example throughout this chapter, could benefit from. New Venture Fitness Drinks' products contain all the ingredients used to make smoothies and similar fitness drinks and shakes.
3. Besides buying cooperatives, identify three ways that small businesses partner with other small businesses to cut costs without sacrificing their competitiveness.
4. Do you think the majority of entrepreneurs spend an equal amount of time focusing on cost cutting and increasing revenues to improve the financial position of their firms? If not, which of the two do you think they spend more time on, and why?

The process of a firm's financial management is shown in Figure 8.2. It begins by tracking the company's past financial performance through the preparation and analysis of financial statements. These statements organize and report the firm's financial transactions. They tell a firm how much money it is making or losing (income statement), the structure of its assets and liabilities (balance sheet), and where its cash is coming from and going (statement of cash flows). The statements also help a firm discern how it stacks up against its competitors and industry norms. Most firms look at two to three years of past financial statements when preparing forecasts.

The next step is to prepare forecasts for two to three years in the future. In turn, forecasts are used to prepare a firm's pro forma financial statements, which, along with its more fine-tuned budgets, constitute its financial plan.

The final step in the process is the ongoing analysis of a firm's financial results. **Financial ratios**, which depict relationships between items on a firm's financial statements, are used to discern whether a firm is meeting its financial objectives

FIGURE 8.2
The Process of Financial Management



and how it stacks up against its industry peers. These ratios are also used to assess trends. Obviously, a completely new venture would start at step 2 in Figure 8.2. It is important that a new venture be familiar with the entire process, however. Typically, new ventures prepare financial statements quarterly so that as soon as the first quarter is completed, the new venture will have historic financial statements to help prepare forecasts and pro forma statements for future periods.

It is important for a firm to evaluate how it is faring relative to its industry. Sometimes raw financial ratios that are not viewed in context are deceiving. For example, a firm's past three years' income statements may show that it is increasing its sales at a rate of 15 percent per year. This number may seem impressive—until one learns that the industry in which the firm competes is growing at a rate of 30 percent per year, showing that the firm is steadily losing market share.

Many experienced entrepreneurs stress the importance of keeping on top of the financial management of a firm. In the competitive environments in which most firms exist, it's simply not good enough to shoot from the hip when making financial decisions. Reinforcing this point, Bill Gates, the founder of Microsoft, said,

> The business side of any company starts and ends with hard-core analysis of its numbers. Whatever else you do, if you don't understand what's happening in your business factually and you're making business decisions based on anecdotal data or gut instinct, you'll eventually pay a big price.[9]

Financial Statements

LEARNING OBJECTIVE

4. Explain the difference between historical and pro forma financial statements.

Historical financial statements reflect past performance and are usually prepared on a quarterly and annual basis. Publicly traded firms are required by the Securities and Exchange Commission (SEC) to prepare financial statements and make them available to the public. The statements are submitted to the SEC through a number of required filings. The most comprehensive filing is the

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Keeping good records is the first step toward prudent financial management. This pair of restaurant owners is checking their bank statement against their records at the end of a busy day.

10-K, which is a report similar to the annual report except that it contains more detailed information about the company's business.[10] The 10-K for any publicly traded firm is available at www.freeedgar.com.

Pro forma financial statements are projections for future periods based on forecasts and are typically completed for two to three years in the future. Pro forma financial statements are strictly planning tools and are not required by the SEC. In fact, most companies consider their pro forma statements to be confidential and reveal them to outsiders, such as lenders and investors, only on a "need-to-know" basis.

Fariz Alikishibayov/Shutterstock

Pro forma financial statements look forward rather than backwards. They help entrepreneurs establish budgets and plan for the future.

To illustrate how these financial instruments are prepared, let's look at New Venture Fitness Drinks, the fictitious sports drink company to which you were introduced in Chapter 3. New Venture Fitness Drinks has been in business for five years. Targeting sports enthusiasts, the company sells a line of nutritional fitness drinks. It opened a single location in 2016, added a second location in 2018, and plans to add a third in 2019. The company's strategy is to place small restaurants, similar to smoothie restaurants, near large outdoor sports complexes. The company is profitable and is growing at a rate of 25 percent per year.

Historical Financial Statements

LEARNING OBJECTIVE

5. Describe the different historical financial statements and their purposes.

Historical financial statements include the income statement, the balance sheet, and the statement of cash flows. The statements are usually prepared in this order because information flows logically from one to the next. In start-ups, financial statements are typically scrutinized closely to monitor the financial progress of the firm. On the rare occasion when a company has not used financial statements in planning, it should prepare and maintain them anyway. If a firm goes to a banker or investor to raise funds, the banker or investor will invariably ask for copies of past financial statements to analyze the firm's financial history. If a firm does not have these statements, it may be precluded from serious consideration for an investment or a loan. Let's look at each of these statements.

Income Statement. The **income statement** reflects the results of the operations of a firm over a specified period of time.[11] It records all the revenues and expenses for the given period and shows whether the firm is making a profit or is experiencing a loss (which is why the income statement is often referred to as the "profit-and-loss statement"). Income statements are typically prepared on a monthly, quarterly, and annual basis. Most income statements are prepared in a multiyear format, making it easy to spot trends.

The consolidated income statement for the past three years for New Venture Fitness Drinks is shown in Table 8.1. The value of the multi-period format is clear. It's easy to see that the company's sales are increasing at the rate of about 25 percent per year, it is profitable, and its net income is increasing. The numbers are used to evaluate the effect of past strategies and to help project future sales and earnings.

The three numbers that receive the most attention when evaluating an income statement are the following:

- **Net sales: Net sales** consist of total sales minus allowances for returned goods and discounts.
- **Cost of sales (or cost of goods sold): Cost of sales** includes all the direct costs associated with producing or delivering a product or service, including the material costs and direct labor. In the case of New Venture Fitness Drinks, this would include the ingredients that go into the fitness drinks and the labor needed to produce them.
- **Operating expenses: Operating expenses** include marketing, administrative costs, and other expenses not directly related to producing a product or service.

One of the most valuable things that entrepreneurs and managers do with income statements is to compare the ratios of cost of sales and operating expenses to net sales for different periods. For example, the cost of sales for New Venture Fitness Drinks, which includes the ingredients for its fitness drinks and the labor needed to make them, has been 55, 49, and 46 percent of sales for 2016, 2017, and 2018, respectively. This is a healthy trend. It shows that the company is steadily decreasing its material and labor costs per dollar of sales.

TABLE 8.1 Consolidated Income Statements for New Venture Fitness Drinks, Inc.

	December 31, 2018	December 31, 2017	December 31, 2016
Net sales	$586,600	$463,100	$368,900
Cost of sales	268,900	225,500	201,500
Gross profit	317,700	237,600	167,400
Operating expenses			
Selling, general, and administrative expenses	117,800	104,700	90,200
Depreciation	13,500	5,900	5,100
Operating income	186,400	127,000	72,100
Other income			
Interest income	1,900	800	1,100
Interest expense	(15,000)	(6,900)	(6,400)
Other income (expense), net	10,900	(1,300)	1,200
Income before income taxes	184,200	119,600	68,000
Income tax expense	53,200	36,600	18,000
Net income	131,000	83,000	50,000
Earnings per share	1.31	0.83	0.50

This is the type of trend that can be noticed fairly easily by looking at a firm's multiyear income statements.

Profit margin is a ratio that is of particular importance when evaluating a firm's income statements. A firm's **profit margin**, or return on sales, is computed by dividing net income by net sales. For the years 2016, 2017, and 2018, the profit margin for New Venture Fitness Drinks has been 13.6, 17.9, and 22.3 percent, respectively. This is also a healthy trend. A firm's profit margin tells it what percentage of every dollar in sales contributes to the bottom line. An increasing profit margin means that a firm is either boosting its sales without increasing its expenses or that it is doing a better job of controlling its costs. In contrast, a declining profit margin means that a firm is losing control of its costs or that it is slashing prices to maintain or increase sales.

One ratio that will not be computed for New Venture Fitness Drinks is **price-to-earnings ratio, or P/E ratio**. New Venture Fitness Drinks is incorporated, so it has stock, but its stock is not traded on a public exchange such as the NASDAQ or the New York Stock Exchange. The P/E ratio is a simple ratio that measures the price of a company's stock against its earnings.[12] Generally, the higher a company's price-to-earnings ratio goes, the greater the market thinks it will grow. In 2018, New Venture Fitness Drinks earned $1.31 per share. If it was listed on the NASDAQ and its stock was trading at $20 per share, its P/E would be 15.3. This is what is meant when you hear that a company is selling for "15 times earnings."

The importance of looking at several years of income statements rather than just one is illustrated in the nearby "Savvy Entrepreneurial Firm" feature.

Balance Sheet. Unlike the income statement, which covers a specified *period* of time, a **balance sheet** is a snapshot of a company's assets, liabilities, and

SAVVY ENTREPRENEURIAL FIRM

Know the Facts Behind the Numbers

Let's say that New Venture Fitness Drinks was interested in hiring a new chief executive officer (CEO) and was interviewing the CEOs of three small restaurant chains. To get a sense of how savvy each candidate was at managing a firm's finances, the board of directors of New Venture Fitness Drinks asked each person to submit the 2018 income statement for his or her current firm. An analysis of an abbreviated version of each firm's income statement is shown here.

	Candidate 1: CEO of New Venture Soup and Salad	Candidate 2: CEO of New Venture Beef	Candidate 3: CEO of New Venture Sea Food
Net sales	$326,400	$281,200	$486,700
Cost of sales	150,500	143,900	174,700
Gross profit	175,900	137,300	312,000
All expenses, including taxes and depreciation	114,200	112,400	150,000
Net income	61,700	24,900	162,000

By glancing at these statements, it would appear that the shrewdest financial manager of the three is the CEO of New Venture Sea Food. The company's net income is more than double that of the other two firms. In addition, New Venture Sea Food's cost of sales was 35.9 percent of net sales in 2018, compared to 46.1 percent for New Venture Soup and Salad and 51 percent for New Venture Beef. Similarly, New Venture Sea Food's expenses were 30.9 percent of sales, compared to 35.0 percent for New Venture Soup and Salad and 40 percent for New Venture Beef.

Fortunately, one of the board members of New Venture Fitness Drinks asked a series of questions during the personal interviews of the candidates and uncovered some revealing information. As it turns out, New Venture Sea Food was in the hottest segment of the restaurant industry in 2018. Seafood restaurants of comparable size produced about 1.5 times as much net income as New Venture Sea Food did. So if candidate 3 had done his job properly, his company's net income should have been in the neighborhood of $240,000 instead of $162,000. New Venture Soup and Salad was in a slow-growth area and at midyear feared that it might not meet its financial targets. So the CEO pulled several of his best people off projects and reassigned them to marketing to develop new menu items. In other words, the company borrowed from its future to make its numbers work today.

As for New Venture Beef, the CEO found herself in a market that was losing appeal. Several reports that gained national publicity were published early in the year warning consumers of the risks of eating red meat. To compensate, the CEO quickly implemented a productivity improvement program and partnered with a local beef promotion board to counter the bad press with more objective research results about beef's nutritional value. The company also participated in several volunteer efforts in its local community to raise the visibility of its restaurants in a positive manner. If the CEO of New Venture Beef hadn't moved quickly to take these actions, its 2018 performance would have been much worse.

Ultimately, New Venture Fitness Drinks decided that candidate 2, the CEO of New Venture Beef, was the best candidate for its job. This example illustrates the need to look at multiple years of an income statement rather than a single year to fairly assess how well a firm is performing financially. It also illustrates the need to look beyond the numbers and understand the circumstances that surround a firm's financial results.

Questions for Critical Thinking

1. Show the income statements for the three candidates to two or three friends who are majoring in business. Ask them to select the best CEO from among these three people on the basis of these income statements. In addition, ask your friends to explain their choices to you. Did your friends choose the same candidate? If not, what do you think caused the differences in their choices?
2. Based on material presented in this chapter, earlier chapters in this book, and your general business knowledge, where would you go to find information about the growth of the different segments of the restaurant industry? Where would you go to find information about the profitability of the restaurant industry in general?
3. What would have been the appropriate financial information to request from the three candidates for the job?
4. What are the three most important insights you gained from studying this feature? Which of these insights surprised you, and why?

owners' equity at a specific *point* in time.[13] The left-hand side of a balance sheet (or the top, depending on how it is displayed) shows a firm's assets, while the right-hand side (or bottom) shows its liabilities and owners' equity. The assets are listed in order of their "liquidity," or the length of time it takes to convert them to cash. The liabilities are listed in the order in which they must be paid. A balance sheet must always "balance," meaning that a firm's assets must always equal its liabilities plus owners' equity.[14]

The major categories of assets listed on a balance sheet are the following:

- **Current assets: Current assets** include cash plus items that are readily convertible to cash, such as accounts receivable, marketable securities, and inventories.
- **Fixed assets: Fixed assets** are assets used over a longer time frame, such as real estate, buildings, equipment, and furniture.
- **Other assets: Other assets** are miscellaneous assets, including accumulated goodwill.

The major categories of liabilities listed on a balance sheet are the following:

- **Current liabilities: Current liabilities** include obligations that are payable within a year, including accounts payable, accrued expenses, and the current portion of long-term debt.
- **Long-term liabilities: Long-term liabilities** include notes or loans that are repayable beyond one year, including liabilities associated with purchasing real estate, buildings, and equipment.
- **Owners' equity: Owners' equity** is the equity invested in the business by its owners plus the accumulated earnings retained by the business after paying dividends.

Balance sheets are somewhat deceiving. First, a company's assets are recorded at cost rather than fair market value. A firm may have invested $500,000 in real estate several years ago that is worth $1 million today, but the value that is reflected on the firm's current balance sheet is the $500,000 purchase price rather than the $1 million fair market value. Second, intellectual property, such as patents, trademarks, and copyrights, receive value on the balance sheet in some cases and in some cases they don't, depending on the circumstances involved. In many cases, a firm's intellectual property will receive no value on its balance sheet even though it may be very valuable from a practical standpoint.[15] Third, intangible assets, such as the amount of training a firm has provided to its employees and the value of its brand, are not recognized on its balance sheet. Finally, the goodwill that a firm has accumulated is not reported on its balance sheet, although this may be the firm's single most valuable asset.

The consolidated balance sheet for New Venture Fitness Drinks is shown in Table 8.2. Again, multiple years are shown so that trends can be easily spotted. When evaluating a balance sheet, the two primary questions are whether a firm has sufficient short-term assets to cover its short-term debts and whether it is financially sound overall. There are two calculations that provide the answer to the first question. In 2018, the **working capital** of New Venture Fitness Drinks, defined as its current assets minus its current liabilities, was $82,500. This number represents the amount of liquid assets the firm has available. Its **current ratio**, which equals the firm's current assets divided by its current liabilities, provides another picture of the relationship between its current assets and current liabilities and can tell us more about the firm's ability to pay its short-term debts.

New Venture Fitness Drinks' current ratio is 3.06, meaning that it has $3.06 in current assets for every $1.00 in current liabilities. This is a healthy number

TABLE 8.2 Consolidated Balance Sheets for New Venture Fitness Drinks, Inc.

Assets	December 31, 2018	December 31, 2017	December 31, 2016
Current assets			
Cash and cash equivalents	$63,800	$54,600	$56,500
Accounts receivable, less allowance for doubtful accounts	39,600	48,900	50,200
Inventories	19,200	20,400	21,400
Total current assets	122,600	123,900	128,100
Property, plant, and equipment			
Land	260,000	160,000	160,000
Buildings and equipment	412,000	261,500	149,000
Total property, plant, and equipment	672,000	421,500	309,000
Less: accumulated depreciation	65,000	51,500	45,600
Net property, plant, and equipment	607,000	370,000	263,400
Total assets	729,600	493,900	391,500
Liabilities and shareholders' equity Current liabilities			
Accounts payable	30,200	46,900	50,400
Accrued expenses	9,900	8,000	4,100
Total current liabilities	40,100	54,900	54,500
Long-term liabilities			
Long-term debt	249,500	130,000	111,000
Long-term liabilities	249,500	130,000	111,000
Total liabilities	289,600	184,900	165,500
Shareholders' equity			
Common stock (100,000 shares)	10,000	10,000	10,000
Retained earnings	430,000	299,000	216,000
Total shareholders' equity	440,000	309,000	226,000
Total liabilities and shareholders' equity	729,600	493,900	391,500

and provides confidence that the company will be able to meet its current liabilities. The company's trend in this area is also positive. For the years 2016, 2017, and 2018, its current ratio has been 2.35, 2.26, and 3.06, respectively.

Computing a company's overall debt ratio will give us the answer to the second question, as it is a means of assessing a firm's overall financial soundness. A company's debt ratio is computed by dividing its total debt by its total assets. The present debt ratio for New Venture Fitness Drinks is 39.7 percent, meaning that 39.7 percent of its total assets are financed by debt and the remaining 60.3 percent by owners' equity. This is a healthy number for a young firm. The trend for New Venture Fitness Drinks in this area is also encouraging. For the years 2016, 2017, and 2018, its debt ratio has been 42.3, 37.4, and 39.7 percent, respectively. These figures indicate that over time, the company is relying less on debt to finance its operations. In general, less debt creates more freedom for the entrepreneurial firm in terms of taking different actions.

The numbers across all the firm's financial statements are consistent with one another. Note that the $131,000 net income reported by New Venture Fitness Drinks on its 2018 income statement shows up as the difference between its 2018 and 2017 retained earnings on its 2018 balance sheet. This number would have been different if New Venture Fitness Drinks had paid dividends to its stockholders, but it paid no dividends in 2018. The company retained all of its $131,000 in earnings.

Statement of Cash Flows. The **statement of cash flows** summarizes the changes in a firm's cash position for a specified period of time and details why the change occurred. The statement of cash flows is similar to a month-end bank statement. It reveals how much cash is on hand at the end of the month as well as how the cash was acquired and spent during the month.

The statement of cash flows is divided into three separate activities: operating activities, investing activities, and financing activities. These activities, which are explained in the following list, are the activities from which a firm obtains and uses cash:

- **Operating activities: Operating activities** include net income (or loss), depreciation, and changes in current assets and current liabilities other than cash and short-term debt. A firm's net income, taken from its income statement, is the first line on the corresponding period's cash flow statement.
- **Investing activities: Investing activities** include the purchase, sale, or investment in fixed assets, such as real estate, equipment, and buildings.
- **Financing activities: Financing activities** include cash raised during the period by borrowing money or selling stock and/or cash used during the period by paying dividends, buying back outstanding stock, or buying back outstanding bonds.

Interpreting and analyzing cash flow statements takes practice. On the statement, the *uses* of cash are recorded as negative figures (which are shown by placing them in parentheses) and the *sources* of cash are recorded as positive figures. An item such as depreciation is shown as a positive figure on the statement of cash flows because it was deducted from net income on the income statement but was not a cash expenditure. Similarly, a decrease in accounts payable shows up as a negative figure on the cash flow statement because the firm used part of its cash to reduce its accounts payable balance from one period to the next.

The statement of cash flows for New Venture Fitness Drinks is shown in Table 8.3. As a management tool, it is intended to provide perspective on the following questions: Is the firm generating excess cash that could be used to pay down debt or returned to stockholders in the form of dividends? Is the firm generating enough cash to fund its investment activities from earnings, or is it relying on lenders or investors? Is the firm generating sufficient cash to pay down its short-term liabilities, or are its short-term liabilities increasing as the result of an insufficient amount of cash?

Again, a multi-period statement is created so that trends can easily be spotted. A large increase in a firm's cash balance is not necessarily a good sign. It could mean that the firm is borrowing heavily, is not paying down its short-term liabilities, or is accumulating cash that could be put to work for a more productive purpose. On the other hand, it is almost always prudent for a young firm to have a healthy cash balance.

Table 8.3 shows the consolidated statement of cash flows for New Venture Fitness Drinks for two years instead of three because it takes three years of

TABLE 8.3 Consolidated Statement of Cash Flows for New Venture Fitness Drinks, Inc.

	December 31, 2018	December 31, 2017
Cash flows from operating activities		
Net income	$131,000	$83,000
Additions (sources of cash)		
Depreciation	13,500	5,900
Decreases in accounts receivable	9,300	1,300
Increase in accrued expenses	1,900	3,900
Decrease in inventory	1,200	1,000
Subtractions (uses of cash)		
Decrease in accounts payable	(16,700)	(3,500)
Total adjustments	9,200	8,600
Net cash provided by operating activities	140,200	91,600
Cash flows from investing activities		
Purchase of building and equipment	(250,500)	(112,500)
Net cash flows provided by investing activities	(250,500)	(112,500)
Cash flows from financing activities		
Proceeds from increase in long-term debt	119,500	19,000
Net cash flows provided by financing activities	119,500	19,000
Increase in cash	9,200	(1,900)
Cash and cash equivalents at the beginning of each year	54,600	56,500
Cash and cash equivalents at the end of each year	63,800	54,600

balance sheets to produce two years of cash flow statements. The statements show that New Venture Fitness Drinks is funding its investment activities from a combination of debt and earnings while at the same time it is slowly decreasing its accounts receivable and inventory levels (which is good—these items are major drains on a company's cash flow). It is also steadily increasing its cash on hand. These are encouraging signs for a new venture.

Ratio Analysis. The most practical way to interpret or make sense of a firm's historical financial statements is through ratio analysis. Table 8.4 is a summary of the ratios used to evaluate New Venture Fitness Drinks during the time period covered by the previously provided financial statements. The ratios are divided into profitability ratios, liquidity ratios, and overall financial stability ratios. These ratios provide a means of interpreting the historical financial statements for New Venture Fitness Drinks and provide a starting point for forecasting the firm's financial performance and capabilities for the future.

Comparing a Firm's Financial Results to Industry Norms. Comparing its financial results to industry norms helps a firm determine how it stacks up against its competitors and if there are any financial "red flags" requiring attention. This type of comparison works best for firms that are of similar size,

TABLE 8.4 Ratio Analysis for New Venture Fitness Drinks, Inc.

Ratio	Formula	2018	2017	2016
Profitability ratios: associate the amount of income earned with the resources used to generate it				
Return on assets	ROA = net income/average total assets[a]	21.4%	18.7%	14.7%
Return on equity	ROE = net income/average shareholders' equity[b]	35.0%	31.0%	24.9%
Profit margin	Profit margin = net income/net sales	22.3%	17.9%	13.6%
Liquidity ratios: measure the extent to which a company can quickly liquidate assets to cover short-term liabilities				
Current	Current assets/current liabilities	3.06	2.26	2.35
Quick	Quick assets/current liabilities	2.58	1.89	1.96
Overall financial stability ratio: measures the overall financial stability of a firm				
Debt	Total debt/total assets	39.7%	37.4%	42.3%
Debt to equity	Total liabilities/owners' equity	65.8%	59.8%	73.2%

[a]Average total assets = beginning total assets + ending total assets ÷ 2.
[b]Average shareholders' equity = beginning shareholders' equity + ending shareholders' equity ÷ 2.

so the results should be interpreted with caution by new firms. Many sources provide industry-related information. For example, both Hoover's premium service and BizMiner provide industry norms to which a new firm can compare itself and are typically free of charge if accessed via a university library. BizMiner (www.bizminer.com) is particularly good for providing comparison data for private firms. Several suggestions for obtaining comparison data for private firms are provided in Chapter 3.

Forecasts

LEARNING OBJECTIVE

6. Discuss the role of forecasts in projecting a firm's future income and expenses.

As depicted in Figure 8.2, the analysis of a firm's historical financial statement is followed by the preparation of **forecasts**. As noted earlier in the chapter, forecasts are estimates of a firm's future sales, expenses, income, and capital expenditures, based on its past performance, its current circumstances, and its future plans. A firm's forecasts provide the basis for its pro forma financial statements. A well-developed set of pro forma financial statements helps a firm create accurate budgets, build financial plans, and manage its finances in a proactive rather than a reactive manner.

As mentioned previously, newly-established firms typically base their forecasts on a good-faith estimate of sales and on industry averages (based on a percentage of sales) or the experiences of similar start-ups for cost of goods sold and other expenses. As a result, a newly-established firm's forecast should be preceded in its business plan by an explanation of the sources of the numbers for the forecast and the assumptions used to generate them. This explanation is called an **assumptions sheet**, as mentioned in Chapter 6. Investors typically study assumptions sheets like hawks to make sure the numbers contained in the forecasts and the resulting financial projections are realistic. For example, the assumptions sheet for a new venture may say that its forecasts are based on selling 500 units of its new product the first year, 1,000 units the second year, and 1,500 units the third year, and that its cost of goods sold will remain stable (meaning that it will stay fixed at a certain percentage of net sales) over the three-year period. It's up to the reader of the plan to determine if these numbers are realistic.[16] If the reader feels they are not, then the credibility of the entire plan is called into question.

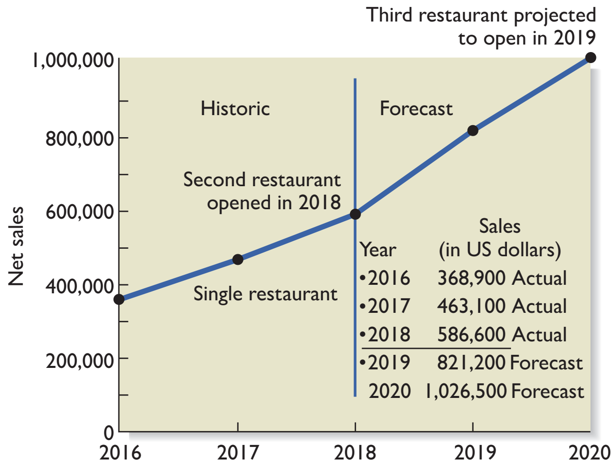
Sales Forecast

A **sales forecast** is a projection of a firm's sales for a specified period (such as a year), though most firms forecast their sales for two to five years into the future.[17] It is the first forecast developed and is the basis for most of the other forecasts.[18] A sales forecast for an existing firm is based on (1) its record of past sales, (2) its current production capacity and product demand, and (3) any factor or factors that will affect its future production capacity and product demand. To demonstrate how a sales forecast works, Figure 8.3 is a graph of the past sales and the forecasted future sales for New Venture Fitness Drinks. The company's sales increased at a rate of about 26 percent per year from 2016 to 2018 as the company became established and more people became aware of its brand. In forecasting its sales for 2019 and 2020, the company took into consideration the following factors:

- The fitness craze in America continues to gain momentum and should continue to attract new people to try its fitness drinks.
- The interest in intramural sports, especially soccer, baseball, and softball, should continue to provide a high level of traffic for its restaurants, which are located near large intramural sports complexes.
- The company expanded from a single location in 2015 to two locations in 2018 (the second restaurant was added in November 2018), and this should increase its capacity to serve fitness drinks by approximately 50 percent. The second restaurant is smaller than the first and is located in an area where the company is not as well known. The company will be actively promoting the new restaurant but knows it will take time to win market share.
- The general economy in the city where the company is located is flat—it is neither growing nor shrinking. However, layoffs are rumored for a larger employer near the location of the new restaurant.

The combination of these factors results in a forecast of a 40 percent increase in sales from 2018 to 2019 and a 25 percent increase in sales from 2019 to 2020. It is extremely important for a company such as New Venture Fitness Drinks to forecast future sales as accurately as possible. If it overestimates the demand for its products, it might get stuck with excess inventory and spend

FIGURE 8.3
Historical and Forecasted Annual Sales for New Venture Fitness Drinks



too much on overhead. If it underestimates the demand for its product, it might have to turn away business, and some of its potential customers might get into the habit of buying other firms' fitness drinks.

Note that sophisticated tools are available to help firms project their future sales. One approach is to use **regression analysis**, which is a statistical technique used to find relationships between variables for the purpose of predicting future values.[19] For example, if New Venture Fitness Drinks felt that its future sales were a function of its advertising expenditures, the number of people who participate in intramural sports at the sports complexes near its restaurants, and the price of its drinks, it could predict future sales using regression analysis as long as it had historical data for each of these variables. If the company used simpler logic and felt that its future sales would increase a certain percentage over its current sales, regression analysis could be used to generate a more precise estimate of future sales than was predicted from the information contained in Figure 8.3. For a new firm that has limited years of "annual data," monthly data could be used to project sales.

Forecast of Costs of Sales and Other Items

After completing its sales forecast, a firm must forecast its cost of sales (or cost of goods sold) and the other items on its income statement. The most common way to do this is to use the **percent-of-sales method**, which is a method for expressing each expense item as a percentage of sales.[20] For example, in the case of New Venture Fitness Drinks, its cost of sales has averaged 47.5 percent over the past two years. In 2018, its sales were $586,600 and its cost of sales was $268,900. The company's sales are forecast to be $821,200 in 2019. Therefore, based on the percent-of-sales method, its cost of sales in 2019 will be $390,000, or 47.5 percent of projected sales. The same procedure could be used to forecast the cost of each expense item on the company's income statement.

Once a firm completes its forecast using the percent-of-sales method, it usually goes through its income statement on an item-by-item basis to see if there are opportunities to make more precise forecasts. For example, a firm can closely estimate its depreciation expenses, so it wouldn't be appropriate to use the percent-of-sales method to make a forecast for this item. In addition, some expense items are not tied to sales. For those items, the firm makes reasonable estimates.

Obviously, a firm must apply common sense in using the percent-of-sales method. If a company is implementing cost-cutting measures, for example, it might be able to justify projecting a smaller percentage increase in expenses as opposed to sales. Similarly, if a firm hires an upper-level manager, such as a chief financial officer, toward the end of the year and plans to pay the person $100,000 the next year, that $100,000 may not have an immediate impact on sales. In this case, the firm's forecast for administrative expenses may have to be adjusted upward beyond what the percent-of-sales method would suggest.

If a firm determines that it can use the percent-of-sales method and it follows the procedure described previously, then the net result is that each expense item on its income statement (with the exception of those items that may be individually forecast, such as depreciation) will grow at the same rate as sales. This approach is called the **constant ratio method of forecasting**. This approach will be used in preparing the pro forma financial statements for New Venture Fitness Drinks in the next section.

A summary of the forecasts used to prepare the pro forma financial statements for New Venture Fitness Drinks is provided in Table 8.5.

In addition to computing sales forecasts, when a company like New Venture Fitness Drinks considers opening a new restaurant or producing a new product, it often completes a break-even analysis in order to calculate a break-even point. The break-even point lets the entrepreneur know if the proposed initiative is feasible. The **break-even point** for a new restaurant or product is

TABLE 8.5 **Forecasts Used to Prepare Pro Forma Financial Statements for New Venture Fitness Drinks, Inc.**

Pro Forma Income Statements	
Net sales	
Historic	Average sales increase of 25% per year
2019	Increase by 40% as the result of increased brand awareness and the opening of a second service location
2020	Increase by 25% as the result of increased brand awareness (a third service location will be opened late in the year)
Cost of goods sold (COGS)	
Historic	Average of 47.5% of sales the past two years
2019	47.5% of sales
2020	47.5% of sales
Selling, general, and administrative expenses	
Historic	Average 22% of sales the past two years
2019	Increase to 25% of sales as the result of the opening of a second service location (the increase will not be any larger as the result of increased operating efficiencies)
2020	25% of sales
Interest expense	
Historic	6% to 7% of long-term debt
2019	7% of long-term debt
2020	7% of long-term debt
Other income	
Historic	Licensing income of $10,900 per year
2019	Licensing income will increase to $20,000 as the result of the renegotiation of the licensing contract
2020	Licensing income will be $20,000
Pro Forma Balance Sheets	
Accounts receivable	
Historic	Accounts receivable have trended down to 6.8% of sales in 2018 from 13.6% of sales in 2017
2019	7% of sales
2020	7% of sales
Inventories	
Historic	Inventories have trended down to 3.3% of sales in 2018 from 4.4% of sales in 2017
2019	4% of sales (reflecting slight increase over 2018 as the result of the opening of a second service location)
2020	4% of sales
Land, buildings, and equipment	
2019	$100,000 in equipment purchases and capital improvements made to existing buildings
2020	$275,000 in capital improvements, including a $100,000 real estate purchase and $175,000 in buildings and equipment

TABLE 8.5 Continued

Pro Forma Income Statements	
Accounts payable	
Historic	Accounts payable have trended down to 5.1% of sales in 2018 from 13.6% of sales in 2017 because of the implementation of more effective collection methods (a slightly higher level of accounts payable will be projected for the future)
2019	7% of sales
2020	7% of sales
Long-term debt	
2019	$75,000 reduction in long-term debt from earnings
2020	$150,000 will be borrowed to finance $275,000 to acquire land, equipment, and buildings (the balance of the acquisition costs will be funded from earnings)

the point where total revenue received equals total costs associated with the output of the restaurant or the sale of the product.[21] In the case of opening a new restaurant, New Venture Fitness Drinks could use break-even analysis as one way of determining whether the proposed initiative is feasible. The formula for break-even analysis is as follows: Total fixed costs/(price – average variable costs). In most instances, average variable cost is the same number as average cost of goods sold. As a result, if the total fixed cost associated with opening a new restaurant is $101,000 per year, the average price for a fitness drink is $2.75, and the variable cost (or cost of goods sold) for each drink is $1.10, then the break-even point for the new restaurant is as follows:

$$\$101.000 \text{ (total fixed costs)}/(\$2.75 - \$1.10) \text{ or } \$1.65 = 61{,}212 \text{ units}$$

This number means that the new restaurant will have to sell 61,212 "units," or fitness drinks, per year to "break even" at the current price of the drinks. That number breaks down to the sale of 170 fitness drinks per day, on average, based on a 360-day year. To determine whether opening the new restaurant is feasible, those leading New Venture Fitness Drinks would compare this number against the historic sales figures for their other restaurants, making adjustments as appropriate (e.g., the new restaurant may have a better or worse location than the existing restaurants). If selling 170 fitness drinks per day seems unrealistic, then the leaders of New Fitness Drinks might opt to not open the new restaurant, or find ways to lower fixed or variable costs or increase revenues. An obvious way to increase revenues is to raise the price of the fitness drinks, if that option is realistic given the competitive nature of the marketplace.

Pro Forma Financial Statements

LEARNING OBJECTIVE

7. Explain the purpose of pro forma financial statements.

A firm's pro forma financial statements are similar to its historical financial statements except that they look forward rather than track the past. New ventures typically offer pro forma statements, but well-managed established firms also maintain these statements as part of their routine financial planning process and to help prepare budgets. The preparation of pro forma statements also helps firms rethink their strategies and make adjustments if necessary. For example, if the pro forma statements predict a downturn in profitability, a firm can make operational changes, such as increasing prices or decreasing expenses, to help prevent the decrease in profitability from actually happening.[22]

A firm's pro forma financial statements should not be prepared in isolation. Instead, they should be created in conjunction with the firm's overall planning activities. For example, it's often critical to have a good sense of how quickly a firm can raise money. Sometimes a firm has a good product or service, good demand, and knows how much capital it needs to maintain a sufficient cash flow, but it can't raise the money in time. This is what happened to Wise Acre Frozen Treats, as illustrated in the nearby "What Went Wrong?" feature. The Wise Acre Frozen Treats case is a good example of how one aspect of financial management (i.e., raising money) can have a dramatic impact on another aspect of financial management (i.e., maintaining a sufficient cash flow).

The following sections explain the development of pro forma financial statements for New Venture Fitness Drinks.

Pro Forma Income Statement

Once a firm forecasts its future income and expenses, the creation of the **pro forma income statement** is merely a matter of plugging in the numbers. Table 8.6 shows the pro forma income statement for New Venture Fitness Drinks. Recall that net sales for New Venture Fitness Drinks are forecast to increase by 40 percent from 2018 to 2019 and by 25 percent from 2019 to 2020, and that its cost of sales has averaged 47.5 percent of net sales. In the pro forma income statement, the constant ratio method of forecasting is used to forecast the cost of sales and general and administrative expenses, meaning that these items are projected to remain at the same percentage of sales in the future as they were in the past (which is the mathematical equivalent of saying that they will increase at the same rate of sales). Depreciation, other income, and several other items that are not directly tied to sales are figured separately—using reasonable estimates. The most dramatic change is "other income," which jumps significantly from 2018 to 2019. New Venture Fitness Drinks anticipates a significant increase in this category as the result of the renegotiation of a licensing agreement for one of its fitness drinks that is sold by another company.

TABLE 8.6 Pro Forma Income Statement for New Venture Fitness Drinks, Inc.

	2018 Actual	2019 Projected	2020 Projected
Net sales	$586,600	$821,200	$1,026,500
Cost of sales	268,900	390,000	487,600
Gross profit	317,700	431,200	538,900
Operating expenses			
Selling, general, and administrative expenses	117,800	205,300	256,600
Depreciation	13,500	18,500	22,500
Operating income	186,400	207,400	259,800
Other income			
Interest income	1,900	2,000	2,000
Interest expense	(15,000)	(17,500)	(17,000)
Other income (expense), net	10,900	20,000	20,000
Income before income taxes	184,200	211,900	264,800
Income tax expense	53,200	63,600	79,400
Net income	131,000	148,300	185,400
Earnings per share	1.31	1.48	1.85

WHAT WENT WRONG?

Be Careful What You Wish for: How Growing too Quickly Overwhelmed One Company's Cash Flow

When Jim Picariello started Wise Acre Frozen Treats, no other company was making organic popsicles from unrefined sweeteners. Working out of a makeshift kitchen in 2006, Picariello developed his recipes using maple syrup and honey. He worked alone for a year and a half before hiring his first employee. About that time, his frozen popsicles really took off; by 2008, Wise Acre Frozen Treats had 15 employees, a 3,000-square-foot manufacturing facility, and was distributing its product to natural food stores and supermarkets across the East Coast. The company was awarded a contract to distribute to the West Coast. Then, abruptly, Wise Acre Frozen Treats failed. What went wrong?

Here's what happened. In its first year, Wise Acre Frozen Treats grew at a measured pace. It was filling orders for eight stores for a few hundred dollars each, nothing Picariello couldn't handle. Early in its second year, it won the "Most Innovative Product" award out of more than 2,000 products at a large food show called Expo East. That award increased Wise Acre Frozen Treats' profile, and it landed a contract with United National Foods, a huge national distributor, for freezer space in premier stores like Whole Foods and Wegmans. At that time, it seemed that things couldn't have worked out better.

Picariello knew he'd need to raise capital to cover the increased pace of activity. Operating expenses including labor, equipment, ingredients, packaging material, insurance, and design and marketing would all increase. Picariello obtained $300,000 from a local bank and $200,000 from an investment firm. But because Wise Acre Frozen Treats had so many orders to fill, it needed about $1 million to make things work. Picariello approached a local high-net-worth individual who agreed to invest $1 million, and who assured Picariello that he could put together the money quickly. Based on that promise, Picariello placed orders for the additional material and equipment Wise Acre Frozen Treats needed.

The timing of the investor's promise couldn't have been worse. In short order, the economy tanked and the investor reneged on his promise. At that point, Picariello characterized his life as a mad dash between running the company and meeting with potential investors. In regard to potential investors, Wise Acre Frozen Treats found itself in somewhat of a no-man's-land. Although its future was bright, the entrepreneurial venture wasn't big enough yet for investors to take notice. As time went on, serious cash flow difficulties kicked in. According to a blog post that Picariello wrote about Wise Acre Frozen Treats' failure, the company was burning through about $30,000 a month at its peak but didn't have the capital to back it up.

In retrospect, many things lined up well for Wise Acre Frozen Treats. It had a product that sold well, it had national distribution, and it had a business plan that indicated that it would take about two years for the company to break even. Its fatal flaw was that it didn't raise the money it needed before it hit major milestones, like getting the big orders. It literally went from eight stores to dozens to hundreds in a matter of months. From a cash standpoint, the firm lacked what it needed to keep up with its growth.

Questions for Critical Thinking

1. What lessons can be learned from Jim Picariello's agreement with the high-net-worth individual, who agreed to invest $1 million in Wise Acre Frozen Treats and then reneged on the agreement when the economy turned sour?
2. Why is it that a company can grow too fast? If Wise Acre Frozen Treats significantly increased its sales, why wouldn't its increased income provide more than enough cash to even out its cash flow?
3. Besides cash flow difficulties, what other problems can a firm experience by growing too quickly?
4. If Jim Picariello starts another company, make a list of the things you think he'll do differently as a result of his Wise Acre Frozen Treats experience.

Sources: J. Picariello, "My Company Grew Too Fast—and Went Out of Business," CBS Moneywatch, available at https://www.cbsnews.com/news/my-company-grew-too-fast-and-went-out-of-business/ (posted August 12, 2010, accessed May 1, 2017); L. Petrecca, "Fast Growth Isn't Always Good: A Big Influx of Orders Can Be Overwhelming," *USA Today*, September 13, 2010, B1.

Pro Forma Balance Sheet

The **pro forma balance sheet** provides a firm a sense of how its activities will affect its ability to meet its short-term liabilities and how its finances will evolve over time. It can also quickly show how much of a firm's money will be tied up in accounts receivable, inventory, and equipment. The pro forma balance sheet is also used to project the overall financial soundness of a company. For example, a firm may have a very aggressive set of pro forma income statements that project rapidly increasing growth and profitability. However, if this rapid growth and profitability push the firm's debt ratio to 75 percent (which is extremely high), investors may conclude that there is too much risk involved for the firm to be an attractive investment.

The pro forma balance sheet for New Venture Fitness Drinks is shown in Table 8.7. Note that the company's projected change in retained earnings each year is consistent with its projected net income for the same period on its pro forma income statements. The same approach was used to construct the pro forma balance sheets as the pro forma income statements. For each item listed under current assets and current liabilities, the item's historical percentage of sales was used to project its future percentage of sales. Several of the numbers were adjusted slightly upward, such as inventory levels and accounts payable, to reflect the potential impact of the opening of the second restaurant.

In regard to property, plant, and equipment, New Venture Fitness Drinks plans to invest $100,000 in 2019 and $275,000 in 2020. The pro forma balance sheet shows a corresponding increase in valuation in this category for 2019 and 2020, respectively. The company's projected long-term debt for 2019 and 2020 reflects changes resulting from principal reductions from cash flow and increased borrowing to fund the property, plant, and equipment purchases just mentioned. These transactions are reflected in the pro forma statement of cash flows for New Venture Fitness Drinks.

TABLE 8.7 Pro Forma Balance Sheets for New Venture Fitness Drinks, Inc.

Assets	December 31, 2018	Projected 2019	Projected 2020
Current assets			
Cash and cash equivalents	$63,800	$53,400	$80,200
Accounts receivable, less allowance for doubtful accounts	39,600	57,500	71,900
Inventories	19,200	32,900	41,000
Total current assets	122,600	143,800	193,100
Property, plant, and equipment			
Land	260,000	260,000	360,000
Buildings and equipment	412,000	512,000	687,000
Total property, plant, and equipment	672,000	772,000	1,047,000
Less: accumulated depreciation	65,000	83,500	106,000
Net property, plant, and equipment	607,000	688,500	941,000
Total assets	729,600	832,300	1,134,100
Liabilities and shareholders' equity			
Current liabilities			
Accounts payable	30,200	57,500	71,900
Accrued expenses	9,900	12,000	14,000
Total current liabilities	40,100	69,500	85,900
Long-term liabilities			
Long-term debt	249,500	174,500	274,500
Total long-term liabilities	249,500	174,500	274,500
Total liabilities	289,600	244,000	360,400
Shareholders' equity			
Common stock (100,000 shares)	10,000	10,000	10,000
Retained earnings	430,000	578,300	763,700
Total shareholders' equity	440,000	588,300	773,700
Total liabilities and shareholders' equity	729,600	832,300	1,134,100

Pro Forma Statement of Cash Flows

The **pro forma statement of cash flows** shows the projected flow of cash into and out of the company during a specified period. The most important function of the pro forma statement of cash flows is to project whether the firm will have sufficient cash to meet its needs. As with the historical statement of cash flows, the pro forma statement of cash flows is broken into three activities: operating activities, investing activities, and financing activities. Close attention is typically paid to the section on operating activities because it shows how changes in the company's accounts receivable, accounts payable, and inventory levels affect the cash that it has available for investing and finance activities. If any of these items increases at a rate that is faster than the company's annual increase in sales, it typically raises a red flag. For example, an increase in accounts receivable, which is money that is owed to a company by its customers, decreases the amount of cash that it has available for investment or finance activities. If accounts receivable gets out of hand, it may jeopardize a company's ability to fund its growth or service its debt.

The pro forma consolidated statement of cash flows for New Venture Fitness Drinks is shown in Table 8.8. The figures appearing on the statement come directly, or are calculated directly from the pro forma income statement and the pro forma balance sheet. The one exception is that the last line of each statement of cash flows, which reflects the company's cash balance at the end of the period, becomes the first line of the company's balance sheet for the next period. The pro forma statement of cash flows for New Venture Fitness Drinks shows healthy cash balances at the end of each projected period and shows

TABLE 8.8 Pro Forma Statement of Cash Flows for New Venture Fitness Drinks, Inc.

	December 31, 2018	Projected 2019	Projected 2020
Cash flows from operating activities			
Net income	$131,000	$148,300	$185,400
Changes in working capital			
Depreciation	13,500	18,500	22,500
Increase (decrease) in accounts receivable	9,300	(17,900)	(14,400)
Increase (decrease) in accrued expenses	1,900	2,100	2,000
Increase (decrease) in inventory	1,200	(13,700)	(8,100)
Increase (decrease) in accounts payable	(16,700)	27,300	14,400
Total adjustments	9,200	16,300	16,400
Net cash provided by operating activities	140,200	164,600	201,800
Cash flows from investing activities			
Purchase of building and equipment	(250,500)	(100,000)	(275,000)
Net cash flows provided by investing activities	(250,500)	(100,000)	(275,000)
Cash flows from financing activities			
Proceeds from increase in long-term debt	119,500	—	100,000
Principle reduction in long-term debt		(75,000)	
Net cash flows provided by financing activities			
Increase in cash	9,200	(10,400)	26,800
Cash and cash equivalents at the beginning of the year	54,600	63,800	53,400
Cash and cash equivalents at the end of the year	63,800	53,400	80,200

that investment activities are being funded more by earnings than by debt. This scenario reflects a company that is generating sufficient cash flow to fund the majority of its growth without overly relying on debt or investment capital.

In regard to dividends, the pro forma statement of cash flows shows that New Venture Fitness Drinks is not planning to pay a dividend to its stockholders in 2019 and 2020. Recall that New Venture Fitness Drinks is incorporated and has stockholders even though it is not traded on an organized exchange. If New Venture Fitness Drinks were planning to pay a dividend, the projected dividend payments would show up under financing activities and would reduce the amount of cash available for investing and financing activities. It is common for a new firm to invest the majority of its cash in activities that fund its growth, such as property, plant, and equipment purchases, rather than pay dividends.

Ratio Analysis

The same financial ratios used to evaluate a firm's historical financial statements should be used to evaluate the pro forma financial statements. This work is completed so the firm can get a sense of how its projected financial performance compares to its past performance and how its projected activities will affect its cash position and its overall financial soundness.

The historical financial ratios and projected ratios for New Venture Fitness Drinks are shown in Table 8.9. The profitability ratios show a slight decline from the historical period to the projected. This indicates that the projected increase in assets and corresponding sales will not produce income quite as efficiently as has been the case historically. Still, the numbers are strong, and no dramatic changes are projected.

The liquidity ratios show a consistently healthy ratio of current assets to current liabilities, suggesting that the firm should be able to cover its short-term liabilities without difficulty. The overall financial stability ratios indicate promising trends. The debt ratio drops from an actual of 39.7 percent in 2018 to a projected 31.8 percent in 2020. The debt-to-equity ratio shows an even more dramatic drop, indicating that an increasing portion of the firm's assets is being funded by equity rather than debt.

In summary, it is extremely important for a firm to understand its financial position at all times and for new ventures to base their financial projections on solid numbers. As mentioned earlier, regardless of how successful a firm is in other areas, it must succeed financially to remain strong and viable.

TABLE 8.9 Ratio Analysis of Historical and Pro Forma Financial Statements for New Venture Fitness Drinks, Inc.

	Historical			Projected	
Ratio	**2016**	**2017**	**2018**	**2019**	**2020**
Profitability ratios					
Return on assets	14.7%	18.7%	21.4%	19.0%	18.9%
Return on equity	24.9%	31.0%	35.0%	28.9%	27.2%
Profit margin	13.6%	17.9%	22.3%	18.1%	18.1%
Liquidity ratios					
Current	2.35	2.26	3.05	2.07	2.24
Quick	1.96	1.89	2.58	1.60	1.78
Overall financial stability ratios					
Debt	42.3%	37.4%	39.7%	29.3%	31.8%
Debt to equity	73.2%	59.8%	65.8%	41.5%	46.6%

Chapter Summary

LO1. To pursue an opportunity and to turn that pursuit into a viable venture, entrepreneurs require financial capital. Financial management deals with this reality. More specifically, financial management is concerned with two activities: raising money and managing a company's finances in a way that achieves the highest rate of return.

LO2. Profitability, liquidity, efficiency, and stability are the four main financial objectives of entrepreneurial firms. Profitability is the ability of a firm to earn a profit, liquidity is the ability of a company to meet or satisfy its short-term obligations, efficiency deals with how productively a firm uses its assets relative to its revenue and profits, and stability is the strength and vigor of the firm's overall financial standing.

LO3. The process of financial management includes the activities a firm takes to determine if its financial objectives are being met. Several documents are foundational to an entrepreneur's efforts to assess the degree to which a firm's financial objectives are being satisfied. These documents, as follows, are prepared regularly: (1) financial statements (a written report that describes a firm's health from a quantitative perspective), (2) forecasts (which are estimates of a firm's future sales, income, expenses, and capital expenditures based on its past performance, current situation, and its future plans), and (3) budgets (which are itemized forecasts of a firm's income, expenses, and capital requirements).

LO4. Historical financial statements reflect past performance. Typically, these documents are prepared on a quarterly and annual basis. The Securities and Exchange Commission (SEC) requires that publicly traded firms prepare and submit these documents. Pro forma financial statements are projections for expected performance in future periods. These projections are based on forecasts and are usually completed for two or three years into the future. Unlike historical financial statements, firms are not required to make their pro forma statements publicly available.

LO5. Historical financial statements include an income statement, a balance sheet, and a statement of cash flows. An income statement reflects the results of a firm's operations over a specified period of time. It records all the revenues and expenses for the given period and shows whether the firm is making a profit or is experiencing a loss. A balance sheet is a snapshot of a company's assets, its liabilities, and owners' equity. While income statements cover a specified period of time, a balance sheet is a snapshot of the firm at a specific point in time. A statement of cash flows summarizes the changes in a firm's cash position for a specified period of time and details why the changes occurred. This statement allows a firm to understand how much cash it has on hand and how its cash was used over a period of time.

LO6. Forecasts are predictions of a firm's future sales, expenses, income, and capital expenditures. A firm's forecasts provide the basis for its pro forma financial statements. When developed effectively, forecasts provide the foundation for a firm to prepare its future-oriented pro forma financial statements. Newly-established firms typically base their forecasts on a good-faith estimate of sales and on industry averages (based on a percentage of sales) or the experiences of similar start-ups for cost of goods sold and other expenses. Once a firm has completed its sales forecast, it must forecast its costs of sales as well as the other items on its income statement. The most common way to do this is to use the percent-of-sales method, which is a method for expressing each expense item as a percentage of sales.

LO7. Pro forma financial statements are similar to historical financial statements except that they look forward rather than backward. Preparing pro forma statements helps entrepreneurs think about the quality of the strategies being implemented by their firm and to make adjustments to those strategies if necessary. Considered to be part of a firm's planning efforts, firms prepare a pro forma income statement, a pro forma balance sheet, and a pro forma statement of cash flows to help them anticipate and prepare for future activities and their anticipated outcomes.

Key Terms

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MyLab Entrepreneurship
If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

8-1. What are the two primary functions of the financial management of a firm?
8-2. What are the four main financial objectives of a firm?
✪ 8-3. What is the difference between historical and pro forma financial statements?
8-4. What is meant by the term *efficiency* as it relates to the financial management of a firm?
8-5. What is meant by the term *stability* as it relates to the financial management of a firm?
8-6. What is the purpose of a forecast? What factors does a firm use to create its forecasts of future sales, income, expenses, and capital expenditures?
8-7. On what factors or conditions do completely new firms base their forecasts?
8-8. What is the purpose of an income statement? What are the three numbers that receive the most attention when evaluating an income statement? Why are these numbers important?
8-9. Why do we need to compare a firm's financial ratio to industry norms?
8-10. How does a firm compute its price-to-earnings ratio? Why does a high price-to-earnings ratio indicate that the stock market thinks the firm will grow?
8-11. What is the purpose of a balance sheet?
8-12. What are the major categories of assets and liabilities on a balance sheet? Briefly explain each category.
✪ 8-13. How do you compute a firm's debt ratio? What is the significance of this ratio?
8-14. How does a firm compute its current ratio? Is this a relatively important or unimportant financial ratio? Explain your answer.
8-15. What is the purpose of a statement of cash flows?
8-16. What are the three separate categories of activities that are reflected on a firm's statement of cash flows? Briefly explain the importance of each activity.
8-17. What is the purpose of financial ratios? Why are financial ratios particularly useful in helping a firm interpret its financial statements?
8-18. What is a *break-even point?*
8-19. Why is a firm's sales forecast the basis for most of its other forecasts?
8-20. What is meant by the percent-of-sales method as it relates to forecasts?

Application Questions

8-21. Suppose a friend of yours showed you the pro forma income statements for his start-up and exclaimed excitedly that during the first three years of operations his firm will make a net income of $150,000 per year, which is just the amount of money ($450,000) the firm will need to pay off a three-year loan. Given your study of this chapter, why is it that your friend may not actually have $450,000 in cash, even though his pro forma income statements say that he will earn that amount of money?

8-22. According to Hong Kong's Commercial Crime Bureau, four different investment scams cost 85 victims around $7.7 million in 2017. This was a three-fold increase compared to 2016. To lure victims, fake bank credit statements are often used as proof of assets, fake professionals give talks, and investors are even taken on tours of the businesses they are supposedly buying. In one case, 18 people were scammed out of nearly $3 million when they thought they were buying a wine and colliery business in mainland China. What advice would you give overseas investors about your country?

8-23. In groups of three, visit a business outlet in your vicinity. With the owner or the manager's consent, prepare a sales forecast for the years 2018 and 2019 based on the outlet's sales from 2015 to 2017. You may present the answer in class.

8-24. Jorge Martinez is thinking about buying an existing printing business and has been carefully studying the records of the business to get a good handle on its historical financial performance. Jorge heard that you are taking a class in entrepreneurship and asks you, "What suggestions do you have for me to make the best use of this financial information (i.e., three years of audited income statements, balance sheets, and statements of cash flow)?" What suggestions would you give Jorge for making the maximum use of the financial statements?

8-25. A friend has come to you for advice. She needs to prepare a business plan for a potential investor and has prepared a very detailed financial plan that she is confident about. However, she is not sure about what should be included in the section on the financial objectives of her firm. What advice would you give her?

8-26. What items on the left side (or top) and what items on the right side (or bottom) of a firm's balance sheet should receive the greatest scrutiny? In regard to each of these items, what are the most important factors that a new venture should focus on to maintain its overall financial health?

8-27. Suppose a colleague of yours is gearing up to write a business plan for a business she intends to start. She told you she plans to prepare the financial statements first to get that job out of the way before she tackles the rest of the plan. What is the flaw in your colleague's logic as described to you?

YOU BE THE VC 8.1 COMPANY: Goonhilly Satellite Earth Station

• Web: www.goonhilly.org • Facebook: Goonhilly Earth Station Ltd • Twitter: @goonhillyorg

Business Idea: The satellite industry is undergoing a revival driven by space exploration and travel. Goonhilly Satellite Earth Station in the United Kingdom is one of the focal points of new developments where high-performance satellites orchestrate the moves of the new generation of high-tech innovators.

Pitch: Goonhilly Earth Station has a proud history of space technology dating back to 1962, when this Cornwall site at the southernmost tip of the United Kingdom was a key part of the first trans-Atlantic TV transmissions. In 1969, it beamed the moon landings to millions; now, the satellite tracking station, which was at one time the largest of its kind in the world, is undergoing a significant upgrade to help maintain its place as the space capital of Britain. Plans are also underway for a comprehensive global expansion program that links sites from the United States to Australia to give 24-hour coverage of the moon and Mars.

In 2018, a contract worth £8.4 million was signed with the European Space Agency (ESA) for Goonhilly to become the first private operator in its deep space communications network. Goonhilly's upgraded antenna will track several of the ESA's deep space missions, including the Mars Express spacecraft, which has been in orbit around the red planet since 2003. It has also opened a new green data center designed to become a high-performance computing hub for artificial intelligence and machine learning. Goonhilly Earth Station has the ideal location, assets, and resource capabilities to support near-space and deep-space communications, consult on systems engineering and space technology projects, and support data-center services.

The current value of the so-called space economy, which is mostly based on the building and operating of rockets and satellites to provide services to earth, is estimated to be $400 billion. However, many investors, analysts, and government officials predict that it could quickly soar to $1 trillion. The UK Space Agency has already declared its goal to have 10 percent of that global space economy by 2030. And contrary to popular myth, it is possible to make a profit in space too. Since 2009, entrepreneurial ventures have achieved $14 billion in exits from the space industry.

Goonhilly's ambitions to be a major part of this drive have been further boosted by the UK Space Agency's funding for Spaceport Cornwall, a partnership between Newquay Airport and Virgin Orbit that will provide the United Kingdom with horizontal launch capabilities, allowing low-cost, reusable access to space. The space airport will be the home of Virgin Orbit's spaceflights, which will be tracked and monitored from Goonhilly.

Goonhilly is also experiencing growing demand for its satellite technology services on the ground, thanks to technological innovations ranging from self-driving cars, to crop management, to the tracking of ships. Goonhilly can deal with much larger data volumes than was previously available, giving applications access to more impressive and cost-effective processes. One of the first customers is data analytics firm Zizo, which is hosting its big data analytics as a service at Goonhilly.

8-28. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

8-29. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 8.2 COMPANY: Amber

• Web: driveamber.com • Facebook: driveamber • Twitter: @Drive_Amber

Business Idea: A 100-percent electric car–sharing system with ambitions to evolve into the first firm deploying self-driving cars on a large scale, or as the Amber team puts it, to become the Spotify or Netflix of mobility.

Pitch: Self-driving cars have long been a staple of science fiction, but experts have predicted that 33 million of them will be on the road by 2040. Firms such as Uber, Tesla, and Google have spent years fighting over who will be the first to make this vision a reality. Amber, a startup from the Netherlands, is planning to speed past them all and take a slice of the global self-drive market, currently valued at $54 billion. Amber was founded in 2016 by Steven Nelemans, Hans de Penning, Joep Sloot, and Merien ten Houten when they were students at the Eindhoven University of Technology. The company currently operates as an app-based car-sharing platform focused on electric cars. Users are notified where they can pick up an Amber car, and the app allows them to lock and unlock it.

The next step for the young Amber team is to reposition themselves. They have already successfully tested their modified fleet of BMW i3s with technology for platooning, which is a form of autonomous driving where a car driven by a human is automatically followed by driverless cars. Using the technology, one person can transport multiple vehicles at the same time; meanwhile, the cars accumulate data and behave according to what they have learned. Initial trials were during the night, when the roads are relatively quiet, but they will eventually self-drive during the day, first on easier backroads and then in busier traffic. Major car companies, tech giants, as well as a handful of startups have spent a combined $80 billion on developing driverless technology—and it is clear why. One estimate by Strategy& forecasts that half the cars on European roads will be autonomous vehicles by 2030, and the figure is expected to be matched in certain markets around the world.

To date, though, there has yet to be a large-scale trial in towns and cities, due in large part to the fact that international governments are strictly limiting driverless cars to testing tracks until all safety implications are properly explored and addressed. However, the Netherlands is at the forefront of legislation to facilitate the use of self-driving vehicles. The Amber team has also formed close partnerships with local governments in cities such as Eindhoven and Helmond, who are supporting these developments and offering city streets as a test pad.

Amber is not developing its own self-driving software but partnering with five different software companies and research institutes, including Nvidia and Microsoft. It is, however, working on building its own electric car, the Amber One, scheduled to appear in 2021 with a lifespan of a million miles.

8-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

8-31. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 8.1

Mary Lynn Schroeder: Building a Successful Business with Limited Money and Limited Business Experience

• Web: www.Inbluehandmade.com • Facebook: Mary Lynn Schroeder • Twitter: @inbluehandmade

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

In 2008, Mary Lynn Schroeder was working in the music business in Chicago. She didn't find the work fulfilling so decided to move on. She departed for southern Illinois, and on the way stopped at a Jo-Ann Fabrics & Crafts store. While she didn't know much about sewing, she bought a sewing machine, primarily in order to hem her jeans and make curtains. She stayed long enough to take several lessons. She arrived in southern Illinois and rented a farmhouse near Carbondale, the home of Southern Illinois University. Schroeder had planned to find a job in Carbondale and settle in. Instead, she unexpectedly fell in love with sewing.

Rather than finding a job, Schroeder started sewing—making small items and doing clothing alterations. The idea of becoming self-sufficient appealed to her. She opened a small consignment shop in a town of about 400, selling her own work and the work of others. The shop had a small studio in the rear where Schroeder did her work. During this period, Schroeder became interested in making leather journals. The idea she settled on was to make journals bound by leather on the front and the back. The cover would have an image on it, selected by the buyer from a book of images she would maintain. The buyer would also be able to provide up to 10 words of text to accompany the image. The combination of these options would result in a one-of-a-kind custom journal with the buyer's favorite phrase on the cover.

Shortly after moving to southern Illinois, Schroeder set up an Etsy shop. For the first year or so she sold small handmade goods. When the leather journal idea came along, she added leather journals and leather sunglass cases to her Etsy store. She would sell 1–2 products a day, which was a pace she could keep up with. At this time, Schroeder was working at Steak & Shake, a burger and shake restaurant, to supplement her income. On December 2, 2009, shortly after Schroeder started selling leather journals, an extraordinary thing happened. Her journal was featured on The Martha Stewart Show. Schroeder woke up the next morning and had 80 orders for journals. This was the beginning of a larger business. She also began establishing wholesale accounts. As a result of her visibility on Etsy, she started receiving offers from chains and boutiques to carry her goods. Schroeder's business, called In Blue Handmade, was poised for growth.

Growing In Blue Handmade with Limited Money and Limited Business Experience

While demand for Schroeder's products was growing, she had two problems: limited money and limited business experience. To grow the business she needed a new website, an online store, and channels through which to sell her products. Rather than raising money to hire developers to build a website and create an online store, and hiring marketing personnel to create channels to sell through, Schroeder chose a different

(*continued*)

approach. She decided to do it inexpensively by using ready-made platforms, shown in the table nearby, to accomplish her objectives. Utilizing these platforms enabled Schroeder to achieve two main goals: First, she was able to build her business with a very low capital investment. As you'll see by reading this case, it costs very little to set up an online store on Shopify or design a website via Squarespace. Second, by utilizing ready-made platforms, she was able to tap into the expertise of the people who built the platforms rather than having to obtain or hire the expertise herself.

The following is a brief overview of the platforms that Schroeder utilized to inexpensively grow In Blue Handmade. After the overview, we'll consider how Schroeder used each platform.

Ready-Made Platforms Utilized by Schroeder to Inexpensively Grow In Blue Handmade

Item Used	Platform	URL
Website	Squarespace	www.squarespace.com
Online store	Shopify	www.shopify.com
Marketplace	Etsy	www.etsy.com
Marketplace	Craft shows and festivals	various

Squarespace

Squarespace is a cloud-based platform that allows you to create a beautiful and highly functional website with no coding experience. Here's how it works. You begin by selecting from one of roughly 70 templates. You pick the template that best resembles the appearance you have in mind for your website. The templates are organized into categories, such as Fashion & Beauty, Food & Drink, Health & Fitness, and Wedding. So, for example, if you're starting a food business, you can select from one of 10 templates specifically designed for food businesses. Squarespace will then ask you questions about your site's intended content and the site's goals. Once you create an account, which comes with a 14-day free trial, you'll be introduced to the Squarespace platform. The platform allows you to substitute your information and images for the information and images on the template, and to customize the template in almost any way you'd like. There is a series of helpful video tutorials that walk you through each step of the process. If you'd like to see what the templates look like, go to www.squarespace.com and click the "Get Started" button. You can view the templates without creating an account.

The end result is a highly polished website that looks like it took a programmer several months and thousands of dollars to produce. You don't need to know how to code—you simply watch the Squarespace videos and use the provided tools. Over one million businesses and individuals have created websites on Squarespace and are active Squarespace customers, which speaks to the platform's ease-of-use, quality, and affordability. All of Squarespace's templates are designed so they'll look good on a PC or a Macintosh and also on mobile devices. Squarespace has robust customer support. It provides live chat, one-hour e-mail response time, and an extensive library of tutorials and video workshops. Squarespace hosts your site and provides you a domain name. It also provides you a real-time analytics dashboard, which helps you track hourly, daily, weekly, and monthly traffic to your website.

In terms of pricing, Squarespace costs $26 per month (or $216 per year) for a business. Squarespace provides the option of coupling its website development and hosting service with an online store. Adding the online store increases the costs for a business to $30 per month (or $312 per year).

Squarespace was an ideal choice for Schroeder because she didn't have the money to hire a developer or enlist a freelancer to build her a website, didn't know how to do it herself, and, if she was like many people, starting with a template actually helped her because it enabled her to visualize what a well-designed website looks like. Squarespace has several competitors which offer a similar service, including Jimbo, Weebly, Wix, and GoDaddy. The only downside to utilizing Squarespace rather than hiring a programmer is some potential customization is foregone.

Shopify

Shopify is a platform that allows you to set up an online store. It lets you organize your products, customize a storefront, accept credit and debit cards, and track and respond to orders. It's a cloud-based product, so there is no installation, and all the upgrading and maintenance of the software is handled by the company. Shopify integrates with existing websites so if you've already built a website, have a domain name, and have arranged for hosting, that doesn't create a problem.

Shopify's set up is similar to Squarespace's. You start by choosing from over one hundred online store templates in Shopify's Theme Store. The best way to see what the templates look like is to go to www.shopify.com, click on the Resources tab at the top, and select Theme Store. Shopify organizes its templates into categories such as Clothing & Fashion, Jewelry & Accessories, Art & Photography, and Electronics. Once you've selected a template, you can create an online store and customize it so its looks as though it was built from scratch, specifically for your business.

Everything you need to sell online is included. Shopify provides you a shopping cart which allows you to process orders and accept payment via credit cards, debit cards, and PayPal. Search Engine Optimization (SEO) features are built-in, which generate traffic and sales from Google, Yahoo, and Bing. The platform optimizes its online stores for the web and for mobile devices. You can manage your store yourself. Again, because Shopify is a hosted solution, you never have to worry about installation, patches, and security updates. All of that is handled by Shopify behind the scenes.

Shopify is a little more complicated than Squarespace. You do need a basic understanding of HTML & CSS. Shopify uses a designer-friendly programming language called Liquid. Liquid is easy to pick up and there are excellent beginner tutorials (written and video) available to help users get up-to-speed quickly. As referred to above, Shopify has a Resources tab on its website. The tab provides access to Guides, Videos, Podcasts, Success Stories, and Forums all designed to assist users and provide access to best practices for utilizing Shopify and for selling online.

Shopify has a variety of pricing plans, depending on the size of a business, the number of transactions that are processed, and the features that are desired. Its basic plan is $29 per month plus 2.9 percent and 30 cents per transaction for credit card processing fees. That plan is suitable for a fairly straightforward business with revenues of less than $20,000 per year. Its top plan is $299 per month plus 2.4 percent and 30 cents per transaction for credit card processing fees. That plan is suitable for a much larger business and includes enhanced features, such as the ability to sell and redeem gift cards.

Shopify was a good choice for Schroeder because, as was the case with Squarespace, it provided her a way to get an online store up-and-running with very little capital investment. It also provided substantial functionality for a relatively small monthly expense. It's not known whether Schroeder needed help setting up her Shopify store or whether she did it herself. Help from a qualified freelancer could have been obtained for a fairly modest upfront cost.

Etsy

Along with selling items via her own website, Schroeder has an Etsy store, as explained earlier. Having an Etsy store provides her a marketplace to sell her products. Etsy, which is the subject of Case 4.1, is an e-commerce website that focuses on handmade or vintage items, as well as unique factory-manufactured goods. These items cover a wide range of product types, including Clothing & Accessories, Kids & Baby, Home & Living, and Craft Supplies & Tools.

To sell on Etsy, you register and create an online Etsy store. You can see Schroeder's Etsy Store, Inblue, at https://www.etsy.com/shop/inblue. According to the site, Inblue, which is now located in Asheville, NC, has been selling on Etsy since 2008 and has 54,730 sales. It currently has 286 items for sale in categories such as Bags, The InBlue Journal, Pocket Journals, Wallets, and Travel Gear. It has a five star rating generated by 12,668 customers. All items for sale are beautifully photographed and smartly described on the site.

Creating an Etsy store is free, and the platform provides all the tools necessary to set up a site. No programming knowledge is needed. Each item in the store costs 20 cents to list. The prices in the store are determined by the seller. Etsy takes a 3.5 percent commission on each sale. There is also a credit card processing fee associated with each transaction. All of the logistics involved with the sales process are handled by the seller. The advantage of selling on Etsy is that the company attracts a global audience of buyers interested in handmade goods. It also assists its sellers in numerous ways. For example, Etsy sends out a newsletter which is seen by upwards of two million people. In each newsletter, it highlights one or more of its sellers, and InBlue has been featured more than once. Etsy also rotates images of items made by its most popular sellers on the front page of its site. Similar to its newsletter, one or more of InBlue's items have been featured. Etsy also provides its sellers development tools, educational material, and offline events to hone their online selling skills.

For Schroeder, Etsy has provided her a marketplace for her products with very little investment on her part. There is no monthly fee to maintain an Etsy store, other than the one-time listing fee of 20 cents an item. Etsy's 3.5 percent commission and the credit card processing fee do not kick in until a sale is made. Etsy has been a good culture match for Schroeder and the products she sells. Etsy's focus is allowing its sellers to build a shop that has a neighborhood feel, and has meaning for both the buyer and the seller. This aspect of Etsy fits nicely with Schroeder's homespun values and the uniqueness of her handcrafted products.

Craft Shows & Festivals

Schroeder also sells her products through traditional craft shows and festivals. By doing so, she in essence brings her online business offline. The only costs involved are travel to the shows and the fees involved with setting up booths and selling via an organized show or festival.

There are two benefits to selling via traditional off-line craft shows and festivals, other than generating sales. The first is the ability to sell misprints. Occasionally, Schroeder or one of her craftspeople ge something wrong, like placing an image in the upper right hand corner of a leather journal rather than the left hand corner. If the item is returned for a refund, it can be sold at a craft fair. The second advantage is the opportunity to meet face-to-face with customers and receive feedback on her items. Schroeder credits the feedback she's received from customers at craft fairs and festivals as instrumental in shaping product decisions.

Schroeder and In Blue Handmade Moving Forward

Partly as a result of her reliance on ready-made platforms, rather than pursuing a more expensive approach, Schroeder's business continues to grow. In 2011, Schroeder moved the business from southern Illinois to Ashville, NC. Ashville provides a rich environment for artists and has a labor pool of people with artistic abilities. It's also a vibrant tech hub and has a growing concentration of craft breweries.

In Blue Handmade is currently the #1 leather shop on Etsy, has 300 wholesale accounts, and employs eight people. It has hired a developer, who focuses mainly on analytics. It still runs its business on the same ready-made platforms it utilized to kick start its growth.

Discussion Questions

8-32. What can a first-time entrepreneur, who may have a good idea but not much money or business acumen, learn from Mary Lynn Schroeder's experience?

8-33. To what degree do you think you'd be capable of building a website on Squarespace and setting up an online store on Shopify? If you don't think you're capable of either of these tasks, what can you do now to obtain the necessary capabilities?

8-34. To what degree do you believe ready-made platforms like Squarespace, Shopify, and Etsy have contributed to the entrepreneurial ecosystem in the United States and abroad? To what degree could you envision using one or more of these platforms if you launched a business of your own?

8-35. Identify and describe a ready-made platform, like Squarespace or Shopify that is not a direct competitor of either one of these platforms but fills a similar role in that it allows an entrepreneur to perform a vital task with very little upfront capital investment.

8-36. Why do you think this case was placed in the chapter titled "Assessing a New Venture's Financial Strength and Viability"?

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CASE 8.2

Fundbox: Designed to Help Small Businesses Minimize Cash Flow Shortfalls

• Web: www.fundbox.com • Facebook: Fundbox • Twitter: @fundbox

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Fundbox is an entrepreneurial start-up that offers 12- and 24-week loans to small businesses. The loans are tied to specific invoices that the businesses have outstanding. Payment for the loans (including principle, interest, and fees) is deducted from a company's bank account in 12- or 24-equal amounts on a weekly basis. Once the money for the invoice comes in, the loan can be paid in full. There is no penalty for early payment.

Fundbox was launched in 2012 by Yuval Ariav, Eyal Shinar, and Tomer Michael, who are technological innovators and financial professionals. The firm's mission is to offer small businesses a common-sense approach to cash-flow management.

The Problem

Almost all small businesses experience cash flow shortfalls. Think of how business works. Businesses often win a contract, purchase the materials and supplies that are needed to produce the firm's product or service, pay employees, and then have to wait 30, 60, or 90 days to receive payment from the customer. This scenario causes even healthy businesses to be short on cash at times. In fact, the better a business does, the more cash flow often becomes a concern. There are two traditional solutions to the problem. The first is to maintain a line of credit at a bank. A line of credit allows a business to borrow up to a certain amount of money and pay it down when money comes in. The problem with this solution is that banks are increasingly reluctant to establish lines of credit for small businesses. Banks also don't like to make short-term loans for specific amounts. The second solution is invoice factoring. With invoice factoring, a company sells its invoices to a factoring company in exchange for a lump sum of money (say $4,500 for a $5,000 invoice). The factoring company then proceeds to collect the money from the company's customer. Many businesses don't like this alternative because it involves a third party having a direct relationship with their customer. If the factoring company becomes aggressive in trying to collect the invoice, it could affect the business' relationship with its customer.

To further complicate things, Days Sales Outstanding (DSO), or the time between when a business issues an invoice and the payment is received, has been increasing across the board in recent years.

Fundbox

Fundbox offers a novel solution to the problem. When an invoice comes in, it will issue a 12- or 24-week loan for the amount of the invoice. Because the loan is matched with a specific receivable, it prevents the repayment of the loan from creating a new cash flow problem for the business. The interest rate on the loan is tied to both the creditworthiness of the borrower and the company that owes the amount on the invoice. This practice encourages borrowers to borrow money on invoices that they are confident will be paid. For example, say a business does $10,000 of work for Home Depot. It knows Home Depot will pay the invoice, but Home Depot may operate on a net 30 or net 60 day payment schedule

tsyhun/Shutterstock

Fundbox has partnerships with many of the top online bookkeeping programs. If a business has a Quickbooks account, for example, it can easily be tied to the business' Quickbooks account.

(meaning that it has 30 days or 60 days to make the payment). If the business has an account with Fundbox, it could get the $10,000 right away, minus Fundbox's fee. Weekly payments would start immediately. When Home Depot paid the invoice, the loan to Fundbox would be paid in full. This scenario allows a business to get its money sooner rather than later and avoid short-term gaps in its cash flow. The interest rate for Fundbox's service varies. According to an article published in *Forbes*, the interest rate charged works out to an APR of 20.8 percent to 28.8 percent. Fundbox has a page on its website that explains its pricing. The page is available at https://fundbox.com/pricing.

Fundbox uses sophisticated data analytics to build a picture of a potential borrower's overall financial health and likelihood of repayment. The majority of Fundbox's customers' invoices average between $800 and $8,000, with a mean of $1,500. Most of Fundbox's users are traditional small businesses, such as subcontractors, plumbers, gardeners, and lawyers. In addition, a growing number of freelancers utilize Fundbox's service.

Partnerships with Bookkeeping Companies

To make it easy for clients, Fundbox has established partnerships with many of the top online bookkeeping programs, including Quickbooks, Freshbooks, Xero, Sage One, and Harvest. For Freshbooks, for example, once a businessperson creates a Fundbox account (sign-up is free), it can easily be tied to the business' Freshbooks account. When an invoice is entered into Freshbooks, Fundbox will analyze all pertinent data to see if a 12- or 24-week loan to cover the amount of the invoice can be made. The business will receive an e-mail message indicating whether a loan can be made. The business can then evaluate the terms of the loan and either accept or pass on the offer. If the offer is accepted, the funds will be deposited in the business' bank account, usually within a day. Fundbox only works with the borrower. In the Home Depot example provided above, if the borrower defaulted on Fundbox's loan, Fundbox would not try to collect the loan amount from Home Depot. Each borrower is given a maximum line of credit from Fundbox, so offers will not be made on all invoices.

B2B Players

Fundbox's loans are most suitable for business to business (B2B) companies. These are businesses that do work for other businesses and issue invoices for the work they do. Most business to consumer companies (B2C) are paid at the point of sale. For example, when you eat at a restaurant or buy a book from Amazon.com, you pay for it right away. The B2B category includes freelancers who do work for businesses. These are individuals who may benefit especially from Fundbox's service. For example, an independent software developer may spend 100 hours developing a mobile app for a small business and invoice the business $15,000. If the payment terms are net 60, the business will have 60 days to pay the bill. Via Fundbox, the independent software developer could get his money right away. For a freelancer, getting money sooner rather than later may make the difference in making rent or paying a mortgage on time.

Fundbox's Future

Since Fundbox went live, it has signed up thousands of active users and clears tens of thousands of invoices annually. Fundbox is among a growing number of start-ups that are using technology to more effectively provide small businesses credit, which typically doesn't provide good returns for traditional lenders. Fundbox is also among a growing number of start-ups that are applying algorithms to the credit approach process; SoFi, Earnest, and Upstart are examples of companies that are doing the same thing in the consumer credit space. What is unique about Fundbox is that it focuses on the B2B space, and connects loans to specific invoices, which helps small businesses minimize cash flow challenges.

The downside to using Fundbox as a fix for cash flow gaps is the costs involved. While the loans are short-term, the interest rate charged works out to an APR of 20.8 percent to 28.8 percent, as mentioned previously. While that rate is lower than other online lenders, it's still higher than traditional banks. The best thing for any small business to do is to check with an accountant or business advisor regarding the wisdom of using Fundbox or a similar product to minimize cash flow shortfalls.

Fundbox has raised $107.5 million from a collection of venture capitalists to fund and grow its operations. Its staple invoice financing business continues to grow. In 2015, Fundbox launched a new product called Credit-as-a-Service, which allows third parties such as accounting software providers to embed Fundbox directly into their applications. In early 2017, Fundbox entered into a partnership with Zoho, a cloud-based business operating system, which will provides Zoho's customers access to Fundbox's offerings. According to Zoho president Raj Sabhlok, "Now, our customers can not only recognize cash flow gaps, but get the cash they need from Fundbox in a few clicks and keep their businesses running smoothly."

Discussion Questions

8-37. Toward the beginning of this case, the following statement appears: "Almost all small businesses experience cash flow shortfalls." What is cash flow? Why is cash flow so critical to an entrepreneurial firm's success? Why do almost all small businesses experience cash flow shortfalls?

8-38. As explained in this chapter, a firm's statement of cash flows is divided into three separate activities. Which of the activities from the statement of cash flows would be affected by a firm's decision to use Fundbox's service? What are some of the potential effects of a small entrepreneurial firm's decision to use Fundbox on the components of that firm's statement of cash flows?

8-39. If Fundbox's cofounders (Yuval Ariav, Eyal Shinar, and Tomer Michael) were to ask your advice about the importance of pro forma statements to their firm's continuing success, what would you say to them? What pro forma statements would you recommend the cofounders develop and why?

8-40. As a young entrepreneur, what lessons about the financial management of a firm can you learn from the actions taken by the three cofounders of Fundbox?

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ESSAY QUESTIONS

1. A close friend has been running a small import–export business. He is extremely busy and seems to be making money. He seems to be funding operations with numerous short-term loans that he is able to pay back within a matter of days. The interest rates are high on these loans, and you ask him why he does this. He explains that he has no time to track the income and expenditure of the business and rarely has the opportunity to speak to his accountant. Write a paragraph explaining why keeping track of cash flow is so important to all businesses.

2. Jarrett Baker is the founder of an enterprise software company located in Chevy Chase, Maryland. By looking at the income statements for Jarrett's business over the past three years, you see that its working capital has declined from $42,400 in 2015 to $17,900 in 2016 to $3,100 in 2017. Develop a paragraph or two to describe how a continuation of this trend would jeopardize the future of Jarrett's business.

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Getting Personal with WILD FRIENDS FOODS

Wild Friends Food/Photo Credit: Keeley Jillotson

Cofounders

KEELEY TILLOTSON

BA, Advertising, Art and Communications, University of Oregon, undecided

ERIKA WELSH

BA, Environmental Studies and Spanish, University of Oregon, undecided

Dialogue with Keeley Tillotson

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
Your job changes all the time! Your title may stay the same but the company is always asking new things of you

BEST ADVICE I'VE RECEIVED
Hire slow, fire fast. Appreciate the people who sign up to work for you.

MY FAVORITE SMARTPHONE APP
Overcast.fm—I'm addicted to podcasts

MY BIGGEST WORRY AS AN ENTREPRENEUR
Work > worry

FAVORITE BAND ON MY SMARTPHONE MUSIC LIST
Windus

WHAT I DO WHEN I'M NOT WORKING
Read, run, do yoga, cook, spend time with friends and turn off my phone!

CHAPTER 9

Building a *New-Venture* Team

MyLab Entrepreneurship

Improve Your Grade!

If your instructor is using MyLab Entrepreneurship, visit **www.pearson.com/mylab/entrepreneurship** for videos, simulations, and writing exercises.

OPENING PROFILE

WILD FRIENDS FOODS

Hitting the Ground Running

• *Web: https://wildfriendsfoods.com* • *Facebook: Wild Friends Foods* • *@2wildfriends*

It all started one rainy Saturday in 2011. Erika Welsh and Keeley Tillotson ran out of peanut butter. They were both vegetarians, and peanut butter was a big part of their diets. They enjoyed cooking, so instead of braving the rain, they decided to make some peanut butter on their own. Welsh had received a Cuisinart food processor for Christmas, so they started with a bag of raw peanuts and added fun ingredients. They liked what they made and started sharing it with friends. Their friends became instant fans and encouraged Welsh and Tillotson to start selling their peanut butter at farmers' markets and street fairs in Eugene, where they were students at the University of Oregon. Welsh and Tillotson were intrigued and the business was born.

The two made a website the first day and named their product Wild Squirrel Nut Butter. The center of the website featured a picture of themselves with the caption "One day, two University of Oregon students had an idea . . . " After making arrangements with a commercial kitchen to make their product, they took their friends' advice and started selling their nut butter around Eugene and online. They caught a big break in April of 2011 when a popular food blogger, Kath Unger, wrote a short piece about their nut butter. The piece led to hundreds of online orders. They got an even bigger break a month later when they were featured in *Oprah Magazine*. They also made their way into local stores, primarily through good old fashioned persistence. They secured a meeting with the CEO of New Seasons Markets in Portland, who told them she would carry their product as soon as it was ready. It was ready and on the shelves in fall 2011. Other grocery stores and retail outlets soon followed.

By this time, Welsh and Tillotson had raised $50,000 from friends and family. Tillotson's dad, Bruce Tillotson, had also joined the business. He had food industry experience, with companies like Coca Cola, and took the lead on sales. Based on his urging, the two young cofounders went on Shark Tank. They struck a deal with Barbara Corcoran, which fell through after the show aired. They had no regrets, recognizing that their Shark Tank experience generated tremendous PR for their company and brand.

During this time, Welsh and Tillotson remained partners in the business. Welsh became the Chief Marketing Officer (CMO) and Tillotson became the CEO. They were fortunate in that they had different, yet complementary, skills. Welsh's role was outward focused. She handled marketing, product development, R&D, social media, and brand

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain the concept called *liability of newness*.
2. Describe a new-venture team and discuss the primary elements that form such a team.
3. Identify professional advisers and explain their role with a new-venture team.
4. Explain why a new-venture team might use consultants to obtain advice.

management. Tillotson's role was more back office—bookkeeping, financial management, hiring, and long term strategy. They were also fortunate in that they're both low drama types of people. When confronting a challenge, they work together and figure things out. One thing that's worked well for Welsh and Tillotson is having a weekly breakfast meeting to talk through challenges and opportunities. Tillotson said they share whatever is on their minds—the good and the bad.

The company remained small with just Welsh, Tillotson and Tillotson's dad, until 2015. They then started building a team. They were careful in hiring, wanting to protect the positive culture they had built. They learned to trust their instincts in hiring and found that given the choice, they would rather have someone with the right personality than a person with the right résumé. In regard to experience, they found that when hiring sales people it was important to hire people who had "done it before." For their other hires, food industry experience wasn't a must. Tillotson says that it's been fun working with her dad. Having him on board full time has been gratifying, because he is as fully invested in the success of the business as they are. She also said that because her Dad is fully committed she doesn't have to worry about him being recruited away. Tillotson's dad is the Chief of Sales which is a key role in the company.

Welsh and Tillotson have also been successful attracting mentors and advisors. They don't have a formal advisory board, but have connected with a number of people who have been helpful. They've found that e-mail works best when reaching out to potential mentors, and have learned that they are more likely to get a positive response if they ask specific questions rather than request general advice. They have also found that having a "humble attitude" is the best recipe for gaining access to high quality feedback.

When asked what has surprised them the most about starting and growing a business, Tillotson says that she and her partner did not realize, early on, how much the business would change as it grew. Several noticeable changes have taken place. The name of the business changed from Wild Squirrel Nut Butter to Wild Friends Foods to provide more room for growth. The product line has evolved and grown. Wild Friends Foods now sells an entire family of peanut butters and nut butters in both 10-ounce and 16-ounce jars, as well as 1.15-ounce single serve packets. Their products fit into the "better for you" category. All of their products use high-quality ingredients and are certified Non-GMO. Examples of the products they sell include Chocolate Coconut Peanut Butter, Chocolate Almond Butter, and Honey Sunflower Butter. The Sunflower Butter works well for people with allergies.

Wild Friends Foods continues to grow. The company's products are sold online and are in more than 2,000 stores nationwide, including Whole Foods, Sprouts, Target, and Publix. While happy with their success, Welsh and Tillotson feel there is a lot of room to grow. Welsh and Tillotson have also received some personal awards. In 2017, they were named to the *Forbes* 30 under 30 in the "Dorm Room Founders" category.

In this chapter, we focus on how the founders of an entrepreneurial venture build a new-venture team as well as the importance of the team to the firm's overall success. A **new-venture team** is the group of founders, key employees, and advisers that move a new venture from an idea to a fully functioning firm.[1] Usually, the team doesn't come together all at once. Instead, it is built as the new firm can afford to hire additional personnel. The team also involves more than paid employees. Many firms have a board of directors, a board of advisors, investors, and other professionals on whom they rely for direction and advice.

In this chapter's first section, we discuss the role of an entrepreneurial venture's founder or founders and emphasize the substantial effect that founders have on their firm's future. We then turn our attention to a discussion about how the founders build a new-venture team, including the recruitment and selection of key employees and the forming of a board of directors. The chapter's second section examines the important role of advisors, lenders and investors, and other professionals in shaping and rounding out a new-venture team.

Liability of Newness as a Challenge

LEARNING OBJECTIVE

1. Explain the concept called *liability of newness*.

As we note throughout this textbook, new ventures have a high propensity to fail. The high failure rate is due in part to what is known as the **liability of newness**, which refers to the fact that companies often falter because the people who start them aren't able to adjust quickly enough to their new roles and because the firm lacks a "track record" with outside buyers and suppliers.[2] Assembling a talented and experienced new-venture team is one path firms can take to overcome these limitations. Indeed, experienced management teams that get up to speed quickly are much less likely to make a novice's mistakes. In addition, firms able to persuade high-quality individuals to join them as directors or advisers quickly gain legitimacy with a variety of people, such as some of those working inside the venture as well as some outside the venture (e.g., suppliers, customers, and investors). In turn, legitimacy opens doors that otherwise would be closed.

Another way entrepreneurs overcome the liability of newness is by attending entrepreneurship-focused workshops and events, such as business plan competitions, Startup Weekends, hackathons, boot camps, and so on. These types of activities are sponsored by local universities, small business development centers, and economic development commissions. Another route to overcoming the liabilities of newness is joining one of the growing number of start-up accelerators that are popping up across the country. Start-up accelerators provide entrepreneurs access to mentors, investors, subject matter experts (such as attorneys and accountants), and other entrepreneurs, as discussed in the "Savvy Entrepreneurial Firm" feature in Chapter 1.

Creating a New-Venture Team

LEARNING OBJECTIVE

2. Describe a new-venture team and discuss the primary elements that form such a team.

Those who launch or establish an entrepreneurial venture have an important role to play in shaping the firm's business model. Stated even more directly, it is widely known that a well-conceived business plan, one that flows from the firm's previously established business model, cannot get off the ground unless a firm has the leaders and personnel to carry it out. As some experts put it, "People are the one factor in production . . . that animates all the others."[3] Often, several start-ups develop what is essentially the same idea at the same time. When this happens, the key to success is not the idea but rather the ability of the initial founder or founders to assemble a team that can execute the idea better than anyone else.[4]

The way a founder builds a new-venture team sends an important signal to potential investors, partners, and employees. Some founders like the feeling of control and are reluctant to involve themselves with partners or hire managers who are more experienced than they are. In contrast, other founders are keenly aware of their own limitations and work hard to find the most experienced people to bring on board. Similarly, some new firms never form an advisory board, whereas others persuade the most important (and influential) people they can find to provide them with counsel and advice. In general, the way to impress potential investors, partners, and employees is to put together as strong a team

FIGURE 9.1
Elements of a New-Venture Team

as possible.[5] Investors and others know that experienced personnel and access to good-quality advice contribute greatly to a new venture's success.

The elements of a new-venture team are shown in Figure 9.1. It's important to carefully think through each element. Miscues regarding whether team members are compatible, whether the team is properly balanced in terms of areas of expertise, and how the permanent members of the team will physically work together can be fatal. Conversely, careful attention in each of these areas can help a firm get off to a good start and provide it an advantage over competitors.

There is a common set of mistakes to avoid when putting together a new-venture team. These mistakes raise red flags when a potential investor, employee, or business partner evaluates a new venture. The most common mistakes are shown in Table 9.1.

In the remainder of this chapter, we examine each element shown in Figure 9.1. While reading these descriptions, remember that entrepreneurial ventures vary in how they use the elements.

The Founder or Founders of a Venture

Founders' characteristics and their early decisions significantly affect the way an entrepreneurial venture is received and the manner in which the new-venture team takes shape. The size of the founding team and the qualities of the founder or founders are the two most important issues in this matter.

Size of the Founding Team. The first decision that most founders face is whether to start a firm on their own or whether to build an initial **founding team**.

TABLE 9.1 Common Mistakes Made in Putting Together a New-Venture Team

- Placing unqualified friends or family members in management positions.
- Assuming that previous success in other industries automatically translates to your venture's industry.
- Presenting a "one person team" philosophy—meaning that one person (or a small group of people) is wearing all hats with no plans to bolster the team.
- Hiring top managers without sharing ownership in the firm.
- Not disclosing or talking dismissively of management team skill or competency gaps.
- Vague or unclear plans for filling the skill or competency gaps that clearly exist.

racorn/Shutterstock

If a new venture is started by more than one person, it is important that the founders have a good rapport and complement one another rather than duplicate one another in terms of skills and backgrounds. Here, the founders of an educational software company have worked together before and are comfortable with each other's personalities and work habits. The woman on the left is a former teacher, the woman in the middle is a software engineer, and the woman on the right is a graphic designer.

Studies show that 50 to 70 percent of all new firms are started by more than one individual.[6] However, experts disagree about whether new ventures started by a team have an advantage over those started by a sole entrepreneur. Teams bring more talent, resources, ideas, and professional contacts to a new venture than does a sole entrepreneur.[7] In addition, the psychological support that cofounders of a business can offer one another can be an important element in a new venture's success.[8]

Conversely, a lot can go wrong in a partnership—particularly one that's formed between people who do not know each other well. Team members can easily differ in terms of work habits, tolerances for risk, levels of passion for the business, ideas on how the business should be run, and similar key issues.[9] If a new-venture team isn't able to reach consensus on these issues, it may be handicapped from the outset.

When a new venture is started by a team, several issues affect the value of the team. First, teams that have worked together before, as opposed to teams that are working together for the first time, have an edge.[10] If people have worked together before and have decided to partner to start a firm together, it usually means that they get along personally and trust one another.[11] They also tend to communicate with one another more effectively than people who are new to one another.[12] Second, if the members of the team are **heterogeneous**, meaning that they are diverse in terms of their abilities and experiences, rather than **homogeneous**, meaning that their areas of expertise are very similar to one another, they are likely to have different points of view about technology, hiring decisions, competitive tactics, and other important activities. Typically, these different points of view generate debate and constructive conflict among the founders, reducing the likelihood that decisions will be made in haste or without the airing of alternative points of view.[13] A founding team can be too big, causing communication problems and an increased potential for conflict. The sweet spot is two to three founders. A founding team larger than four people is typically too large to be practical.[14]

There are three potential pitfalls associated with starting a firm as a team rather than as a sole entrepreneur. First, the team members may not get along. This is the reason investors favor teams consisting of people who have worked together before. It is simply more likely that people who have gotten along with

WHAT WENT WRONG?

Devver: How Miscues in Regard to the Composition and Management of a New-Venture Team Can Kill a Start-Up

Devver (pronounced like "developer," not "devious") launched in 2008 to help software developers use cloud-based services to "test" their code in a more expedient manner than current practices. The firm started by focusing on Ruby on Rails software applications. One of its flagship products, Caliper, provided quality metrics to Ruby on Rails developers for their Ruby on Rails code. By using Caliper, a Ruby on Rails developer could quickly discover problems such as code duplication, complex code, and code "smells." In computer programming, a code smell is any symptom in the source code of a program that possibly indicates a deeper and potentially more serious problem.

Dan Mayer and Ben Brinckerhoff are Devver's cofounders. The two met in high school and started a Web business before their high school graduations. Both studied computer programming in college, Mayer at the University of Colorado and Brinckerhoff at Washington University in St. Louis. The two reunited in 2008 to launch Devver. They are graduates of TechStars, a Boulder, CO-based mentorship-driven, seed-stage investment fund. Devver operated from early 2008 until early 2010, when it went out of business. In announcing its plans to close, the company indicated that although it had worked hard to achieve its vision—to use the cloud to build tools that would change software developers' lives—it couldn't generate sufficient revenue to sustain and grow the company.

In a thoughtful blog post, Ben Brinckerhoff reflected on the reasons for Devver's failure. While the reasons were varied, the key reasons focused on the composition of the founding team, difficulties in communications, and product development.

In regard to the founding team, both Mayer and Brinckerhoff thought of themselves as geeks. Looking back, Brinckerhoff feels it would have been to their advantage to have had another cofounder who loved the business side of running a start-up. In reflecting on this observation, Mayer challenged the oft-repeated statement that "You can teach a hacker business, but you can't teach a businessman how to hack." This statement is sometimes used by technical founders to justify not needing a businessperson on the team. While Mayer acknowledges that it is possible to teach a hacker business, you can't force a hacker to get excited about it, or give it the proper amount of attention. According to Mayer, what hackers like to do is hack. So they measure progress in lines of code written or use a similar metric. It's equally important though to have someone in a start-up measuring progress on business metrics—like number of customers talked to or how well distribution channels are being developed. Not enough of that happened at Devver.

In regard to communication, Devver embraced working remotely. The company started in Boulder, where the two cofounders worked together. Devver's first key hire worked in Pennsylvania, and Mayer later moved to Washington, D.C. The idea was that by embracing working remotely, Devver could hire the best talent available without requiring people to relocate to Colorado. In addition, they felt that by allowing team members to work remotely they would experience minimal distractions, which is important when it comes to effective code writing. Regrettably, achieving these objectives was more difficult than the founders anticipated. Communication was a challenge. It was also an administrative hassle. Mayer and Brinckerhoff found that it was a pain to manage payroll, benefits, and so forth in several states simultaneously. In addition, pair programming was difficult to do remotely—a challenge for which the Devver team never found a good solution.

Finally, Brinckerhoff believes Devver should have spent more time on customer development and finding a minimum viable product. A minimum viable product, which is a staple component of the lean startup movement, has just those features that allow a product to be deployed, and no more. It's typically deployed to early adopters for testing. The idea is to avoid building bells and whistles into products that customers don't need or want. Instead of doing this, Devver did minimal testing of its first product, the Ruby test accelerator, and then focused intently on building out the product without additional interaction with potential users. As a result, its Ruby test acceleration and additional products never really met market needs before Devver ran out of steam. In retrospect, Brinckerhoff believes Devver should have deployed individual products sooner, and solicited more customer feedback about pricing, market size, and technical challenges. Eventually, they learned that their market was too small and their price point needed to be too low to sustain the company.

Questions for Critical Thinking

1. In retrospect, Brinckerhoff believes that it would have been to Devver's advantage to have had a business-oriented cofounder as part of Devver's new-venture team. Do you think the reverse is true? If two businesspeople are set to launch a technology-oriented firm, do you think it is to their advantage to have a technology-oriented cofounder, or is it sufficient to hire technology-oriented personnel?
2. Make a list of the pluses and minuses of adopting a philosophy of allowing workers to work remotely. Is this philosophy better for some types of start-ups than others? What is your opinion of this philosophy?

3. Do some Internet research to try to determine what Dan Mayer and Ben Brinckerhoff are doing today. What do you think they will be doing say ten years from now and why?

Source: B. Brinckerhoff, "Lessons Learned," *Devver Blog*, https://devver.wordpress.com/2010/04/26/lessons-learned (posted April 26, 2010, accessed March 9, 2017).

one another in the past will continue to get along in the future. Second, if two or more people start a firm as "equals," conflicts can arise when the firm needs to establish a formal structure and designate one person as the chief executive officer (CEO). The cofounders of Wild Friends Foods, the focal firm in the chapter's "Opening Profile," avoided this potential problem by quickly establishing Erika Welsh as Chief Marketing Officer (CMO) and Keeley Tillotson as Chief Executive Officer (CEO). If an entrepreneurial start-up has investors, the investors will usually weigh in on who should be appointed CEO. In these instances, it is easy for the founder that wasn't chosen as the CEO to feel slighted. This problem is exacerbated if multiple founders are involved and they all stay with the firm. At some point, a hierarchy will have to be developed, and the founders will have to decide who reports to whom. Some of these problems can be avoided by developing a formal organizational chart from the beginning, which spells out the roles of each founder. Finally, as illustrated in the nearby "What Went Wrong?" feature, if the founders of a firm have similar areas of expertise, it can be problematic. As you will learn by reading this feature, the founders of Devver were both technically oriented, leaving the firm without a leader on the business side.

Qualities of the Founders. The second major issue pertaining to the founders of a firm is the qualities they bring to the table. In the previous several chapters, we described the importance investors and others place on the strength of the firm's founders and the initial management team. One reason the founders are so important is that in the early days of a firm, their knowledge, skills, and experiences are the most valuable resource the firm has. Because of this, new firms are judged largely on their "potential" rather than their current assets or current performance. In most cases, this results in people judging a firm's future prospects by evaluating the strength of its founders and initial management team.

Several features are thought to be significant to a founder's success. The level of a founder's education is important because it is believed that entrepreneurial abilities such as search skills, foresight, creativity, and computer skills are enhanced by obtaining a college degree. Similarly, some observers think that higher education equips a founder with important business-related skills, such as math and communications. In addition, specific forms of education, such as engineering, computer science, management information systems, physics, and biochemistry, provide the recipients of this education an advantage if they start a firm that is related to their area of expertise.[15]

Prior entrepreneurial experience, relevant industry experience, and networking are other attributes that strengthen the chances of a founder's success. Indeed, the results of research studies somewhat consistently suggest that **prior entrepreneurial experience** is one of the most consistent predictors of future entrepreneurial performance.[16] Because launching a new venture is a complex task, entrepreneurs with prior start-up experience have a distinct advantage. The impact of **relevant industry experience** on an entrepreneur's ability to successfully launch and grow a firm has also been studied.[17] Entrepreneurs with experience in the same industry as their current venture will have a more mature network of industry contacts and will have a better understanding of the subtleties of their respective industries.[18] The importance of this factor is particularly evident for entrepreneurs who start firms in technical industries such as biotechnology. The demands of biotechnology are so sufficiently intense that it would be virtually impossible for someone to start a biotech firm while at the same time learning biotechnology. The person must have an understanding of biotechnology prior to launching a firm through either relevant industry experience or an academic background.

A particularly important attribute for founders or founding teams is the presence of a mature network of social and professional contacts.[19] Founders must often "work" their social and personal networks to raise money or gain access to critical resources on behalf of their firms.[20] **Networking** is building and maintaining relationships with people whose interests are similar or whose relationship could bring advantages to a firm. The way this might play out in practice is that a founder calls a business acquaintance or friend to ask for an introduction to a potential investor, business partner, or customer. For some founders, networking is easy and is an important part of their daily routine. For others, it is a learned skill.

Table 9.2 shows the preferred attributes of a firm's founder or founders. Start-ups that have founders or a team of founders with these attributes have the best chances of early success. If an individual is starting a company and is looking for a cofounder, there are several websites dedicated to matchmaking cofounders for start-ups. Two of the best sites are CofoundersLab (www.cofounderslab.com) and Founder2Be (www.founder2be.com).

Along with specific qualities and attributes, entrepreneurs with savvy life skills also have an advantage. Some entrepreneurs who come from a nonbusiness background fear that a lack of business experience will be their Achilles' heel. There are several steps, techniques, or approaches to business that entrepreneurs can utilize to overcome a lack of business experience. These steps and approaches are highlighted in the "Savvy Entrepreneurial Firm" feature.

The Management Team and Key Employees

Once the decision to launch a new venture has been made, building a management team and hiring key employees begins. Start-ups vary in terms of how quickly they need to add personnel. In some instances, the founders work alone for a period of time while the business plan is being written and the venture begins taking shape. In other instances, employees are hired immediately.

TABLE 9.2 Preferred Attributes of the Founder or Founders of an Entrepreneurial Venture

Attribute	Explanation
Firm started by a team	New ventures that are started by a team can provide greater resources, a broader diversity of viewpoints, and a broader array of other positive attributes than ventures started by individuals.
Higher education	Evidence suggests that important entrepreneurial skills are enhanced through higher education.
Prior entrepreneurial experience	Founders with prior entrepreneurial experience are familiar with the entrepreneurial process and are more likely to avoid costly mistakes than founders new to the rigors of the entrepreneurial process.
Relevant industry experience	Founders with experience in the same industry as their new venture will most likely have better-established professional networks and more applicable marketing and management expertise than founders without relevant industry experience.
Broad social and professional network	Founders with broad social and professional networks have potential access to additional know-how, capital, and customer referrals.

SAVVY ENTREPRENEURIAL FIRM

Overcoming a Lack of Business Experience in Malaysia

Many people who start businesses do not have prior business experience. This is especially true for the recent innovations in IT that have led people to start businesses in areas that have never existed before. Some of these new business owners worry that people with experience in accounting, finance, and management will generally have an easier time starting a business than those who are tackling these challenges for the first time.

There are several methods and approaches to starting a business that people can take to compensate for their lack of business experience. However, first let's look at some of the characteristics a new business owner should have. A successful business owner should be:

1. creative
2. sure about the business
3. realistic
4. fast
5. honest
6. firm
7. friendly
8. careful
9. sincere
10. prepared to face failure

In Malaysia, there are several ways for a person to successfully launch a business even with a lack of prior experience.

Get Business Assistance and Advice

There are many places for business founders to get business assistance and advice. SME Corporation Malaysia, for example, is a government agency that provides management assistance and coaching to business owners. It is a central point of reference for information and advisory services for all small and medium enterprises (SMEs) in the country. Information is also available from SME Toolkit Malaysia, which is a project by Dun & Bradstreet (D&B) Malaysia Sdn. Bhd. and the Small and Medium Enterprise Department of the World Bank Group. There are also several organizations that provide coaching, advice, and support to specific groups of business owners and tailor their offerings to fit the groups. An example is the National Association for Women Entrepreneurs of Malaysia, an organization that promotes, develops, and enhances the efforts and activities of women entrepreneurs.

If you're looking for a support group in your area and can't find one, check the Meetup website. Meetup (www.meetup.com) is an online platform that allows individuals to organize local groups via the Internet. Once a group is formed, its members get together on a regular basis offline. You may simply follow the directions on Meetup's home page to discover if there is a small business or entrepreneurship Meetup group in your area. The following is a sample of small business Meetup groups that have taken place in Malaysia:

- Business networks
- Social media training
- Discussion and sharing on expanding your business across national borders

Participate in Online Forums and Q&A Sites

There are a growing number of online forums that provide support and advice to business owners. An example is the SMI SME Business Directory, which sponsors online forums that cover topics such as selecting a business, successful business planning, start-up funding, and financial management. The general tone of the forums tends to be supportive and upbeat, which is exactly what business owners with limited experience need. There are growing numbers of other websites that can be very helpful for entrepreneurs, especially for those who lack business experience.

Pick a Type of Business That Minimizes the Need for Prior Experience

There are also other alternatives for starting a business that minimize the need for prior experience. These alternatives allow people to pursue an opportunity in which the fundamentals of the business have already been thought out. Franchising, for example, offers an individual the opportunity to own a business using a tested and refined business system. Another alternative would be direct sales or multilevel marketing. These options require minimum experience and have been successful even for those who lack business experience entirely.

Questions for Critical Thinking

1. Identify the sources of business assistance available in your area free of charge.
2. Identify three sources of business assistance or advice not mentioned in this feature that would be particularly useful for someone who is starting a business without prior business experience.
3. How valuable do you think online forums, like the one mentioned previously, can be to someone who is trying to learn the business aspect of starting a business?
4. What additional techniques can people who do not have prior business experience utilize to compensate for their lack of experience?

Sources: Smibusinessdirectory, SME Corporation Malaysia, www.smibusinessdirectory.com.my (accessed March 21, 2018); International Finance Corporation, SME Toolkit, malaysia.smetoolkit.org (accessed March 21, 2018); NAWEM, nawem.org.my (accessed March 21, 2018); Meetup, "We Are What We Do," www.meetup.com (accessed March 21, 2018); Smibusinessdirectory, SMI Business, www.smibusinessdirectory.com.my (accessed March 21, 2018).

Many organizations hire interns, who are individuals who work for the business as an apprentice or trainee for the purpose of obtaining practical experience. The interns pictured here work for a firm that develops customer relationship management (CRM) software products.

goodluz/Shutterstock

One technique available to entrepreneurs to help prioritize their hiring needs is to maintain a skills profile. A **skills profile** is a chart that depicts the most important skills that are needed and where skills gaps exist. A skills profile for New Venture Fitness Drinks, the fictitious company introduced in Chapter 3, is shown in Figure 9.2. Along with depicting where a firm's most important skills gaps exist, a skills profile should explain how current skills gaps are being dealt with. For example, two of New Venture Fitness Drink's skills gaps are being covered (on a short-term basis) by members of the board of advisors and the third skills gap does not need to be filled until the firm initiates a franchising program, which is still three to five years in the future.

Evidence suggests that finding good employees (and certainly good key employees) today is not an easy task. According to a 2016 survey reported by the Society of Human Resource Management (SHRM), more than two-thirds of the 3,300 organizations included in the survey indicated that they are having a difficult time recruiting for job openings. This number is up from 2013, when half of the responding organizations reported having recruiting challenges. Interestingly, many of the respondents to the survey reported a lack of technical skills as a key reason behind the challenges they are having finding candidates for open jobs. The respondents also said that the most common types of new skills required for the full-time jobs they needed to fill in the last year were actually workplace or soft skills such as interpersonal skills, teamwork, and leadership.[21]

To save money, increase flexibility, and mitigate the difficulty in finding good employees, new ventures use four different sources of labor to get their work done. These are shown in Table 9.3. The first is employees. An **employee** is someone who works for a business, at the business' location or virtually, utilizing the business' tools and equipment and according to the business' policies and procedures.[22] These rules can vary somewhat, particularly as it pertains to working at the business' location. Most businesses bring on employees fairly slowly because of the costs involved. While employees are valuable, they are expensive. An employee who makes $50,000 a year costs a business more than $50,000 a year. Along with an employee's base salary, the employer pays a portion of the employee's Social Security (FICA) and Medicare taxes, provides workers' compensation insurance, pays into an unemployment fund, and provides

	Executive Leadership	Store Operations	Supply Chain Management	Marketing and Sales	HR/Recruiting	Accounting and Finance	Community Relations	Information Systems	Franchise Operations
Jack Petty	X								
Peggy Wells		X				X			
Jill Petersen				X					
Cameron Ivey			X						
Gap 1					O				
Gap 2							O		
Gap 3									O

X = position filled
O = position vacant

FIGURE 9.2
Skills Profile for New Venture Fitness Drinks

benefits (such as health insurance and paid vacation) if benefits are part of the job. A general rule of thumb for an employer that offers benefits is that the benefits and taxes cost 33 percent of the base pay. As a result, a $50,000 per year employee would cost the business $66,500 per year.

The second resource that businesses utilize to get their work done is interns. An **intern** is a person who works for a business as an apprentice or trainee for the purpose of obtaining practical experience. For example, TOMS (the focal firm in Case 4.2), used many interns in getting its business up and running and still relies heavily on interns today. Many tech companies, in particular, have formal internship programs. Facebook runs two separate internship programs, one for

TABLE 9.3 Sources of Labor That New Ventures Utilize to Get Their Work Done

Type of Labor	Description
Full- or part-time employee	Someone who works for a business, at the business' location, utilizing the business' tools and equipment and according to the business' policies and procedures.
Intern	A person who works for a business as an apprentice or trainee for the purpose of obtaining practical experience.
Freelancer (or contractor)	A person who is in business for themselves, works on their own time with their own tools and equipment, and performs services for a number of different clients.
Virtual assistant	A freelancer who provides administrative, technical, or creative assistance to clients remotely from a home office.

Engineering, Tech, & Design and the other for Business. These programs are described at https://www.facebook.com/careers/university. Google sponsors a variety of internship programs, which are detailed at https://careers.google.com/students/. Many firms run internship programs not only to utilize the help, but as a recruiting tool. It provides them a chance to "look" at a potential hire before making a formal commitment to that person. Many companies also enjoy having interns around because of their vigor, enthusiasm, and tech-savvy skills. For example, a start-up founded by two 50-year-old individuals may learn a lot from college-aged interns about how to use social media platforms such as Facebook and Twitter more effectively in their business.

The third resource that firms utilize to get their work done is freelancers (also called contractors). A **freelancer** is a person who is in business for themselves, works on their own time with their own tools and equipment, and performs services for a number of different clients.[23] For example, a business may hire a freelancer to manage the search engine optimization (SEO) for its website, and pay the freelancer an hourly or monthly fee. Businesses typically find freelancers via word of mouth or through websites such as Guru or Upwork. Guru and Upwork, as explained in the "Partnering for Success" feature in Chapter 4, specialize in matching freelancers with businesses that are looking for specific types of help.

The fourth resource that businesses draw upon to complete their work is virtual assistants. A **virtual assistant** is a freelancer who provides administrative, technical, or creative assistance to clients remotely from a home office. Businesses use virtual assistants for everything from making customer service calls, to data entry in accounting or bookkeeping platforms, to sending out thank you notes to clients. Similar to freelancers, virtual assistants can be located on online platforms like Odesk and Elance. As of March 2017, both Guru and Upwork had large numbers of virtual assistants listed who were looking for additional work.

An advantage businesses have in using freelancers and virtual assistants is that they are considered to be "independent contractors." As a result, a business is not responsible for costs (such as Social Security and Medicare taxes, workers' compensation insurance, paying into an unemployment fund, and benefits) beyond their hourly or contracted pay. Businesses have to be careful, however, to not incorrectly categorize an employee as an independent contractor to save money on taxes and benefits. The IRS looks closely at the distinction and can levy severe penalties if workers are misclassified.

Many founders worry about hiring the wrong person for a key role, regardless of whether the person is an employee, an intern, a freelancer, or a virtual assistant. Because most new firms are strapped for cash, everyone who is hired must make a valuable contribution. It's not good enough to hire someone who is well intended but who doesn't precisely fit the job. On some occasions, key hires work out perfectly and fill the exact roles that a firm's founders need. For example, Dave Olsen was one of the first employees hired by Starbucks founder Howard Schultz. At the time of his hiring, Olsen was the owner of a popular coffeehouse in the university district of Seattle, the city where Starbucks was launched. In his autobiography, Schultz recalls the following about the hiring of Olsen:

> On the day of our meeting, Dave and I sat on my office floor and I started spreading the plans and blueprints out and talking about my idea. Dave got it right away. He had spent ten years in an apron, behind a counter, serving espresso drinks. He had experienced firsthand the excitement people can develop about espresso, both in his café and in Italy. I didn't have to convince him that this idea had big potential. He just knew it in his bones. The synergy was too good to be true. My strength was looking outward: communicating the vision, inspiring investors, raising money, finding real estate, designing the stores, building the brand, and planning for the future. Dave understood the inner workings: the nuts and bolts of operating a retail café, hiring and training baristas (coffee brewers), ensuring the best quality coffee.[24]

PARTNERING FOR SUCCESS

Collaborative Software: Helping New Venture Team Members Achieve Their Goals

What Is Collaborative Software?

Collaborative software is a computer program designed to help people involved in a common task achieve their goals. Think of a basketball team. Although each of the five members of a team are individuals, they must coordinate their efforts to achieve the best results. Similar situations occur in business organizations. A group of software engineers may be working on the same project. Collaborative software helps them coordinate their effort to achieve the best possible outcome.

Tools That Are Normally Included

The way collaborative software programs work is that they offer a common shared environment for people who are working together toward a common goal. The environment includes a set of tools that facilitate the accomplishment of group work. Examples of the types of tools that facilitate and manage group activity include:

- *Project management*—schedule, track, and chart the steps in a project as it is being completed.
- *Workflow systems*—manage the bureaucratic portion of a project, like moving a purchase order through the various levels of approval.
- *Chat or messaging*—lets participants exchange instant messages across the network to which the collaborative system is connected. Particularly important for group members who are geographically separated.
- *Document repository*—acts as a central repository for files, which facilitates the access, use, and manipulation of documents by multiple users. Most collaborative systems provide a routine for document editing. Once a user takes control of a document, it is unavailable for others to edit, until the user releases it for approval or editing by others.
- *Gantt charts*—charts in which a series of horizontal lines shows the amount of work done or production completed in certain periods of time in relation to the amount planned for those periods.
- *Audio and video conferencing*—provides for real time conferencing for team members.
- *Discussion forums*—allows group members to contribute to discussions on specific topics.
- *Electronic calendars*—schedule meetings and events and automatically notify and remind group members.
- *Budget management*—compares the budget to actual expenditures in real time.
- *Client portals*—allow a group to interact with clients in a private online environment.

Most collaborative software systems are judged by their usefulness and ease of use. The ultimate test of a system is whether it allows its members to effectively coordinate their work. Back to the basketball example—the members of a basketball team have to execute the right play at the right time, without running into each other, as well as adjust their play as the game unfolds. That's exactly what the members of a group at work must do. Collaborative software is meant to facilitate the process.

Examples of Collaborative Software Programs

There are a number of good collaborative software programs available. The following are examples of three collaborative management software programs, including a brief description of each one.

Basecamp. Basecamp, the focal firm discussed in Case 9.1, is a web-based program that makes it simple to communicate and collaborate on projects. It is used by millions of people and 98 percent of its customers recommend it, primarily for its simplicity. It costs $29.00 per user per month. Its tools include brainstorming, chat/messaging, cooperative writing, discussion boards, document management, group calendars, project management, and task management. Basecamp is available at https://basecamp.com.

Smartsheet. Smartsheet is an online project management and task collaboration tool. It features an easy to use spreadsheet-line interface and costs $10 per month per user. It was named the 2015 Google Marketplace App of the Year and the 2015 Microsoft 0365 App of the Year. Its tools, which are extensive, include budget management, bug tracking, collaboration, file sharing, Gantt charts, idea management, issue management, milestone tracking, percent-complete tracking, portfolio management, project planning, resource management, status tracking, task management, and time and expense tracking. Smartsheet is available at www.smartsheet.com.

Buildertrend. Buildertrend is an example of a collaborative software program designed for a specific industry—the home building and remodeling industry. It costs $99.99 a month for an unlimited number of users within the same company. It is a cloud-based program—users log in from PCs, laptops, iPads, and iPhones. Its primary suite of tools, tailored for home building or remodeling, include online scheduling, change orders, document management, photos, customer selections, warranty, purchase orders, lead management, and more. Its more traditional tools include budget management, collaboration, file sharing, Gantt charts, milestone tracking, percent-complete tracking, project planning, status tracking, and time and expense tracking.

Questions for Critical Thinking

1. How large do you think a start-up needs to be to effectively take advantage of collaborative management programs? Along with full- and part-time employees, should companies include interns, freelancers, and virtual assistants on projects that use collaborative management programs? Why or why not?
2. If you set out to select a collaborative management program for a business you were building, how would you go about selecting the program that would work the best for your business?
3. Imagine you've started a home remodeling business. Discuss the advantages to using a collaborative management program such as Buildertrend from the outset for your business.
4. The "Opening Profile" focused on Wild Friends Foods, a start-up that is making products based on nut and seed butter. Discuss how Wild Friends Foods could benefit from using a collaborative software program like Smartsheet.

Sources: Wikipedia, Collaborative Software, www.wikipedia.com (accessed March 10, 2017); Top Project Management Tools, Capterra, available at https://www.capterra.com/project-management-software/ (accessed March 10, 2017).

The fear that an employee will not work out as well as Dave Olsen did for Starbucks is one of the attractions of hiring interns, freelancers, and virtual assistants. These individuals work on strictly an "as needed" basis, or on fairly short-term contracts, and a business can simply move on if the person doesn't work out. In contrast, separating from a full-time or even a part-time employee can be much more difficult.

In entrepreneurial firms, it is particularly important that all members of a new venture team work effectively together. An increasing number of new venture teams are using collaborative software as a tool for coordinating their efforts. The nearby "Partnering for Success" feature focuses on collaborative software and provides examples of leading collaborative software programs.

The Roles of the Board of Directors

If a new venture organizes as a corporation, it is legally required to have a **board of directors**—a panel of individuals who are elected by a corporation's shareholders to oversee the management of the firm.[25] A board is typically made up of both inside and outside directors. An **inside director** is a person who is also an officer of the firm. An **outside director** is someone who is not employed by the firm. A board of directors has three formal responsibilities: (1) appoint the firm's officers (the key managers), (2) declare dividends, and (3) oversee the affairs of the corporation. In the wake of corporate scandals such as Enron, WorldCom, and others, there is a strong emphasis on the board's role in making sure the firm is operating ethically. One outcome of this movement is a trend toward putting more outsiders on boards of directors, because people who do not work for the firm are usually more willing to scrutinize the behavior of management than insiders who work for the company. Most boards meet formally three or four times a year. Large firms pay their directors for their service. New ventures are more likely to pay their directors in company stock or ask them to serve without direct compensation—at least until the company is profitable. The boards for publicly traded companies are required by law to have audit and compensation committees. Many boards also have nominating committees to select stockholders to run for vacant board positions. A list of the most desirable qualities in a board of directors and the most desirable qualities in individual board members is provided in Table 9.4.

If handled properly, a company's board of directors can be an important part of the new-venture team.[26] Providing expert guidance and legitimacy in the eyes of others (e.g., customers, investors, and even competitors) are two ways a board of directors can help a new firm get off to a good start and develop what, it is hoped, will become a sustainable competitive advantage.

TABLE 9.4 Attributes of Effective Boards of Directors and Effective Board Members

Attributes of Effective Boards of Directors
- Strong communication with the CEO
- Customer-focused point of view
- Complementary mix of talents
- Decisiveness
- Mutual respect and regard for each other and the firm's management team
- Ability and willingness to stand up to the CEO and the firm's top managers
- Strong ethics

Attributes of Strong Board Members
- Strong personal and professional networks
- Respected in their field
- Willingness to make personal introductions on behalf of the firm
- Strong interpersonal communication skills
- Pattern recognition skills
- Investment and/or operating experience
- Ability and willingness to mentor the CEO and the firm's top managers

Provide Expert Guidance. Although a board of directors has formal governance responsibilities, its most useful role is to provide guidance and support to the firm's managers.[27] Many CEOs interact with their board members frequently and obtain important input. The key to making this happen is to pick board members with needed skills and useful experiences who are willing to give advice and ask insightful and probing questions. The extent to which an effective board can help shape a firm and provide it a competitive advantage in the marketplace is expressed by Ram Charan, an expert on the role of boards of directors in corporations:

> They (effective boards) listen, probe, debate, and become engaged in the company's most pressing issues. Directors share their expertise and wisdom as a matter of course. As they do, management and the board learn together, a collective wisdom emerges, and managerial judgment improves. The on-site coaching and consulting expand the mental capacity of the CEO and the top management team and give the company a competitive edge out there in the marketplace.[28]

Because managers rely on board members for counsel and advice, the search for outside directors should be purposeful, with the objective of filling gaps in the experience and background of the venture's executives and the other directors. For example, if two computer programmers started a software firm and neither one of them had any marketing experience, it would make sense to place a marketing executive on the board of directors. Indeed, a board of directors has the foundation to effectively serve its organization when its members represent many important organizational skills (e.g., manufacturing, human resource management, and financing) involved with running a company.

Lend Legitimacy. Providing legitimacy for the entrepreneurial venture is another important function of a board of directors. Well-known and respected board members bring instant credibility to the firm. For example, just imagine the positive buzz a firm could generate if it could say that Blake Mycoskie of TOMS or Drew Houston of Dropbox had agreed to serve on its board of directors. This phenomenon is referred to as **signaling**. Without a credible signal, it is difficult for potential customers, investors, or employees to identify high-quality start-ups. Presumably, high-quality individuals would be reluctant to serve on the board of a low-quality firm because that would put their reputation at risk. So when a high-quality individual does agree to serve on a firm's board, the individual is in essence "signaling" that the company has potential to be successful.[29]

Achieving legitimacy through high-quality board members can result in other positive outcomes. Investors like to see new-venture teams, including the board of directors, that have people with enough clout to get their foot in the door with potential suppliers and customers. Board members are also often instrumental in helping young firms arrange financing or funding. As we will discuss in Chapter 10, it is almost impossible for an entrepreneurial venture's founders to get an investor's attention without a personal introduction. One way firms deal with this challenge is by placing individuals on their boards who are acquainted with people in the investment community.

Potbelly, which is a restaurant chain that specializes in low-cost sandwiches, cookies, and shakes, is an example of a company with a well-designed board of directors. Its eight-member board consists of one inside director and seven outsiders. The board members are listed below. Note that the outside members include individuals with backgrounds in restaurant chain development, retailing, hospitality management, e-commerce, and consumer products. Potbelly, which launched an IPO in 2013 and has aggressive growth plans, will benefit from guidance in each of the areas the different board members represent.[30]

1.	Aylwin Lewis	CEO and President of Potbelly
2.	Peter Bassi	Retired Chairman of Yum! Restaurants International
3.	Ann-Marie Campbell	President, Southern Division of The Home Depot
4.	Susan Chapman-Hughes	Senior Vice President of American Express
5.	Dan Ginsberg	Special Advisor to the Founders of Dermalogica, a U.S.-based skincare brand
6.	Maria Gottschalk	CEO of Pampered Chef
7.	Harvey Kanter	CEO of Blue Nile, an online retailer of diamonds and fine jewelry
8.	Carl Warschausky	CEO of World Kitchen, a global housewares and consumer products manufacturer

Rounding Out the Team: The Role of Professional Advisors

LEARNING OBJECTIVE

3. Identify professional advisers and explain their role with a new-venture team.

Along with the new-venture team members we've already identified, founders often rely on professionals with whom they interact for important counsel and advice. In many cases, these professionals become an important part of the new-venture team and fill what some entrepreneurs call "talent holes."

Next, we discuss the roles that boards of advisors, lenders, investors, and other professionals play in rounding out new-venture teams.

Board of Advisors

Some start-up firms are forming advisory boards to provide them direction and advice.[31] An **advisory board** is a panel of experts who are asked by a firm's managers to provide counsel and advice on an ongoing basis. Unlike a board of directors, an advisory board possesses no legal responsibility for the firm and gives nonbinding advice.[32] As a result, more people are willing to serve on a company's board of advisors than on its board of directors because it requires less time and no legal liability is involved. A board of advisors can be established for general purposes or can be set up to address a specific issue or need. For example,

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This pair of young entrepreneurs is taking some advice from a member of their Board of Advisors. A board of advisors is a panel of experts who are asked by a firm's founders and managers to provide counsel and advice on an on-going basis.

some start-ups set up customer advisory boards shortly after they are founded to help them fine-tune their initial offerings. Similar to a board of directors, the main purpose of a board of advisors is to provide guidance and lend legitimacy to a firm. The most important thing that advisory board members can do is make high-level introductions to early customers, suppliers, and business partners.[33]

Most boards of advisers have between 5 and 15 members. Entrepreneurial firms typically pay the members of their board of advisors a small honorarium for their service either annually or on a per-meeting basis. Boards of advisors interact with each other and with a firm's managers in several ways. Some advisory boards meet three or four times a year at the company's headquarters or in another location. Other advisory boards meet in an online environment. In some cases, a firm's board of advisors will be scattered across the country, making it more cost-effective for a firm's managers to interact with the members of the board on the telephone, via e-mail, or through a Skype conference call, rather than to bring them physically together. In these situations, board members don't interact with each other at all on a face-to-face basis, yet still provide high levels of counsel and advice.

The fact that a start-up has a board of directors does not preclude it from having one or more boards of advisors. For example, Coolibar, a maker of sun protective clothing, has a board of directors and a medical advisory board. According to Coolibar, its medical advisory board "provides advice to the company regarding UV radiation, sunburn, and the science of detecting, preventing, and treating skin cancer and other UV-related medical disorders, such as lupus."[34] The board currently consists of nine medical doctors, all with impressive credentials. Similarly, InTouch Health, a medical robotics and instruments company, has a board of directors along with an advisory board that has three distinct areas of expertise: Business & Strategy, Applications & Clinical, and Scientific & Technical. In introducing its advisory boards on its website, InTouch Health says, "InTouch Health has the benefit of a talented and accomplished advisory board that contributes their experience and talents in business and strategy, applications and clinical, and scientific and technical areas to assist us to further advance our mission and values."[35]

Several guidelines are followed when organizing a board of advisors. First, a board of advisors should not be organized just so a company can boast of it. Advisers will become quickly disillusioned if they don't play a meaningful role in the firm's development and growth. Second, a firm should look for board members who are compatible and complement one another in terms of experience and expertise. Unless the board is being established for a specific purpose, a board that includes members with varying backgrounds is preferable to a board of people with similar backgrounds. Third, when inviting a person to serve on its board of advisors, a company should carefully spell out to the individual the rules in terms of access to confidential information.[36] Some firms ask the members of their advisory board to sign nondisclosure agreements, which we described in Chapter 7. Finally, firms should caution their advisers to disclose that they have a relationship with the venture before posting positive comments about it or its products on blogs or on social networking sites. A potential conflict of interest surfaces when a person says positive things about a company without disclosing an affiliation with the firm, particularly if there is a financial stake in the company.

Although having a board of advisors is widely recommended in start-up circles, most start-ups do not have one. As a result, one way a start-up can make itself stand out is to have one or more boards of advisors.

Lenders and Investors

As emphasized throughout this book, lenders and investors have a vested interest in the companies they finance, often causing these individuals to become very involved in helping the firms they fund. It is rare that a lender or investor will put money into a new venture and then simply step back and wait to see what happens. In fact, the institutional rules governing banks and investment firms typically require that they monitor new ventures fairly closely, at least during the initial years of a loan or an investment.[37]

The amount of time and energy a lender or investor dedicates to a new firm depends on the amount of money involved and how much help the new firm needs. For example, a lender with a well-secured loan may spend very little time with a client, whereas a venture capitalist may spend an enormous amount of time helping a new venture refine its business model, recruit management personnel, and meet with current and prospective customers and suppliers. In fact, evidence suggests that an average venture capitalist is likely to visit each company in a portfolio multiple times a year.[38] This number of visits denotes a high level of involvement and support.

As with the other nonemployee members of a firm's new-venture team, lenders and investors help new firms by providing guidance and lending legitimacy and assuming the natural role of providing financial oversight. In some instances, lenders and investors also work hard to help new firms fill out their management teams. Sometimes this issue is so important that a new venture will try to obtain investment capital not only to get access to money, but also to obtain help hiring key employees.

For example, during its beginning stages, eBay's founders, Pierre Omidyar and Jeff Skoll, decided to recruit a CEO. They wanted someone who was not only experienced, but who also had the types of credentials that Wall Street investors value. They soon discovered that every experienced manager they tried to recruit asked if they had venture capital backing—which at that time they did not. For a new firm trying to recruit a seasoned executive, venture capital backing is a seal of legitimacy. To get this valuable seal, Omidyar and Skoll obtained funding from Benchmark Venture Capital, even though eBay didn't really need the money. Writer Randall Stross recalls this event as follows:

> eBay was an anomaly: a profitable company that was able to self-fund its growth and that turned to venture capital solely for contacts and counsel. No larger lesson can be drawn. When Benchmark wired the first millions to eBay's bank account, the figurative check was tossed into the vault—and there it would sit, unneeded and undisturbed.[39]

This strategy worked for eBay. Soon after affiliating with Benchmark, Bob Kagle, one of Benchmark's general partners, led eBay to Meg Whitman, an executive who had experience working for several top firms, including Procter & Gamble, Disney, and Hasbro. In March 2008, Whitman stepped down as eBay's president and CEO. Her tenure at eBay was considered to be very successful during a critical period in the firm's early development and growth.

Bankers also play a role in establishing the legitimacy of new ventures and their initial management teams. Research evidence rather consistently suggests that the presence of bank loans is a favorable signal to other capital providers.[40] Investors often take a seat on the boards of directors of the firms they fund to provide oversight and advice. It is less common for a banker to take a seat on the board of directors of an entrepreneurial venture, primarily because bankers provide operating capital rather than large amounts of investment capital to new firms.

There are additional ways that lenders and investors add value to a new firm beyond financing and funding. These roles are highlighted in Table 9.5.

Other Professionals

LEARNING OBJECTIVE

4. Explain why a new-venture team might use consultants to obtain advice.

At times, other professionals assume important roles in a new venture's success. Attorneys, accountants, and business consultants are often good sources of counsel and advice. The role of lawyers in helping firms get off to a good start is discussed in Chapter 7, and the role of accountants is discussed in Chapter 8. Here, we examine the role a consultant may play.

Consultants

A **consultant** is an individual who gives professional or expert advice. New ventures vary in terms of how much they rely on business consultants for direction. In some ways, the role of the general business consultant has diminished in importance as businesses seek specialists to obtain advice on complex issues such as patents, tax planning, and security laws. In other ways, the role of general business consultant is as important as ever; it is the general business consultant who can conduct in-depth analyses on behalf of a firm, such as preparing a feasibility study or an industry analysis. Because of the time it would take, it would be inappropriate to ask a member of a board of directors or board of advisors to take on one of these tasks on behalf of a firm. These more time-intensive tasks must be performed by the firm itself or by a paid consultant.

Those leading an entrepreneurial venture often turn to consultants for help and advice because while large firms can afford to employ experts in many

TABLE 9.5 Beyond Financing and Funding: Ways Lenders and Investors Add Value to an Entrepreneurial Venture

- Help identify and recruit key management personnel
- Provide insight into the industry and markets in which the venture intends to participate
- Help the venture fine-tune its business model
- Serve as a sounding board for new ideas
- Provide introductions to additional sources of capital
- Recruit customers
- Help to arrange business partnerships
- Serve on the venture's board of directors or board of advisors
- Provide a sense of calm in the midst of the emotional roller-coaster ride that many new-venture teams experience

areas, new firms typically can't. If a new firm needs help in a specialized area, such as building a product prototype, it may need to hire an engineering consulting firm to do the work. Consultants' fees are typically negotiable. If a new venture has good potential and offers a consulting firm the possibility of repeat business, the firm will often be willing to reduce its fee or work out favorable payment arrangements.

Consultants fall into two categories: paid consultants and consultants who are made available for free or at a reduced rate through a nonprofit or government agency. The first category includes large international consulting firms, such as Deloitte Management Consulting, BearingPoint USA, Accenture, and IBM Business Global Services. These firms provide a wide array of services but are beyond the reach of most start-ups because of budget limitations. But there are many smaller, localized firms. The best way to find them is to ask around for a referral.

Consultants are also available through nonprofit or government agencies. SCORE, for example, is a nonprofit organization that provides free consulting services to small businesses. SCORE currently has 11,000+ volunteers, 320 local chapters, and provides assistance across 62 industries via confidential business mentoring in person or via e-mail, free business tools, templates, and tips via its website at www.score.org, and inexpensive or free business workshops (locally) and webinars (online 24/7). An increasing number of SCORE volunteers, called mentors, assist clients via e-mail rather than face-to-face. Commonly, SCORE mentors are retired business owners who counsel in areas as diverse as cash flow management, operations, and sales.[41] Similarly, the Small Business Administration, a government agency, provides a variety of consulting services to small businesses and entrepreneurs, primarily through its network of Small Business Development Centers (SBDC), which are spread throughout the United States. SBDC advisers provide prospective and current small business owners a variety of free business consulting and low-cost training services including business plan development, manufacturing assistance, financial packaging and lending assistance, exporting and importing support, disaster recovery assistance, healthcare guidance, and similar types of assistance.[42]

In summary, putting together a new-venture team is one of the most critical activities a founder or founders of a firm undertake. Many entrepreneurs suffer by not thinking broadly enough or carefully enough about this process. Ultimately, people must make any new venture work. New ventures benefit by surrounding themselves with high-quality employees and advisers to tackle the challenges involved with launching and growing an entrepreneurial firm.

Chapter Summary

LO1. The liability of newness refers to the fact that entrepreneurial ventures often falter or even fail because the people who start them can't adjust quickly enough to their new roles and because the firm lacks a "track record" with customers and suppliers. These limitations can be overcome by assembling a talented and experienced new-venture team.

LO2. A new-venture team is the group of people who move a new venture from an idea to a fully functioning firm. Company founders, key employees, the board of directors, the board of advisors, lenders and investors, and other professionals are the primary elements involved with forming a new-venture team. A heterogeneous founding team has members with diverse abilities and experiences. A homogeneous founding team has members who are very similar to one another. The personal attributes that affect a founder's chances of launching a successful new firm include level of education, prior entrepreneurial experience, relevant industry experience, and the ability to network. Networking is building and maintaining relationships with people who are similar or whose friendship could bring advantages to the firm.

A skills profile is a chart that depicts the most important skills that are needed in a new venture and where skills' gaps exist. Finding good employees and effective new-venture team members is challenging. Founders may draw from their personal networks to find the needed talent or may ask existing employees for referrals.

A board of directors is a panel of individuals who are elected by a corporation's shareholders to oversee the management of the firm. It is typically made up of both inside and outside directors. An inside director is a person who is also an officer of the firm. An outside director is someone who is not employed by the firm. When a high-quality individual agrees to serve on a company's board of directors, the individual is in essence expressing an opinion that the company has potential (why else would the individual agree to serve?). This phenomenon is referred to as signaling.

LO3. An advisory board is a panel of experts who are asked by a firm's management team to provide counsel and advice on an ongoing basis. Along with lenders and investors and, potentially, consultants, advisory board members are the source of an entrepreneur's efforts to "round out" their new-venture team. We say "round out" because the roles these groups play in a new-venture success are less direct and less frequent compared to the influence of the other elements associated with forming a new-venture team. Most entrepreneurial firms have between 5 and 15 members on a board of advisors. Typically, these individuals are paid a small honorarium for their services.

Lenders and investors have a vested interest in the entrepreneurial firm's success. As the size of their investment increases, lenders and investors tend to be more involved in supporting the new venture's efforts to gain traction in the marketplace as a foundation of organizational success. Helping to recruit key employees, providing information about the industry in which the venture intends to compete, and serving as a sounding board for potential competitive actions are examples of the issues lenders and investors address with new-venture team members.

LO4. The primary reason new ventures turn to consultants for help and advice is that although large firms can afford to employ experts in many areas, new firms typically can't. Consultants can be paid or can be part of a nonprofit or government agency and provide their services for free or for a reduced rate.

Key Terms

advisory board, **352**
board of directors, **350**
consultant, **355**
employee, **346**
freelancer, **348**
founding team, **340**
heterogeneous, **341**
homogeneous, **341**
inside director, **350**
intern, **347**
liability of newness, **339**
networking, **344**
new-venture team, **338**
outside director, **350**
prior entrepreneurial experience, **343**
relevant industry experience, **343**
signaling, **351**
skills profile, **346**
virtual assistant, **348**

MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

9-1. What is a new-venture team?
9-2. Who are the primary participants in a start-up's new-venture team?
9-3. What is liability of newness?
✪ 9-4. What can a new venture do to overcome the liability of newness?
9-5. Do new ventures started by a team have an advantage over new ventures started by a sole entrepreneur, or is the opposite the case?
9-6. What are the differences between a heterogeneous and a homogeneous founding team?
9-7. What are the two potential pitfalls of using a team to start a firm?
9-8. What are the personal attributes that affect a founder's chances of launching a successful new firm?
9-9. Why does having relevant industry experience help the founder or founders of a firm?
✪ 9-10. What are the attributes of a firm's founder that typically lead to its success?
9-11. What are some of the methods used by founders to find good employees?
9-12. What is a board of directors?
9-13. What are the desired attributes of good board members?
9-14. What are the three formal responsibilities of a board of directors?
9-15. How does recruiting a well-known and highly respected board of directors lend legitimacy to a firm?
9-16. How do lenders and investors add value to an entrepreneurial venture?
9-17. What is the purpose of forming an advisory board?
9-18. What are the different ways advisory boards meet and conduct their business?
9-19. What are the guidelines to follow when establishing a board of advisors?
9-20. In what ways do lenders and investors lend legitimacy to a firm?
9-21. Why do new ventures often turn to consultants for advice?
9-22. Explain the difference between the two types of consultant that may be available for a new venture.
9-23. What type of advice and counsel do SCORE volunteers provide?

Application Questions

9-24. Emily Jones is in the middle of starting her own business in the advertising industry. She is leaning toward incorporation rather than an LLC because she would like to attract employees by issuing stock. Emily is currently going through all the documents that need to be submitted to the company secretary. One of the requirements for setting up a corporation is the appointment of a board of directors. At the moment, she has no trouble selecting her inside directors, but she struggles with the appointment of outside directors. What should she look out for when making her selection? Advise her.

9-25. According to materials in this chapter, prior entrepreneurial experience, relevant industry experience, and networking are attributes that strengthen a person's chances of launching a successful venture. Think about the type of company you might choose to launch one day. Which of these three attributes do you possess? What steps can you take today to build strengths in the areas where you lack them?

9-26. Greg Mathews has completed his business plan for a ski resort and is ready to put his plan into action. He has been working alone for the past three months to put his venture in place. He now needs to start hiring employees for his resort to build his management and key employee team. As you have been in the recruitment services for the last 10 years, he has come to seek advice from you on the primary elements of a good team. What would your advice be?

9-27. Cindy Combs, a professional investor, was having lunch with a colleague recently and said, “Do you remember Peter Kennedy the entrepreneur we met the other day who created an iPhone app that helps busy families keep track of their activities? I checked up on him and concluded that he has all the right personal attributes not only to be an app developer but to be a successful entrepreneur. He’s thinking about creating some additional family-focused apps and I’m inclined to invest in his business.” Cindy’s meal companion said, “Really, tell me about Peter’s characteristics that are so impressive to you.” What do you think Cindy said in response to her lunch companion’s question about Peter’s characteristics?

9-28. Jose Peacher is an executive with a large manufacturing company. A former coworker of his recently started a company and raised $1 million from a well-known angel investor even though he did not need the money to launch the business. Jose thinks his friend is foolish and cannot think of a single reason to take money from an investor if you do not require the funds to launch. If you were talking to Jose about his view, what would you tell him about this matter?

9-29. Lauren Mitchell is achieving some success with the real estate firm she launched two years ago. A rebounding local economy has helped as has the fact that she is well connected with those heading the chamber of commerce in the city in which her firm is located. She feels, however, that she is having to cover too many of the tasks required for her firm to keep running herself. She has asked you for your advice given that she knows you are taking an entrepreneurship course. Use your knowledge about a skills profile to help Lauren understand how to proceed with her labor-related challenges.

9-30. Charlie Berry, Shelly Toombs, Nancy Harder, James Ndofor, Jennifer Atwood, and Cliff Bell are all experienced software engineers. For some time, they’ve talked about starting a company—the six of them—around a software solution in which all of them have an interest. Based on materials in this chapter, what challenges do you anticipate these six people will likely encounter cofounding a firm?

YOU BE THE VC 9.1 Company: Giraffe

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Business Idea: Getting a job can be tough in the best of circumstances, but what do you do when you live far away from main business hubs, transport is expensive, and you rarely even get to hear about openings? Giraffe, a South African mobile app, connects employers and employees to quickly determine the right fit.

Pitch: At 40 percent, South Africa's unemployment rate is one of the highest in the world. In addition to the usual challenges of matching candidates with the right training and experience with the most suitable jobs, large sections of the population live very far from business areas, public transport is expensive, and Internet access is patchy. Job seekers traditionally relied on word-of-mouth to find work and would often accept any job they could get.

When the ownership of mobile phones soared to 91 percent of the population, Anish Shivdasani, a specialist in digital and mobile industries, saw an opportunity. Almost overnight, there were millions of job seekers who had no previous access to opportunities but did own a mobile device with an Internet connection. In 2013, Shivdasani founded Giraffe as a fully automated, low-cost recruitment phone app focusing on medium- to low-skilled jobs in areas such as field sales, customer service, and retail.

Giraffe is completely free for candidates to sign up for and easy to use even for the completely non-tech-savvy. The service does not interact with candidates or businesses face-to-face or offer training courses; it uses mobile technology and matching algorithms to automatically source, screen, and contact qualified candidates with great accuracy.

One of the first client groups to sign up for Giraffe's mobile-based job platform was call centers. Would-be recruiters said they loved the access to a wider range of applicants, but there was one important thing missing: what did the applicants sound like? To help with the initial assessment and accurate shortlisting of candidates, Giraffe built a bespoke voice-screening feature. Candidates qualifying for a position are invited for a voice assessment via SMS. With the click of a button, Giraffe's system automatically calls the candidate and plays a customizable instruction. The candidate's response is recorded and a voice clip sent to the employer's dashboard. Employers can build a digital library of voice clips, reducing valuable time that would have been spent on the selection and interview processes. This initial first-round screening process is useful for candidates too, as it avoids wasting their time and travel expenses as well.

Today, Giraffe has more than a thousand businesses using its platform, recruiting from a base of over a million candidates. Since Giraffe was founded, more than half a million candidates have been invited to interviews, and hundreds of thousands are now employed as a result.

9-31. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

9-32. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 9.2 COMPANY: Eatsee

• Web: eatsee.app • Instagram: eatsee.app

Business Idea: Eatsee is an app that does away with traditional, closely typed restaurant menus by allowing diners to see what dishes really look like by using their mobile phones to scroll through the beautifully shot visuals of an entire menu.

Pitch: Capitalizing on the idea that we consume food with our eyes long before we get to taste it, Eatsee has built itself as the Instagram for food and eating out. While many restaurants are very creative with their dishes, they often falter at the first hurdle—creating a compelling menu. Typically, menus are uninspiring lists broken up into courses, and they say very little about the food on offer. Even when photos are included, the quality is often not that great.

A media and technology entrepreneur and self-confessed foodie from Newcastle, Australia, Jessica Koncz used to spend hours on Instagram trying to find pictures of restaurant food that appealed to her. Koncz knew she was not alone; her own food-focused Instagram page boasted 50,000 followers who shared her passion for discovering food visually. She wondered why restaurants didn't create visual menus that could be viewed on a diner's phone and was shocked to find that the concept didn't already exist. So Jessica decided to do it herself, and the Eatsee app was born.

Eatsee allows diners to discover the hottest dishes at nearby cafes and restaurants. Its settings can be personalized to show individual preferences like distance, price, dietary requirements, and meal types. Once users settle on where to eat out, the dish-based discovery app allows them to scroll through beautifully shot photos of the entire menu before they decide what to order. The top ten dishes of the venue are also listed on the app, and customers can rate by swiping left or right.

Eatsee makes its money through a $200 to $1,000 onboarding fee, which includes a professional photoshoot of a restaurant's entire menu. After that, Eatsee adopts a SaaS-style pricing model where restaurants are charged a $99 monthly fee. For Koncz, the concept is about more than simply enabling restaurants to offer better digital marketing; she believes that food outlets are not served well at all by any of the existing food tech platforms such as UberEats and Deliveroo. While such platforms do drive footfall, it is often at the cost of high fees and a drop in casual traffic. Eatsee puts power back into the hands of restaurants by giving them access to monthly analytics and private reviews from customers.

Eatsee is currently being rolled out in Australia and the United States, but there are plans to take it global. Koncz is already comparing her app to Yelp, a company worth nearly a billion dollars, and she believes Eatsee has the potential to scale to a similar size as the reviews giant.

9-33. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

9-34. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 9.1

Basecamp: Implementing Novel Work Design and Human Resource Management Practices

• *Web: www.basecamp.com* • *Facebook: 37signals* • *Twitter: @basecamp*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Basecamp, formally known as 37Signals, was founded in 1999 by Jason Fried, Carlos Segura, and Ernest Kim. The company started as a website redesign firm. By 2003, its client list had grown and the founders started looking for collaboration software they could use to manage the projects on which they were working. They looked at the software that was available and nothing fit their needs. The existing project management software broadcast project schedules, included Gantt charts, and focused on numbers. What they needed was a program that would allow them to talk to their clients, deliver work, get feedback, and keep everyone on the same page. So rather than compromising, they built their own project management software strictly for internal use. As they started using it with clients, clients started asking them where they could get it. A lightbulb went off, and they decided to offer their software for sale, naming it Basecamp.

The Basecamp software product sold well and by 2004 the company shifted its focus from web design to software development. Additional products followed including Backpack, Campfire, and Highrise. Ruby on Rails, a web application framework, was developed to make Basecamp. It was later released as an open source development framework and has become quite popular.

In February 2014, the company announced it was changing its name from 37Signals to Basecamp, its most popular product. It also announced it was stepping back from its other products—Campfire and Highrise—and would either sell them or continue supporting existing customers (but not take on new ones). Its 43 employees would focus strictly on Basecamp. In a blog post explaining the move, Fried said he and his team have always enjoyed being a small company and they "could hire a bunch more people to do a bunch more things," but that kind of rapid expansion is at odds with their company culture.

A Different Kind of Company

Basecamp, and 37Singals before it, has always been a different sort of company. Two of its initial founders moved on shortly after the company launched. The company is now led by Fried, an original cofounder, and David Heinemeier Hansson, who came along when Basecamp was built and is the inventor of Ruby on Rails. Both have strong opinions about design, business, technology, and how to build a healthy company. To share their thoughts they started a blog (Single vs. Noise), have written three books (*Getting Real*, *Remote*, and *Rework*), and are generally outspoken.

While many of Fried and Hansson's opinions are provocative, they are both widely respected. Basecamp is used by thousands of companies, has millions of

(*continued*)

users, and has high customer satisfaction ratings. Fried and Hansson are also considered to be thought leaders in product development and work design. In regard to both topics, Fried and Hansson's writings focus on two consistent themes. The first is simplicity. Basecamp does not have as many features as most collaborative software platforms, and that is by choice. Basecamp focuses on the basics, and executes on the basics extremely well. The company is also built on simplicity, as illustrated in the examples provided below. The second is a belief that every company has two products. The first is the product (or products) the company sells and the second is the company itself. The latter is considered to be the more important of the two. Fried has noted that when companies iterate on their products, their products get better. Basecamp iterates on its products but also iterates on itself to make itself better. Fried and Hansson try to improve the work environment at their firm on an ongoing basis.

Nine Novel Work Design and Human Resource Management Practices

Fried and Hansson's beliefs about simplicity and putting as much thought into the design of their company as the design of their products have led to the development of novel work design and HRM practices. The following are nine examples that illustrate how Fried and Hansson think and how Basecamp operates. They aren't gimmicks. They are well-thought-out practices. They're also not for everyone. Basecamp, and 37Singals earlier, built a culture that supports its practices.

While unique to Basecamp, the nine examples that appear next do provide food for thought. They are examples of how one firm has chosen to question conventional thinking and try novel approaches in the interest of maximizing performance and employee satisfaction. A good time to think about these types of practices is when a business starts. The longer a business exists, the more difficult it becomes to set aside entrenched practices and adopt novel ways of thinking and behaving.

Nine Novel Work Design and HRM Practices Employed by Basecamp

	Work design and/or HRM practice	Explanation
1.	40 Hours a Week Is Enough	Basecamp encourages its employees to work 40 hours a week and no more. It believes that 40 hours is plenty to do great work. To make this possible, the company is careful to not steal its employees' time. There is only one meeting a month. There are few impromptu conversations. Instead of tapping someone on the shoulder to tell them something, managers post things on Basecamp (the software product) to allow employees to consume the information when it is convenient for them to do so rather than when the manager wants to convey it.
2.	Library Rules	You can walk into a library anywhere in the world and people know how to behave. They're quiet—they respect the fact that people are there to study, to think, to work, and to learn. Basecamp practices "library rules" in its office. If you walk into Basecamp's office—even with its open floor plan—it is quiet. People respect the fact that employees are there to study, to think, to work, and to learn. If you need to talk to someone, there are rooms set aside for that purpose.
3.	No Talk Thursdays	No Talk Thursdays means that on Thursday afternoons, no one in the office talks to anyone else. What happens is a tremendous amount of work gets done. There are few if any interruptions, no one drops by anyone else's office, and no one strikes up a conversation. Everyone just works. Jason Fried, one of Basecamp's cofounders, talks about this concept often. He says he gets e-mails from people who say, "we tried this—it's been great!"
4.	Work Can Wait	As part of Basecamp's philosophy that 40 hours of work a week is enough, every employee can set their own work schedule. They can then set a setting in Basecamp (the software product) that prevents them from receiving company notifications outside their work hours. So, if your work hours are 10:00 am – 6:00 pm Monday through Friday, you can't receive company notifications or be contacted (via Basecamp) during any other times. Of course, in the case of an emergency employees can be reached by phone or text. But most employee communication is routed through the Basecamp software product, so employees rarely deal with work-related issues on their own time.

	Work design and/or HRM practice	Explanation
5.	Asynchronous Communication	In Basecamp's view, this is what often happens in organizations, which it feels is the wrong approach. A manager calls a one hour meeting. Ten employees have to drop what they're doing to listen to what the manager has to say. The manager thinks he or she is only taking an hour, but in reality 11 hours (1 manager and 10 employees) of productivity has been spent. Employees are told to think things over, but most return to what they're doing and little is accomplished. That's synchronous communication—everyone has to be together to hear the same thing at the same time. Basecamp believes in the opposite—asynchronous communication. People don't have to be at the same place at the same time to consume information. Managers write-up what they have to say, post it in a chat room, and employees see it when it's convenient for them. They then have time to think about it before they respond.
6.	Remote Work	Remote work is what some people call telecommunicating. Employees work from various locations. Basecamp is a big fan. About 15 of the company's 55 employees work in its Chicago headquarters. The rest are spread out over 30 cities in the world. Basecamp wants to hire the best programmers in the world. Most companies say the same thing, Basecamp reasons, but what they really mean is that they want to hire the best programmers who either live within driving distance of their headquarters or are willing to move. Allowing remote work is integral to Basecamp's culture. The company believes it has been able to attract and retain world-class talent as a result of its remote work policies.
7.	Flex Time	Basecamp provides its employees discretionary time to pursue work-related projects. While many companies have similar policies, Basecamp regularly gives employees an entire month away from regular work activities to pursue new ideas of their choosing, either as an individual or in a team. At the month's end, employees share their projects at a company-wide "Pitch Day" and receive feedback from peers. A number of features that are included in Basecamp, the software product, were developed through this program.
8.	The Calm Company	This initiative is more a philosophy rather than a technique. The leaders of Basecamp have noticed a trend in tech firms that they feel is counterproductive. In many companies, long hours, excessive busyness, and a lack of sleep have become badges of honor. Basecamp thinks that's wrong. It has spent 17 years creating the exact opposite type of culture—a culture that isn't fueled by stress, or late nights, or manufactured busywork, or growth at all costs. So, here is how Basecamp strives to operate. No growth-at-all-costs. No false busyness. No ego-driven decisions. No keeping up with the Joneses Corporation. No hair on fire. Apparently it's working, given that Basecamp has been profitable 68 straight quarters, which is 17 straight years. *Here is an aside*—in addition to the three books mentioned earlier, Basecamp's founders have written a fourth book, titled *The Calm Company*, which was scheduled to be published in late 2017.
9.	A Culture of Trust and Generosity	Basecamp routinely conducts experiments to enhance the work environment. Many of the experiments foster a sense of trust between the company and its employees. For example, every employee in the United States is issued a company American Express card in their name. The card can be used for any work-related expense—no pre-approval necessary. Similarly, each employee can spend $1,000 a year on continuing education. It can be something work-related or something completely different—like learning a musical instrument, taking cooking classes, or learning photography. The point is to learn something that enriches you as a person. Basecamp is also generous with its employees. It monitors industry salaries annually and makes sure it is paying in the top 5 percent. It also has favorable employee benefits. Basecamp feels a culture of trust and generosity not only is aligned with its culture but yields a ROI in increased employee autonomy, satisfaction, and commitment.

Discussion Questions

9-35. Share your general reaction to this case study. Do you think Basecamp's approaches to work design and HRM are transferrable to other organizations, or do you think they're unique to Basecamp? Explain your answer.

9-36. Of the nine novel work design and HRM practices employed by Basecamp included in the case study, identify the two practices that resonated with you the most, and that you believe would be most important to use in an entrepreneurial start-up firm.

9-37. In the case, the observation was made that in many companies, long hours, excessive busyness, and a lack of sleep have become badges of honor. Why do you think this has happened? Do you agree with the leaders of Basecamp that that way of working is counterproductive? If you launched a start-up, how would you avoid allowing a culture to develop that championed long hours, excessive busyness, and a lack of sleep?

9-38. According to the case, Basecamp has been profitable 68 straight quarters, 17 straight years. To what degree do you think Basecamp's work design and HRM practices have contributed to its success?

Sources: N. Tamble. "37 Signals: A Case Study in Work Environment Redesign," Deloitte University Press, 2013; J. Fried. "Jason Fried, Why 40 Hours is Enough: Lessons From Basecamp—Lean Startup 2016," available at https://www.youtube.com/watch?v=r_cc-JrTe38 (posted December 12, 2016, accessed March 11, 2017); J. Fried. "Why Work Doesn't Happen At Work," TedTalks, available at https://www.youtube.com/watch?v=5XD2kNopsUs (posted November 24, 2010, accessed March 12, 2017); J. Fried. "Founders' Stories: Basecamp's Jason Fried," available at https://www.youtube.com/watch?v=JxtYiK5GACc (posted March 19, 2014, accessed March 12, 2017).

CASE 9.2

Zappos: Making Human Resources the Key to Customer Service

• *Web: www.Zappos.com* • *Facebook: Zappos.com* • *Twitter: @zappos*

Bruce R. Barringer, *Oklahoma State University*

R. Duane Ireland, *Texas A&M University*

Introduction

Zappos.com is an online shoe and apparel retailer that has built a strong brand and has shown impressive sales growth since its founding. Based in Las Vegas, NV, the company had zero sales in 1999, $370 million in 2005, and over $1 billion in 2008. In 2009, Amazon.com acquired Zappos for $1.2 billion with the agreement that it could operate autonomously and maintain its unique culture. Zappos' formula for success is seemingly simple. It acquires customers through word-of-mouth and search engine marketing (SEM) and then wows them with customer service that keeps them coming back. The popular press often touts Zappos as the classic example of what can be accomplished through exemplary customer service.

But what's really behind Zappos's extraordinary success? Its prices are slightly on the high end. Its website isn't fancy. And it sells shoes and clothing for crying out loud! How does Zappos consistently deliver such a high level of customer service that people are willing to buy shoes, clothing, and a variety of other items to the tune of $1 billion-plus per year? Read on.

Why Shoes?

Zappos was founded by Nick Swinmurn in 1999. Swinmurn had such a hard time finding shoes that he started an e-commerce company to help people just like himself. He was turned away by investors who thought it was crazy to think that people would buy shoes online. Seriously—who buys shoes without trying them on first? Swinmurn persevered, heartened by the fact that over $2 billion in shoes are sold via mail-order catalogs every year—so people do buy shoes without trying them on. Selling shoes is also a fundamentally good business. You don't need to educate people about the product—people know shoes. The brands are strong, and the margins are good. The average order on Zappos.com is over $100. It's also possible to run an effective SEM campaign for shoes. Try this: Search Google for "Nike shoes," "tennis shoes," and "running shoes," one by one. How many times do you see search engine ads for Zappos to the right of the results? Many, right?

Zappos' original name was ShoeSite. A few months after the company launched, the name was changed to Zappos. The name "Zappos" is a variation of "zapatos," which is the Spanish name for shoes. Swinmurn decided to abandon the name ShoeSite because he didn't want to limit the company to only selling footwear.

Customer Service

According to reliable reports, customer service is what makes Zappos special. Call center employees do not use scripts and aren't pressed to keep calls short. The longest recorded call was 10 hours and 43 minutes by customer service agent Steven Weinstein. There is a video on Zappos' website that explains the call (www.zappos.com/about/record-call). Shipping and returns are free. The warehouse is open 24/7 so customers can place an order as late as 11 pm and still receive quick delivery. Behind the scenes, most orders are upgraded to next-day delivery so customers are pleasantly surprised when their order arrives eariler than expected. Normally, the early arrival is accompanied by an e-mail message from Zappos saying that the order was upgraded to next-day delivery because you are a "valued customer."

Zappos also has a very liberal return policy. It will take returns for up to 365 days, although most returns come within 30 days. About 40 percent of all items ordered are returned. When a customer is on the phone with a Zappos employee and is struggling with which pair of shoes to buy, the Zappos employees will suggest that the customer buy both pairs, and simply return the less desirable shoes. If Zappos' warehouse is out of a pair of shoes a customer wants, Zappos will e-mail the customer links to other websites where the shoes are for sale. Zappos also does little things to help its customers. For example, its toll-free phone number is listed at the top of every page on its website. Employees are given sufficient autonomy so they can do what they believe is "right" for the customer. For example, on one occasion a woman called Zappos to return a pair of boots for her husband because he died in a car accident. The next day she received a flower delivery, which the call center employee had billed to Zappos without checking with her supervisor.

What all this effort has gotten Zappos is a loyal customer base and word-of-mouth advertising. Approximately 50 percent of Zappos' orders come from existing customers.

Tony Hsieh

CEO Tony Hsieh is at the center of everything Zappos does. In his early 20s, Hsieh started a company called LinkExchange, which let small companies barter for banner ads. Hsieh insisted that every e-mail coming into the company was answered promptly and politely. In college, Hsieh made money by selling pizzas out of his Harvard dorm room. A classmate, Alfred Lin, bought whole pizzas from Hsieh and resold them piece by piece, making more money. Hsieh sold LinkExchange to Microsoft for $265 million in 1998 and he and Lin started an angel investment fund. Zappos' founder Nick Swinmurn pitched Hsieh and Lin, trying to raise money. Hsieh was so impressed with Zappos' market opportunity that he invested in the firm and briefly served as Zappos' co-CEO with Swinmurn. It wasn't long before Hsieh and Lin were running Zappos. Hsieh became Zappos' CEO and Lin became the CFO in the early 2000s.

Hsieh isn't the typical CEO, and his values, personality, and approach to doing business have clearly shaped Zappos' culture. Hsieh works in an open space amid a cluster of employee cubicles. His desk is the same size as his call center employees. Hsieh hosts employee parties and barbecues at his home, encourages employees to hang out after work, and spends his spare time studying the science of happiness. Zappos' employees are encouraged to decorate their work spaces. Hsieh's desk features jungle vines and an inflatable monkey. If you'd like to see it, go to Google Images and type "Tony Hsieh's Desk" into the search bar. Hsieh's desk has to be seen to be believed.

Human Resources

While exemplary customer service may be what keeps Zappos' customers coming back, the root of the company's competitive advantage is its human resource management policies. The company is fiercely protective of its culture, which has been crafted to facilitate its high level of customer service. The firm has established 10 core values, which define its culture, brand, and business strategies, and are shown next. Every new employee, regardless of his/her assignment, is required to undergo a four-week customer loyalty training course, which includes at least two weeks of talking on the phone with customers in the call center. Employees enjoy free lunches, no-charge vending machines, a company library, a nap room, and free health care (although employees do pay for their dependents).

Zappos' 10 Core Values

1. Deliver WOW through Service
2. Embrace and Drive Change
3. Create Fun and a Little Weirdness
4. Be Adventurous, Creative, and Open-Minded
5. Pursue Growth and Learning
6. Build Open and Honest Relationships with Communication
7. Build a Positive Team and Family Spirit
8. Do More with Less
9. Be Passionate and Determined
10. Be Humble

That's not all. After training, each new customer service hire is given what Zappos calls "the offer." The company says to each new hire, "If you quit today, we'll pay you for the amount of time you've worked, plus $2,000." Why would Zappos do this? The answer to this question is simply that the firm wants employees to quit if they don't like the Zappos' culture. The $2,000 payoff is small potatoes, Hsieh and his top management team believe, as opposed to having a half-hearted employee on the payroll. Over 97 percent of employees who complete training turn down the offer.

Social Media

Another distinctive aspect of Zappos is its extensive use of social media, which includes Twitter, Facebook, YouTube, and Pinterest. Hsieh encourages his employees to use social media to put a human face

The familiar Zappos logo.

360b/Alamy Stock Photo

on the company. Each new employee is trained to use Twitter, and employees are encouraged to tweet about what they are doing at work and share resources that customers might find useful. There's even a company leaderboard that shows which employees are on Twitter and how many followers they have. Hsieh has 2.8 million followers, and follows 352,000 others.

The company's encouragement of Twitter use coincides with core value 6: Build Open and Honest Relationships with Communication. Hsieh himself is very authentic in his tweets. For example, on one occasion, before going onstage for a tech conference, Hsieh tweeted: "Spilled Coke on left leg of jeans, so poured some water on right leg so looks like denim fade." Hsieh also uses Twitter to solicit customer feedback. In his tweets, he frequently refers to something Zappos is doing and asks, "What do you think about this?" The replies he gets are from Zappos' employees, customers, and others.

Zappos' Facebook page provides an effective vehicle for feedback and discussions with customers. Its YouTube channel features videos that mostly highlight the work culture at Zappos' headquarters, including behind-the-scenes clips. Zappos' blog, Beyond the Box, focuses on five categories: culture, community, clarity, lifestyle, and sustainability. The firm posts to its blog on business and non-business related topics. Zappos' Pinterest site allows users to explore the firm's products.

New Initiatives

Zappos has recently launched two new initiatives in the human resources area. The first is the launching of a program called Zappos Insiders. Zappos Insiders are people who are interested in working for Zappos, if not now at some point down the road. Zappos Insiders are the first to know about job openings (in their desired job family), stay in-the-know about the latest news and happenings at Zappos, chat with the Zappos recruiting team during bi-weekly Tweetchats, and gain exclusive access to online and in-person events with current Zappos' employees. You can sign-up to become a Zappos Insider at https://jobs.jobvite.com/zappos/p/inside.

The second new initiative is a bold one. Zappos is adopting a "holacracy" approach to organizing the company. Zappos will eliminate traditional managers, do away with typical corporate hierarchy, and get rid of job titles, at least internally. The idea is to replace the traditional corporate chain of command with a series of overlapping, self-governing teams for the purpose of giving employees more of a voice in the way the company is run and keeping the firm lean and nimble as it continues to grow.

What Lies Ahead

By all accounts, Amazon.com has been true to its word and has allowed Zappos to operate independently since it acquired the firm in 2009. Zappos is still quirky, is pushing the boundaries in regard to customer service and human resources management, and is reportedly profitable and growing. It has added to its product line—along with shoes and clothing it now sells bags, housewares, beauty products, eyewear, jewelry, and a number of other categories of products.

Two main challenges lie ahead for Zappos with the first one being competition in its primary categories—shoes and clothing. Zappos is a mainstream online retailer that carries shoes and clothing across the price gamut. Its women's heels, for example, range from \$830 Chloe Gosselin—Calico to \$49.00 Michael Antonio Jimmy—Patent. The challenge with this strategy is that Zappos is now being attacked by niche players at both ends of the price spectrum. In shoes, for example, it's being attacked from the top by high-end online retailers like Bluefly (www.bluefly.com), which have a larger selection of high-end shoes than Zappos does, and from the bottom by low-end online shoe retailers like Payless Shoes (www.payless.com), which sells shoes for as little as $9.99. A similar dynamic exists in online clothing. Zappos also has competition from mainline online shoe and clothing retailers that sell across the price spectrum like it does. Competitors include Shoebuy.com and JCPenney.com.

The second challenge is whether Zappos will be able to maintain its unique culture. Often, the quirky nature of a start-up culture gives way to a more formal culture as a company grows and matures. Zappos seems to be resisting this, in part by implementing the new hiring practices and new way of organizing as described previously. In regard to its new way of organizing, which replaced hierarchies and bosses with "self-management," Zappos may have gone too far. A number of articles have been published indicating that this initiative has not gone well. The gist of these articles is that the move left employees confused and somewhat demoralized. From early 2015 to early 2016, 29 percent of the Zappos staff turned over. And in 2016, the company missed the *Fortune* "100 Best Companies to Work For" list for the first time in eight years. How Zappos plans to recover from these setbacks is unclear. A wild card regarding Zappos' culture is whether Tony Hsieh will remain at the helm. There is no indication that Hsieh plans to leave, but if he did, Zappos would lose its spiritual leader. A change in leadership at the top could result in Zappos moving more in the direction of a mainstream company rather than preserving its unusual, yet seemingly effective, corporate culture.

Discussion Questions

9-39. What steps did Zappos take early in its life as a company to overcome the liability of newness?

9-40. What can entrepreneurs learn from Zappos' experience about motivating employees and building a healthy organizational culture?

9-41. Do some additional Internet research about Zappos' decision to shift to a "holacracy" approach to organization and management and whether Zappos is sticking with this approach. Use the information you found to provide an update on the health of Zappos' organizational culture.

9-42. In 2000, Tony Hsieh wrote a book titled *Delivering Happiness* in which he asserts that employee satisfaction is the key to business success. Do you think Hsieh is right? On a scale of 1 to 10 (10 is high), how important do you think employee satisfaction is to business success? Explain your answer.

Sources: Zappos Homepage, www.zappos.com (accessed March 12, 2017); J. Reingold, "How a Radical Shift Left Zappos Reeling," *Fortune*, March 4, 2016; J. McGregor, "Zappos Says Goodbye to Bosses," *Washington Post*, January 3, 2014; M. Chafkin, "The Zappos Way of Managing," www.inc.com/magazine/20090501/the-zappos-way-of-managing_pagen_4.html (posted May 1, 2009, accessed March 12, 2017); T. Hsieh, *Delivering Happiness* (New York: Hachette Book Group, 2010).

ESSAY QUESTIONS

1. The reality television show *Dragons' Den* is a global hit, with local versions of the program broadcast in nearly 30 countries. The format is pretty standardized, with entrepreneurs pitching their business ideas to a panel of venture capitalists. Equity in the business is offered in return for a cash investment. The panellists question the entrepreneurs and make an assessment as to whether they want to make an investment. When more than one panellist wants to invest, they compete for the opportunity by making better offers. As with any relationship with a VC, a business is looking for much more than just a cash investment. Write a paragraph or two explaining what else a VC can offer a business in these circumstances.

2. While taking an entrepreneurship course, you heard from several local entrepreneurs who visited your class that in their view, mistakes are easy to make when forming a team to operate a new venture. A friend of yours is interested in opening his own business and wants to effectively establish a team for his new venture. After thinking about your friend's interests and in light of your desire to help him, write a paragraph or two to describe the mistakes you would tell him to try to avoid as he establishes his new-venture team.

Endnotes

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Getting Personal with KINVOLVED

Kinvolved, Inc.

Cofounders

ALEXANDRA MEIS

Master's in Public Administration, Health Policy Analysis, NYU, 2013

MIRIAM ALTMAN

Master's in Public Administration, Public and Nonprofit Management and Policy, NYU, 2013

Dialogue *with* Alexandra Meis

FAVORITE BAND ON MY SMARTPHONE LIST
Anything from Taylor Swift to Frank Sinatra

BEST ADVICE I'VE RECEIVED
Persistence is omnipotent

WHAT I DO WHEN I'M NOT WORKING
I love indoor spinning and outdoor cycling. I also enjoy spending time with my dog, Jolly

MY FAVORITE SMARTPHONE APP
I love Spotify's mobile app. Slack's mobile app is great, and helps me easily stay in touch with our team members living nearby and around the world

FAVORITE PERSON I FOLLOW ON INSTAGRAM
I just follow my friends and family. Kinvolved's Creative Director, Runy, is a professional photographer. His Instagram, @ligtneye, has gorgeous pictures from around the world

FIRST ENTREPRENEURIAL EXPERIENCE
When I was growing up, my two cousins and I would actually sell seashells by the sea shore. We would collect shells, paint them, and try to turn a profit

CHAPTER 10

Getting *Financing* or Funding

MyLab Entrepreneurship

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OPENING PROFILE

KINVOLVED

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Miriam Altman started her career as a high school teacher in a New York City public school. One thing that troubled her was inconsistent student attendance in her classroom. Sometimes only three out of 30 students would show up for her first period. Many of her students were missing 10 percent or more of their school days. Altman knew this was a problem given that attendance is the #1 predictor of school success. Altman also noticed that parents were not as involved as one might expect. She talked to her peers about her concerns, and the general sentiment was that involving parents wasn't the most effective solution.

Altman started talking to parents, and found that the exact opposite was the case. She learned that most parents were engaged, and really wanted to be informed if their child didn't show up for school. In many school districts across America, but not all, parents are informed when their child is absent. Reasons for not informing parents include the fact that some schools simply don't have the resources to make timely notifications. In other instances, robocalls are made, which often go unanswered and provide no way for a parent to dialogue with a teacher or a school. Altman started forming relationships with her students' parents, and found that it made a difference. When she was able to communicate with parents, attendance went up.

After her third year of teaching, Altman decided to leave teaching to attend graduate school. She was admitted to the NYU Wagner Graduate School of Public Service in the fall of 2011. On her first day of graduate school, she met Alexandra Meis. Altman and Meis shared an interest in school-aged children. During the years Altman was a teacher, Meis worked in the South Bronx educating and advocating for families of children with special needs. The two became aware of a competition sponsored by the Fels Institute of Government at the University of Pennsylvania. Entrants in the competition were required to pick a topic in the public policy arena that they cared about and that was relevant to their local community—and propose a solution. Altman and Meis entered the 2012 competition and won the $15,000 first prize (Meis later said it felt like $15 million). The problem they addressed was inconsistent student attendance in New York City public schools. Their solution was a mobile app (named Kinvolved) that would allow teachers and/or administrators to take attendance via a smartphone

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Describe the importance of financing for entrepreneurial success.
2. Explain why most entrepreneurial ventures need to raise money during their early life.
3. Identify and describe the three sources of personal financing available to entrepreneurs.
4. Identify and explain the three steps involved in properly preparing to raise debt or equity financing.
5. Explain the three most important sources of equity funding that are available to the entrepreneurial firm.
6. Describe common sources of debt financing entrepreneurial firms use.
7. Describe several creative sources of financing entrepreneurial firms may choose to use.

and alert parents and caregivers via a text message or an e-mail when their child was not in school. The goal was to increase school attendance through increased parental involvement.

The validation that the competition provided encouraged Altman and Meis to continue working on their idea. They used the money they won in the competition to build a prototype of the app. They also made maximum use of the NYU entrepreneurial ecosystem. In 2013, they entered the NYU Business Plan Competition, and won first place in the social venture track. The prize was $50,000. They graduated from NYU in the spring of 2013, and entered the NYU summer Launchpad, which provides mentorship and a small amount of funding. During their time as graduate students, Altman and Meis talked to hundreds of teachers, administrators, and parents about their idea, and iterated and improved on the idea. They also tested Kinvolved's system at a Harlem elementary school, and got great results. Reflecting on this time, Altman later said that starting Kinvolved while Meis and she were in graduate school was a blessing. It provided them time to really think about their idea without the distractions of a traditional job.

Fast forward to the present. Kinvolved became a company and is now in over 100 schools. The way the app works is as follows. Teachers use the app to take attendance at the beginning of each class period. There is no setup on the teacher's part—the student data is loaded by Kinvolved. Once attendance is taken, the teacher pushes a button and a text message or e-mail is sent to up to 10 parents and caregivers for each child who is absent. The entire process takes just a minute or two. A parent or caregiver who receives an absent message can respond and interact directly with the teacher. On the school administration side, data is collected at the student, class, and school level, allowing administrators to use Kinvolved to spot trends regarding attendance at multiple levels.

In regard to its funding journey, Altman and Meis have been very resourceful. They found that raising money for an EdTech start-up isn't easy. The initial funding came from their college experiences, which included the competitions mentioned above, the NYU Summer Launchpad, and a $5,000 E-Team grant from NCIIA (now VentureWell). That amount totaled approximately $80,000, which funded their prototype and initial customer discovery. In the fall of 2013, they ran an Indiegogo crowdfunding campaign, and raised $20,350 from 114 backers. If you'd like to see the campaign, which includes a video pitch, simply go to www.indiegogo.com. Just type Kinvolved in the search bar and select "Only ended campaigns." The purpose of the campaign was to subsidize the cost of the Kinvolved program for 400 teachers during the 2013–2014 school year.

After Altman and Meis completed their graduate degrees, they committed to Kinvolved full time. Kinvolved is a social venture with a dual bottom line—making a profit and providing a social good. Consistent with this positioning, Kinvolved is a Certified B Corporation, which is a third party standard that holds companies accountable for certain social sustainability and environmental performance standards. Kinvolved's dual bottom line has played a role in its efforts to raise money. In the fall of 2013, Altman and Meis raised a seed round from the Blue Ridge Foundation, now Blue Ridge Labs, which provided a small amount of funding and office space. Blue Ridge Labs is a Brooklyn, NY–based social impact incubator. Additional funds were raised in early 2017 from a social-impact investor. Fundraising, which is critical for the purpose of fueling Kinvolved's growth, is ongoing.

Kinvolved's short-term goal is to scale to school districts on a national level. Its ultimate objective is to make a meaningful difference nationwide in solving inconsistent school attendance. Kinvolved also routinely receives inquiries from schools in foreign countries. However, before expanding internationally, the firm wants to increase its footprint in U.S. schools.

In this chapter, we focus on the process of getting financing or funding. We begin by discussing why firms raise capital. We follow this with a description of personal financing and the importance of personal funds, capital from friends and family, and bootstrapping in the early life of a firm. We then turn to the different forms of equity, debt, and creative financing available to entrepreneurial ventures. We also emphasize the importance of preparing to secure these types of financing.

The Importance of Getting Financing or Funding

LEARNING OBJECTIVE

1. Describe the importance of financing for entrepreneurial success.

Few people deal with the process of raising investment capital until they need to raise capital for their own firm. As a result, many entrepreneurs go about the task of raising capital haphazardly, because they lack experience in this area and because they don't know much about their options.[1] This shortfall may cause a business owner to place too much reliance on some sources of capital and not enough on others.[2] Entrepreneurs need to have as full an understanding as possible of the alternatives that are available in regard to raising money. And raising money is a balancing act. Although a venture may need to raise money to survive, its founders usually do not want to deal with people who don't understand or care about their long-term goals.

The need to raise money surprises a number of entrepreneurs, in that many of them launch their firms with the intention of funding all their needs internally. Commonly, though, entrepreneurs discover that operating without investment capital or borrowed money is more difficult than they anticipated. Because of this, it is important for entrepreneurs to understand the role of investment capital in the survival and subsequent success of a new firm.

Why Most New Ventures Need Funding

LEARNING OBJECTIVE

2. Explain why most entrepreneurial ventures need to raise money during their early life.

There are three reasons that most entrepreneurial ventures need to raise money during their early life: cash flow challenges, capital investments, and lengthy product development cycles. These reasons are laid out in Figure 10.1. Let's look at each reason so we can better understand their importance.

Cash Flow Challenges

As a firm grows, it requires an increasing amount of cash to operate as the foundation for serving its customers. Often, equipment must be purchased and new employees hired and trained before the increased customer base generates additional income. The lag between spending to generate revenue and earning income from the firm's operations creates cash flow challenges,

FIGURE 10.1
Three Reasons Start-Ups Need Funding

Being an entrepreneur in the biotech industry requires a lot of determination and drive. The path to getting a new drug approved takes up to 10 years. This "tortoise-like pace" of new product development takes substantial up-front investment.

Bullistar/Shutterstock

particularly for new, often small, ventures, as well as for ventures which are growing rapidly.

If a firm operates in the red, its negative real-time cash flow, usually computed monthly, is called its burn rate. A company's **burn rate** is the rate at which it is spending its capital until it reaches profitability. Although a negative cash flow is sometimes justified early in a firm's life—to build plants and buy equipment, train employees, and establish its brand—it can cause severe complications. A firm usually fails if it burns through all of its capital before it becomes profitable. This is why inadequate financial resources is a primary reason new firms fail.[3] A firm can simply run out of money even if it has good products and satisfied customers.

To prevent their firms from running out of money, most entrepreneurs need investment capital or a line of credit from a bank to cover cash flow shortfalls until their firms can begin making money. It is usually difficult for a new firm to get a line of credit from a bank (for reasons discussed later). Because of this, new ventures often look for investment capital, bootstrap their operations, or try to arrange some type of creative financing.

Capital Investments

Firms often need to raise money early on to fund capital investments. Although it may be possible for the venture's founders to fund its initial activities, it becomes increasingly difficult for them to do so when it comes to buying property, constructing buildings, purchasing equipment, or investing in other capital projects. Many entrepreneurial ventures are able to delay or avoid these types of expenditures by leasing space or co-opting the resources of alliance partners. However, at some point in its growth cycle, the firm's needs may become specialized enough that it makes sense to purchase capital assets rather than rent or lease them.

Lengthy Product Development Cycles

In some industries, firms need to raise money to pay the up-front costs of lengthy product development cycles. For example, it typically takes between two and four years to develop an electronic game. In the prescription drug industry,

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Startup Weekend: A Fertile Place to Meet Business Cofounders

Startup Weekend: • Web: www.startupweekend.com • Facebook: startupweekend • Twitter: @ StartupWeekend

Startup Weekend is a for-profit organization that organizes weekend events. The purpose is to create a context in which small groups of people conceive and start a business in 54 hours. Startup Weekends are held periodically in local communities and on college campuses across the United States. Since Startup Weekend launched in 2006, the organization has helped local volunteers put on over 2,900 Startup Weekend events in 150 countries. The events have involved over 193,000 entrepreneurs. A number of exciting businesses are rooted in a Startup Weekend, including Easy Taxi (the world's most downloaded taxi app), Rover (a platform for booking dog sitters and the subject of Case 2.2), Thimble (an online code editor), and LaunchRock (a customer-acquisition platform).

Here's how it works. Each Startup Weekend is semi-autonomous and is organized by a group of local volunteers. The local volunteers get support through Startup Weekend's events team, which is located in Seattle, WA. The local volunteers pick the date, find a venue to hold the event, and organize the weekend. A typical Startup Weekend attracts 60–120 people. The ideal mix of participants is 50 percent technical (developers, coders, designers) and 50 percent business (marketing, finance, law). The only requirement for admission (other than a nominal admission fee) is to have a passion for entrepreneurship and a willingness to work with like-minded, motivated people to develop a product or business in one weekend.

Many Startup Weekends are organized around themes. Examples include Fashion & Tech, Mobile, Education, Health & Wellness, and Food. A Startup Weekend is organized as follows.

Friday: Participants arrive between 5 and 7 pm, begin networking, and eat dinner. After a short ice-breaking exercise, the pitches begin. Anyone is welcome to make a 60-second pitch of a business idea. If the Startup Weekend is a themed weekend (such as Fashion & Tech or Health & Wellness), all the pitches must adhere to the theme. After the pitches are finished, all attendees vote on their favorites. The top ideas are selected to be worked on for the weekend. Teams form organically and consolidate, and the work begins.

Saturday: Teams work all day, with the occasional breaks to eat. Mentors and coaches circulate to provide support and advice. Individual team members reach out to people in their networks (typically via text or e-mail) to solicit feedback and advice. The pace is quick and intense, and the business idea may iterate multiple times. A path forward is eventually agreed upon and a rough prototype takes shape. Most teams build a website. Approximately 95 percent of Startup Weekend ideas are mobile or web focused (regardless of the theme); thus, the need for developers, coders, and designers. The idea is not to conceive an idea for a business. The idea is to build a business.

Sunday: Teams continue their work from morning until mid-afternoon. Around 3 to 4 pm, they start wrapping things up and practicing their presentations. After the judges arrive, presentations begin. The initial 50-person group is now ten 5-person teams. The judges select the top teams, give out awards, and the event ends—with just 54 hours from first hearing an idea to the birth of a business.

Afterwards: Whether the team stays together after the Startup Weekend concludes is strictly up to the members of the team. About 55 percent of Startup Weekend participants continue working on their idea with their team intact. Approximately 23 percent continue working together with some of their team members. Thus, for participants, Startup Weekend is a fertile place to find a team of people to work with on a business idea. To learn whether a Startup Weekend is being planned for your city or area, simply access the "Upcoming Events" link on Startup Weekend's website.

There is a version of Startup Weekend called 3 Day Startup that is designed specifically for college campuses. It is a non-profit organization, and provides more structure and support than Startup Weekend provides. 3 Day Startups have taken place at more than 150 schools across 6 continents. As of April 2017, 119 companies have launched that got their start via a 3 Day Startup weekend. You can learn more about 3 Day Startup at 3daystartup.org.

Questions for Critical Thinking

1. In referring to Startup Weekend, someone made the comment "It's not a start-up factory, it's an entrepreneur factory." What do you think the person meant by that comment?
2. To what degree do you agree with the basic premise of the feature that Startup Weekends represent a fertile place to meet business cofounders?
3. What can people learn by attending a Startup Weekend, even if they ultimately do not stay together with their team after the weekend ends?
4. Spend some time looking at the website for 3 Day Startup. How do Startup Weekend and 3 Day Startup compare? Are both equally suited for college student entrepreneurs?

Source: Startup Weekend Homepage, www.startupweekend.com (accessed April 21, 2017); 3 Day Startup Homepage, www.3daystartup .org (accessed April 22, 2017).

the path from the research lab to the patient takes an average of 10 years.[4] This tortoise-like pace of product development requires substantial up-front investment before the anticipated payoff is realized. While the prescription drug industry is an extreme example, lengthy product development cycles are the realities ventures face in many industries.

To meet these challenges, and others described in the chapter and throughout the book, many entrepreneurs like to partner with others to launch their ventures. A fertile place for young entrepreneurs to find potential business partners is to attend a Startup Weekend. A description of what a Startup Weekend is and why it represents a fertile place to find a business partner is describe in the nearby "Partnering for Success" feature.

Sources of Personal Financing

LEARNING OBJECTIVE

3. Identify and describe the three sources of personal financing available to entrepreneurs.

Typically, the seed money that gets a company off the ground comes from the founders' own pockets. There are three categories of sources of money in this area: personal funds, friends and family, and bootstrapping. These sources are depicted in Figure 10.2 and are explained next.

Personal Funds

The vast majority of founders contribute personal funds along with **sweat equity** to their ventures.[5] In fact, according to data compiled by Fundable, 57 percent of start-ups are funded, at least in part, by the entrepreneurs' personal savings and credit. The average amount invested is $48,000.[6] Sweat equity, which represents the value of the time and effort that a founder puts into a new venture, is also important. Because many founders do not have a substantial amount of cash to put into their ventures, it is often the sweat equity that makes the most difference.

Friends and Family

Friends and family are the second source of funds for many new ventures. According to the same Fundable data, 38 percent of start-ups receive funds from friends and family, with an average investment of $23,000.[7] This type of contribution often comes in the form of loans or investments, but can also involve outright gifts, foregone or delayed compensation (if a friend or family member works for the new venture), or reduced or free rent. For example, Cisco Systems, the giant producer of Internet routers and switches, started in the house of one of its cofounder's parents.

There are three rules of thumb that entrepreneurs should follow when asking friends and family members for money. First, the request should be presented in a businesslike manner, just as one would deal with a banker or investor. The potential of the business along with the risks involved should be carefully and

FIGURE 10.2
Sources of Personal Financing

Personal Funds	Friends and Family	Bootstrapping
Involves both financial resources and sweat equity. Sweat equity represents the value of the time and effort that a founder puts into a firm.	Often comes in the form of loans or investments, but can also involve outright gifts, foregone or delayed compensation, or reduced or free rent.	Finding ways to avoid the need for external financing through creativity, ingenuity, thriftiness, cost-cutting, obtaining grants, or any other means.

fully described. Second, if the help the entrepreneur receives is in the form of a loan, a promissory note should be prepared, with a repayment schedule, and the note should be signed by both parties. Stipulating the terms of the loan in writing reduces the potential of a misunderstanding and protects both the entrepreneur and the friend or family member providing the funding. Third, financial help should be requested only from those who are in a legitimate position to offer assistance. It is not a good idea to ask certain friends or family members, regardless of how much they may have expressed a willingness to help, for assistance if losing the money would cripple them financially. Entrepreneurs who are unable to repay a loan to a friend or family member risk not only damaging their business relationship with them, but their personal relationship as well.[8]

Loan agreements to facilitate a friends and family loan can be obtained via an attorney. There are also Internet-based companies that walk entrepreneurs and friends or family members who are willing to make a loan through the steps of preparing a legally enforceable loan agreement and promissory note. Examples include LegalZoom, RocketLawyer, and Nolo. A **promissory note** details the terms of a loan agreement. If you'd like to see how it works, go to RocketLawyer.com/LoanAgreement and follow the online prompts.

Bootstrapping

Bootstrapping is a third source of seed money for new ventures. **Bootstrapping** is finding ways to avoid the need for external financing or funding through creativity, ingenuity, thriftiness, cost-cutting, or any means necessary.[9] (The term comes from the adage "pull yourself up by your bootstraps.") It is the term attached to the general philosophy of minimizing start-up expenses by aggressively pursuing cost-cutting techniques and money-saving tactics. There are many well-known examples of entrepreneurs who bootstrapped to get their companies started. Legend has it that Steve Jobs and partner Steve Wozniak sold a Volkswagen van and a Hewlett-Packard programmable calculator to raise $1,350, which was the initial seed capital for Apple Computer.

There are many ways entrepreneurs bootstrap to raise money or cut costs. Some of the more common examples of bootstrapping are provided in Table 10.1. A simple example of bootstrapping is that fax machines are no longer an absolute necessity, in most cases. There are several web-based services that allow businesses to fax documents for free or for a small monthly fee, as long as they have a scanner and are able to scan the document into a word processing program. The document can then be sent to the recipient's fax machine and it will print out as a normal fax. Examples of companies that offer variations of this service are eFax, MyFax, and OnlineFaxes. The overarching point is that a little ingenuity (learning how to fax for free, for example) can save an entrepreneur the cost of purchasing a fax machine.

TABLE 10.1 Examples of Bootstrapping Methods

- Buy used instead of new equipment
- Coordinate purchases with other businesses
- Lease equipment instead of buying
- Obtain payments in advance from customers
- Minimize personal expenses
- Avoid unnecessary expenses, such as lavish office space or furniture
- Buy items cheaply, but prudently, through discount outlets or online auctions such as eBay, rather than at full-price stores
- Share office space or employees with other businesses
- Hire interns

While bootstrapping and using personal funds are highly recommended actions in almost all start-up situations, there are subtle downsides. Cost-cutting and saving money are admirable practices, but pushing these practices too far can hold a business back from reaching its full potential. For example, renting space in a community incubator or building where other start-ups are located, rather than working from home, may be worth it if it provides entrepreneurs access to a network of people who can be relied on to provide social support and business advice.[10]

Preparing to Raise Debt or Equity Financing

LEARNING OBJECTIVE

4. Identify and explain the three steps involved in properly preparing to raise debt or equity financing.

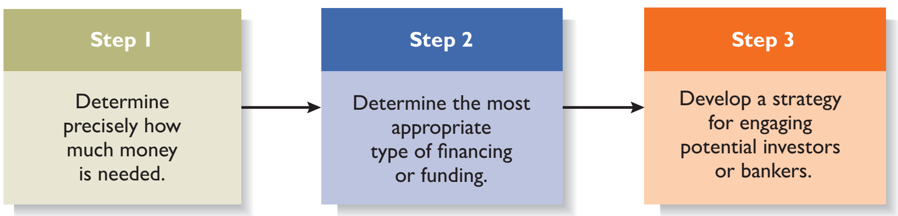
Once a start-up's financial needs exceed what personal funds, friends and family, and bootstrapping can provide, debt and equity are the two most common sources of funds. The most important thing an entrepreneur must do at this point is determine precisely what the company needs and the most appropriate source to use to obtain those funds. A carefully planned approach to raising money increases a firm's chance of success and can save an entrepreneur considerable time.

The steps involved in properly preparing to raise debt or equity financing are shown in Figure 10.3 and are discussed next.

Step 1 **Determine precisely how much money the company needs.** Constructing and analyzing documented cash flow statements and projections for needed capital expenditures are actions taken to complete this step. This information should already be in the business plan, as described in Chapter 6. Knowing exactly how much money to ask for is important for at least two reasons. First, a company doesn't want to get caught short, yet it doesn't want to pay for capital it doesn't need. Second, entrepreneurs talking to a potential lender or investor make a poor impression when they appear uncertain about the amount of money required to support their venture.

Step 2 **Determine the most appropriate type of financing or funding.** Equity and debt financing are the two most common alternatives for raising money. **Equity financing** (or funding) means exchanging partial ownership of a firm, usually in the form of stock, in return for funding. Angel investors, private placement, venture capital, and initial public offerings are the most common sources of equity funding (we discuss all these sources later in the chapter). Equity funding is not a loan—the money that is received is not paid back. Instead, equity investors become partial owners of the firm. Some equity investors invest "for the long haul" and are content to receive a return on their investment through dividend payments on their stock. More commonly, equity investors have a three- to five-year investment horizon and expect to get their money back, along with a substantial capital gain, through the sale of their stock. The stock is typically sold following a **liquidity event**, which is an occurrence that converts some or all of a company's

FIGURE 10.3
Preparation for Debt or Equity Financing



stock into cash. The three most common liquidity events for a new venture are when it goes public, finds a buyer, or merges with another company.

Because of the risks involved, equity investors are very demanding and fund only a small percentage of the business plans they consider.[11] An equity investor considers a firm that has a unique business opportunity, high growth potential, a clearly defined niche market, and proven management to be an ideal candidate. In contrast, businesses that don't fit these criteria have a hard time getting equity funding. Many entrepreneurs are not familiar with the standards that equity investors apply and get discouraged when they are repeatedly turned down by venture capitalists and angel investors. Often, the reason they don't qualify for venture capital or angel investment isn't because their business proposal is poor, but because they don't meet the exacting standards equity investors usually apply.[12]

Debt financing is getting a loan. The most common sources of debt financing are commercial banks and Small Business Administration (SBA) guaranteed loans. The types of bank loans and SBA guaranteed loans available to entrepreneurs are discussed later in this chapter. In general, banks lend money that must be repaid with interest. Banks are not investors. As a result, bankers are interested in minimizing risk, properly collateralizing loans, and repayment, as opposed to return on investment and capital gains. The ideal candidate for a bank loan is a firm with a strong cash flow, low leverage, audited financial statements, good management, and a healthy balance sheet. A careful review of these criteria demonstrates why it is difficult for start-ups to receive bank loans. Most start-ups are simply too early in their life cycle to have the set of characteristics bankers want.

Table 10.2 provides an overview of three common profiles of new ventures and the type of financing or funding that is appropriate for each one. This table illustrates why most start-ups must rely on personal funds, friends and family, and bootstrapping at the outset and must wait until later to obtain equity or debt financing. Indeed, most new ventures do not have the characteristics required by bankers or investors until they have proven their product or service idea and have achieved a certain measure of success in the marketplace.

Step 3 **Developing a strategy for engaging potential investors or bankers.** There are three steps to developing a strategy for engaging potential investors or bankers. First, the lead entrepreneurs in a new venture should prepare an **elevator speech (or pitch)**—a brief, carefully constructed statement that outlines the merits of a business opportunity. Why is it called an elevator speech? If an entrepreneur stepped into an elevator on the 25th floor of a building and found that by a stroke of luck a potential investor was in the same elevator, the entrepreneur would have the time it takes to get from the 25th floor to the ground floor to try to get the investor interested in the business opportunity. Most elevator speeches are 45 seconds to 2 minutes long.[13]

There are many occasions when a carefully constructed elevator speech might come in handy. For example, many university-sponsored centers for entrepreneurship hold events that bring investors and entrepreneurs together. Often, these events include social hours and refreshment breaks designed specifically for the purpose of allowing entrepreneurs looking for funding to mingle with potential investors. An outline for a 60-second elevator speech is provided in Table 10.3.

TABLE 10.2 Matching an Entrepreneurial Venture's Characteristics with the Appropriate Form of Financing or Funding

Characteristics of the Venture	Appropriate Source of Financing or Funding
The business has high risk with an uncertain return:	Personal funds, friends and family, and other forms of bootstrapping
Weak cash flow	
High leverage	
Low to moderate growth	
Unproven management	
The business has low risk with a more predictable return:	Debt financing
Strong cash flow	
Low leverage	
Audited financials	
Good management	
Healthy balance sheet	
The business offers a high return:	Equity
Unique business idea	
High growth	
Niche market	
Proven management	

The second step in developing a strategy for engaging potential investors or bankers is more deliberate and requires identifying and contacting the best prospects. First, the new venture should carefully assess the type of financing or funding it is likely to qualify for, as depicted in Table 10.2. Then, a list of potential bankers or investors should be compiled. If venture capital funding is felt to be appropriate, for example, a little legwork can go a long way in pinpointing likely investors. A new venture should identify the venture funds that are investing money in the industry in which it intends to compete and target those firms first. To do this, look to the venture capital firms' websites. These reveal the industries in which the firms have an interest. Sometimes, these sites also provide a list of the companies the firm has funded. For an example, access the website of Sequoia Capital (www.sequoiacap.com), a well-known venture capital firm.

A cardinal rule for approaching a banker or an investor is to get a personal introduction. Bankers and investors receive many business plans, and most of them end up in what often becomes an unread stack of paper in a corner in their offices. To have your business plan noticed, find someone who knows the banker or the investor and ask for an introduction.

The third step in engaging potential investors or bankers is to be prepared to provide the investor or banker a completed business plan and make a presentation of the plan if requested. We looked at how to present a business plan in Chapter 6. The presentation should be as polished as possible and should demonstrate why the new venture represents an attractive endeavor for the lender or investor.

TABLE 10.3 Guidelines for Preparing an Elevator Speech

The elevator speech is a very brief description of your opportunity, product idea, qualifications, and market. Imagine that you step into an elevator in a tall building and a potential investor is already there; you have about 60 seconds to explain your business idea.

Step 1 Describe the opportunity or problem that needs to be solved	20 seconds
Step 2 Describe how your product or service meets the opportunity or solves the problem	20 seconds
Step 3 Describe your qualifications	10 seconds
Step 4 Describe your market	10 seconds
Total	60 seconds

Sources of Equity Funding

LEARNING OBJECTIVE

5. Explain the three most important sources of equity funding that are available to the entrepreneurial firm.

The primary disadvantage of equity funding is that the firm's owners relinquish part of their ownership interest and may lose some control. The primary advantage is access to capital. In addition, because investors become partial owners of the firms in which they invest, they often try to help those firms by offering their expertise and assistance. Unlike a loan, the money received from an equity investor doesn't have to be paid back. The investor receives a return on the investment through dividend payments and by selling the stock.

Next, we describe the three most common forms of equity funding.

Business Angels

Business angels are individuals who invest their personal capital directly in start-ups. The term *angel* was first used in conjunction with finance to describe wealthy New Yorkers who invested in Broadway plays. The prototypical business angel, who invests in entrepreneurial start-ups, is about 50

Antonio Guillem/Shutterstock

An entrepreneurial career can be full of thrilling moments. This team of entrepreneurs just received an e-mail message from an angel investor who committed to invest $60,000 in their start-up.

years old, has high income and wealth, is well educated, has succeeded as an entrepreneur, and invests in companies that are in the region where he or she lives.[14] These investors generally invest between $10,000 and $500,000 in a single company and are looking for companies that have the potential to grow 30 to 40 percent per year before they are acquired or go public.[15] Many well-known firms have received their initial funding from one or more business angels. For example, Apple received its initial investment capital from Mike Markkula, who obtained his wealth as an executive with Intel. In 1977, Markkula invested $91,000 in Apple and personally guaranteed another $250,000 in credit lines. When Apple went public in 1980, his stock in the company was worth more than $150 million.[16] Similarly, in 1998, Google received its first investment from Sun Microsystems's cofounder Andy Bechtolsheim, who gave Larry Page and Sergey Brin (Google's cofounders) a check for $100,000 after they showed him an early version of Google's search engine.[17] Can you imagine what Bechtolsheim's investment was worth when Google went public in 2005?

There were 304,930 active angel investors in 2015, which is the most recent count available.[18] The number of angel investors has increased dramatically over the past decade.[19] The rapid increase is due in part to the high returns that some angels report. In 2015, angels invested $24.6 billion in ventures; this was an increase of 1.9 percent over 2014. The average deal size was $345,390, which generally included more than one investor. A total of 71,110 start-ups received funding. Software accounted for the largest share of angel investment in 2015, with 18 percent of total investment, followed by Healthcare Services/Medical Devices and Equipment (16 percent), Biotech (13 percent), Industrial/Energy (11 percent), Retail (10.6 percent), and Media (9 percent). The average equity received was 14.9 percent with deal valuation at $2.32 million.[20] According to the Center for Venture Research at the University of New Hampshire, the yield rate for angel investments in 2015 was 18 percent. The **yield rate** is defined as the percentage of investment opportunities that are brought to the attention of angel investors that result in an investment. This means that in 2015, an entrepreneur seeking an angel capital had a roughly 1 in 5 chance of getting an investment.[21]

Business angels are valuable because of their willingness to make relatively small investments. This gives access to equity funding to a start-up that needs just $75,000 rather than the $1 million minimum investment that most venture capitalists require. Many angels are also motivated by more than financial returns; they enjoy the process of mentoring a new firm. Most angels remain fairly anonymous and are matched with entrepreneurs through referrals. To find a business angel investor, an entrepreneur should discreetly work a network of acquaintances to see if anyone can make an appropriate introduction. An advantage that college students have in regard to finding business angels is that many angels judge college- or university-sponsored business plan or business model competitions. The number of organized groups of angels continues to grow. Typically, each group consists of 10 to 150 angel investors in a local area that meet regularly to listen to business plan presentations. An example of an angel group is the Central Texas Angel Network, (CTAN) located in Austin, TX. It is a relatively large angel group, with 165 angel investors with expertise in multiple industry sectors. The group has invested $75 million in more than 135 start-ups since its inception in 2006. The members of the CTAN invest in ventures and mentor the entrepreneurs in whom they choose to invest and connect them to resources. The process the network follows to vet investment opportunities is explained on the CTAN website, which is available at www.centraltexasangelnetwork.com.[22]

According to the Ewing Marion Kauffman Foundation, less than 3 percent of start-ups receive angel funding. Despite the small numbers, angel investors can add tremendous value to companies through access to capital along with their expertise, networks, and guidance.[23]

Venture Capital

Venture capital is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential.[24] According to the National Venture Capital Association, there are 798 venture capital firms in existence with $165.3 billion under management. In 2015, venture capital firms invested $28.2 billion in 3,709 companies.[25] The peak year for venture capital investing was 2000, when $98.6 billion was invested at the height of the e-commerce craze. A distinct difference between angel investors and venture capital firms is that angels tend to invest earlier in the life of a company, whereas venture capitalists come in later. The majority of venture capital money goes to follow-on funding for businesses that were originally funded by angel investors, government programs (which are discussed later in the chapter), or by some other means.

Venture capital firms are limited partnerships of money managers who raise money in "funds" to invest in start-ups and growing firms. The funds, or pools of money, are raised from high-net-worth individuals, pension plans, university endowments, foreign investors, and similar sources. In 2015, the average fund size was $135 million.[26] The investors who invest in venture capital funds are called **limited partners**. The venture capitalists, who manage the fund, are called **general partners**. The venture capitalists who manage the fund receive an annual management fee in addition to 20 to 25 percent of the profits earned by the fund. The percentage of the profits the venture capitalists receive is called the **carry**. So if a venture capital firm raised a $100 million fund and the fund grew to $500 million, a 20 percent carry means that the firm would get, after repaying the original $100 million, 20 percent of the $400 million in profits, or $80 million. Some venture capital firms invest in specific areas. For example, Foundry Group invests in information technology start-ups.[27] Similarly, BEV Capital invests exclusively in consumer-oriented businesses and technology companies that service consumer-oriented businesses. Examples of firms in their portfolio include Redfin (online real-estate brokerage), Brendon Publishing International (a publisher of value-priced children's books), Cool Cuts 4 Kids (a chain of hair cut salons for children ages 0–12), and Adexa (a supply chain planning software company).[28]

Because of the venture capital industry's lucrative nature and because in the past venture capitalists have funded high-profile successes such as Google, Facebook, Snap, and Twitter, the industry receives a great deal of attention. But actually, venture capitalists fund less than 1 percent of new firms.[29] As mentioned previously in this chapter, many entrepreneurs become discouraged when they are repeatedly rejected for venture capital funding, even though they may have an excellent business plan. Venture capitalists are looking for the "home run." The result is that they do not fund the majority of business plans they receive and review.

Still, for the firms that qualify, venture capital is a viable alternative to equity funding. An advantage to obtaining this funding is that venture capitalists are extremely well connected in the business world (by this we mean that they have a large number of useful contacts with customers, suppliers, government representatives, and so forth) and can offer a firm considerable assistance beyond funding. Firms that qualify typically obtain their money in stages that correspond to their own stage of development. Once a venture capitalist makes an investment in a firm, subsequent investments are made in **rounds** (or stages) and are referred to as **follow-on funding**. Table 10.4 shows the various stages in the venture capital process, from the seed stage to buyout financing.

An important part of obtaining venture capital funding is going through the **due diligence** process, which refers to the process of investigating the merits of a potential venture and verifying the key claims made in the business plan. Firms that prove to be suitable for venture capital funding should conduct

TABLE 10.4 Rounds (or Stages) of Venture Capital Funding

Round or Stage	Purpose of the Funding
Seed funding	Investment made very early in a venture's life to fund the development of a prototype and feasibility analysis.
Start-up funding	Investment made to firms exhibiting few if any commercial sales but in which product development and market research are reasonably complete. Management is in place, and the firm has its business model. Funding is needed to start production.
First-stage funding	Funding that occurs when the firm has started commercial production and sales but requires financing to ramp up its production capacity.
Second-stage funding	Funding that occurs when a firm is successfully selling a product but needs to expand both its capacity and its markets.
Mezzanine financing	Investment made in a firm to provide for further expansion or to bridge its financing needs before launching an IPO or before a buyout.
Buyout funding	Funding provided to help one company acquire another.

their own due diligence of the venture capitalists with whom they are working to ensure that they are a good fit. An entrepreneur should ask the following questions and scrutinize the answers to them before accepting funding from a venture capital firm:

- Do the venture capitalists have experience in our industry?
- Do they take a highly active or passive management role?
- Are the personalities on both sides of the table compatible?
- Does the firm have deep enough pockets or sufficient contacts within the venture capital industry to provide follow-on rounds of financing?
- Is the firm negotiating in good faith in regard to the percentage of our firm they want in exchange for their investment?

Along with traditional venture capital, there is also **corporate venture capital**. This type of capital is similar to traditional venture capital except that the money comes from corporations that invest in start-ups related to their areas of interest.[30] Corporate venture capital firms provide an estimated 10.5 percent of the venture capital invested by all venture groups. Examples of corporate venture capital firms include Intel Capital, GV (formally Google Ventures), GE Ventures, and Time Warner Investments.

Just because a firm receives venture capital funding does not mean it will be successful. In fact, venture-funded firms are under extreme pressure to perform to meet investors' expectations. A firm that received venture capital funding, DrawQuest, and regrettably failed is profiled in the nearby "What Went Wrong?" feature. The feature includes a heartfelt statement by its founder, Chris Poole, which provides unique insight into how failing after taking money from venture capitalists feels.

Initial Public Offering

Another source of equity funding is to sell stock to the public by staging an **initial public offering (IPO)**. An IPO is the first sale of stock by a firm to the public. Any later public issuance of shares is referred to as a **secondary market offering**. When a company goes public, its stock is typically traded on one of the major stock exchanges. Most entrepreneurial firms that go public trade on

WHAT WENT WRONG?

How One Start-Up Caught the Attention of VCs, Gained 25,000 Daily Users, and Still Failed

DrawQuest was launched in February 2013 by Christopher Poole. It was a pivot—an earlier version of the product was called Canvas. DrawQuest was an app built for the iPad, iPhone, and iPad Touch. The idea was to encourage creativity through a daily drawing challenge.

Here's how it worked. Each day, a drawing challenge was posted. The DrawQuest screen would display part of a picture and challenge the user to complete it. For example, the screen might show a picture of a child looking out into the water, and the challenge would be "What's in the water?" The user would then complete the picture. Other examples include a screen with a hat at the top, and the challenge would be "Who's wearing the hat?" Similarly, the screen might include a person standing on a balcony, and the challenge would be "What can you see from the balcony?" The DrawQuest app provided a basic kit of online drawing tools to complete the picture. The point wasn't to create an elegant drawing. In fact, the tools resulted in the drawings being somewhat cartoonish in nature. The point was to force people to be creative by deciding what to put in the water or what could be seen from the balcony. The app and the basic set of drawing tools were free. DrawQuest made money be selling upgrades to the kit of drawing tools, like better brushes, additional palettes of paint, more vivid colors, and so forth.

The app itself did well. In the short year it was in existence it reached 1.4 million downloads, 550,000 registered users, 400,000 monthly users, and 25,000 daily users. One of the draws was becoming part of the DrawQuest community. You could follow friends and view their drawings. One of the coolest features was instant replay. You could watch a replay of a friend drawing his or her picture.

To fund the venture, DrawQuest raised money from marquee investors. A $625,000 seed fund was raised in 2010 (when the founders were working on a different app), and $3 million was raised in two subsequent venture rounds from Union Square Ventures, Andreessen Horowitz, Lerer Ventures, Chris Dixon, and several others. Despite all of this, DrawQuest failed. What went wrong?

In a heartfelt bog post titled "Today My Startup Failed" and in an interview with TechCrunch, Poole outlined the reasons that led to DrawQuest's demise. In short, the company never figured out the business side of the venture. The in-app upgrades, such as better paintbrushes and enhanced palettes of paint, didn't sell as well as anticipated, leaving DrawQuest with insufficient income. Part of the problem was that users didn't feel a sense of urgency to upgrade. A large portion of Candy Crush's success, for example, is that people buy extra lives. DrawQuest didn't have the same emotional "I can't play if I don't pay" urgency. The DrawQuest app was also expensive to develop and maintain. Another issue DrawQuest encountered was the pivot that Poole and his team executed. Prior to DrawQuest, the team built an app named Canvas that did not work out. They pivoted to DrawQuest, which resonated better with users and drew a larger audience. The problem is that they spent half their investors' money on Canvas. Referring to that challenge, Poole wrote, "We built this app (DrawQuest) with less than half of our runway remaining. You have to do twice as much with half as much money. It's really freaking hard."

Ultimately, Poole and his team decided to pull the plug. They investigated selling DrawQuest to another company, but no one bit. In the blog post titled "Today My Startup Failed," Poole provided insight into the human side of business failure. He wrote:

> I'm disappointed that I couldn't produce a better outcome for those who supported me the most—my investors and employees. Few in business will know the pain of what it means to fail as a venture-backed CEO. Not only do you fail your employees, your customers, and yourself, but you fail your investors—partners who helped you bring your idea to life.

Questions for Critical Thinking

1. Examine the problems that DrawQuest encountered. How could the company have avoided or navigated around each problem?
2. What alternatives did DrawQuest have for generating income for its app? Why do you think the company didn't try any of these alternatives before shutting down?
3. Based on what you learned in Chapter 4, complete a Barringer/Ireland Business Model template for DrawQuest. Is there anything that is noticeable in the business model template that may have forecast that DrawQuest would have a hard time surviving?
4. A common start-up idea on college and university campuses is to build a smartphone app. What lessons can students building apps learn from DrawQuest's experience?

Sources: C. Poole, "Today My Startup Failed," Chris Hates Writing blog, available at https://chrishateswriting.com/post/74083032842/today-my-startup-failed (accessed April 21, 2017); J. Constine, "With Traction but Out of Cash, 4Chan Founder Kills off Canvas/DrawQuest," TechCrunch, available at https://techcrunch.com/2014/01/21/when-goods-not-good-enough/ (posted January 21, 2014, accessed April 21, 2017); E. Hamburger, "4chan Creator Chris Poole Draws a Future Where Anyone Can Make Art," The Verge, available at https://www.theverge.com/2013/2/8/3942110/drawquest-for-ipad-chris-poole-moot (posted February 8, 2013, accessed April 21, 2017).

the NASDAQ, which is weighted heavily toward technology, biotech, and small-company stocks.[31] An IPO is an important milestone for a firm.[32] Typically, a firm is not able to go public until it has demonstrated that it is viable and has a bright future.

Firms decide to go public for several reasons. First, it is a way to raise equity capital to fund current and future operations. Second, an IPO raises a firm's public profile, making it easier to attract high-quality customers, alliance partners, and employees. Third, an IPO is a liquidity event that provides a mechanism for the company's stockholders, including its investors, to cash out their investments. Finally, by going public, a firm creates another form of currency that can be used to grow the company. It is not uncommon for one firm to buy another company by paying for it with stock rather than with cash.[33] The stock comes from "authorized but not yet issued stock," which in essence means that the firm issues new shares of stock to make the purchase. Examples of well-known firms that have gone public in recent years include Twillo, Square, GoDaddy, and Snap (the parent company of Snapchat).

Although there are many advantages to going public, it is a complicated and expensive process and subjects firms to substantial costs related to SEC reporting requirements. Many of the most costly requirements were initiated by the **Sarbanes-Oxley Act** of 2002. The Sarbanes-Oxley Act is a federal law that was passed in response to corporate accounting scandals involving prominent corporations, such as Enron and WorldCom. This wide-ranging act established a number of new or enhanced reporting standards for public corporations. As with all legislation, potential future changes to this law would alter its impact on firms including entrepreneurial ventures.

The first step in initiating a public offering is for a firm to hire an investment bank. An **investment bank** is an institution that acts as an underwriter or agent for a firm issuing securities.[34] The investment bank acts as the firm's advocate and adviser and walks it through the process of going public. The most important issues the firm and its investment bank must agree on are the amount of capital needed by the firm, the type of stock to be issued, the price of the stock when it goes public (e.g., $20 per share), and the cost to the firm to issue the securities.

An investment bank must satisfy a number of stipulations to assure the Securities and Exchange Commission (SEC) that the offer is legitimate. During the time the SEC is investigating the potential offering, the investment bank issues a **preliminary prospectus** that describes the offering to the general public. The preliminary prospectus is also called the "red herring." After the SEC has approved the offering, the investment bank issues the **final prospectus**, which sets a date and issuing price for the offering.

In addition to getting the offering approved, the investment bank is responsible for drumming up support for the offering. As part of this process, the investment bank typically takes the top management team of the firm wanting to go public on a **road show**, which is a whirlwind tour that consists of meetings in key cities, where the firm presents its business plan to groups of investors.[35] Until December 1, 2005, the presentations made during these road shows were seen only by the investors physically present in the various cities; an SEC regulation went into effect at that time requiring that road show presentations be taped and made available to the public. Road show presentations can be viewed online at www.retailroadshow.com. If enough interest in a potential public offering is created, the offering will take place on the date scheduled in the prospectus. If there isn't, the offering will be delayed or canceled.

Timing and luck play a role in whether a public offering is successful. For example, a total of 447 IPOs raised about $65 billion in 1999, the height of the Internet bubble. When the bubble burst in early 2001, the IPO marketplace all but dried up, particularly for technology and telecom stocks. Since then, the market has recovered. There were 117 IPOs in 2015, which raised a total of

$21.86 billion. That number is down from 2014, which produced 2017 IPOs and $42.3 billion in invested capital.[36] The vitality of the IPO market hinges largely on the state of the overall economy and the mood of professional investors. However, even when facing a strong economy and a positive mood toward investing, an entrepreneurial venture should guard itself against becoming caught up in the euphoria and rushing its IPO.

A variation of the IPO is a **private placement**, which is the direct sale of an issue of securities to a large institutional investor. When a private placement is initiated, there is no public offering, and no prospectus is prepared.

Sources of Debt Financing

LEARNING OBJECTIVE

6. Describe common sources of debt financing entrepreneurial firms use.

Debt financing involves getting a loan or selling corporate bonds. Because it is virtually impossible for a new venture to sell corporate bonds, we'll focus on obtaining loans.

There are two common types of loans. The first is a **single-purpose loan**, in which a specific amount of money is borrowed that must be repaid in a fixed amount of time with interest. The second is a **line of credit**, in which a borrowing "cap" is established and borrowers can use the credit at their discretion. Lines of credit require periodic interest payments.

There are two major advantages to obtaining a loan as opposed to equity funding. The first is that none of the ownership of the firm is surrendered—a major advantage for most entrepreneurs. The second is that interest payments on a loan are tax deductible, in contrast to dividend payments made to investors, which are not.

There are two major disadvantages of getting a loan. The first is that it must be repaid, which may be difficult in a start-up venture in which the entrepreneur is focused on getting the company off the ground. Cash is typically "tight" during a new venture's first few months and sometimes for a year or more. The second is that lenders often impose strict conditions on loans and insist on ample collateral to fully protect their investment. Even if a start-up is incorporated, a lender may require that an entrepreneur's personal assets be collateralized as a condition of the loan. In addition, a lender may place a stipulation on a loan, such that the borrower must "maintain a cash balance of $25,000 or more" in its checking account or the loan will become due and payable.

The three common sources or categories of debt financing available to entrepreneurs are described next.

Commercial Banks

Historically, commercial banks have not been viewed as practical sources of financing for start-up firms.[37] This sentiment is not a knock against banks; it is just that banks are risk averse, and financing start-ups is risky business. Instead of looking for businesses that are "home runs," which is what venture capitalists seek to do, banks look for customers who will reliably repay their loans. As shown in Table 10.2, banks are interested in firms that have a strong cash flow, low leverage, audited financials, good management, and a healthy balance sheet. Although many new ventures have good management, few have the other characteristics, at least initially. But banks are an important source of credit for small businesses later in their life cycles.

There are two reasons that banks have historically been reluctant to lend money to start-ups. First, as mentioned previously, banks are risk averse. In addition, banks frequently have internal controls and regulatory restrictions prohibiting them from making high-risk loans. So when an entrepreneur approaches a banker with a request for a $250,000 loan and the only collateral he or she has to offer is the recognition of a problem that needs to be solved, a plan to solve it, and perhaps some intellectual property, there is usually no practical way for the bank to help. Banks typically have standards that guide their lending, such as minimum debt-to-equity ratios that work against start-up entrepreneurs.

The second reason banks have historically been reluctant to lend money to start-ups is that lending to small firms is not as profitable as lending to large firms, which have been the staple clients of commercial banks. If an entrepreneur approaches a banker with a request for a $25,000 loan, it may simply not be worth the banker's time to complete the due diligence necessary to determine the entrepreneur's risk profile. Considerable time is required to digest a business plan and investigate the merits of a new firm. Research shows that a firm's size is an important factor in determining its access to debt capital.[38] The $25,000 loan may be seen as both high risk and marginally profitable (based on the amount of time it would take to do the due diligence involved), making it doubly uninviting for a commercial bank.[39]

Despite these historical precedents, some banks are starting to engage start-up entrepreneurs—although the jury is still out regarding how significant these lenders will become. When it comes to start-ups, some banks are rethinking their lending standards and are beginning to focus on cash flow and the strength of the management team rather than on collateral and the strength of the balance sheet. Entrepreneurs should follow developments in this area closely.

SBA Guaranteed Loans

Commercial banks, savings and loans, credit unions, and other specialized lenders are eligible to participate in the **SBA Guaranteed Loan Program**. The most notable SBA program available to small businesses is the **7(A) Loan Guaranty Program**. This program accounts for 90 percent of the SBA's loan activity. The program operates through private-sector lenders who provide loans that are guaranteed by the SBA. The loans are for small businesses that are unable to secure financing on reasonable terms through normal lending channels. The SBA does not currently have funding for direct loans, other than a program to fund direct loans for businesses in geographic areas that are hit by natural disasters.

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The SBA Guaranteed loan program enables banks to loan money to qualified entrepreneurs to start or grow their businesses. This young entrepreneur received a $150,000 SBA guaranteed loan through a commercial bank to finance her florist shop.

Almost all small businesses are eligible to apply for an SBA guaranteed loan. The SBA can guarantee as much as 75 percent (debt to equity) on loans up to $5 million. For loans of $150,000 or under, the guaranteed amount is 85 percent. Guaranteed loan funds can be used for almost any legitimate business purpose. The maximum lengths of the loans are 7 years for working capital, 10 years for equipment (or useful life of equipment), and 25 years for real estate purchase. To obtain an SBA guaranteed loan, an application must meet the requirements of both the SBA and the lender. Typically, individuals must pledge all of their assets to secure the loan. Interest rates are negotiated between the borrower and the lender but are subject to SBA maximums.[40] The average SBA 7(A) loan amount in 2015 was $371,628.[41]

Although SBA guaranteed loans are utilized more heavily by existing small businesses than start-ups, they should not be dismissed as a possible source of funding. There is a general misconception that the SBA is a "lender of last resort" and only distressed businesses qualify for SBA guaranteed loans. Just the opposite is true. Only viable businesses are eligible under the SBA 7(A) Loan Guaranty Program.[42]

The SBA has several loan programs that apply under special circumstances. For example, the SBA Microloan program provides loans up to $50,000 to help small businesses and certain not-for-profit childcare centers start and expand. The average microloan is about $13,000. The SBA has several disaster loan programs, which provide low-interest disaster loans to businesses of all sizes. You can learn more about these programs at www.sba.gov.

Other Sources of Debt Financing

There are a variety of other avenues business owners can pursue to borrow money or obtain credit. There is a group of online lenders, including OnDeck, Kabbage, and BlueVine that provide loans to businesses. Depending on the company, loans are available from $2,000 to $2 million. Interest rates are normally higher than those charged by a commercial bank, so it is advisable to check the terms carefully.[43] A similar category of loans are peer-to-peer loans facilitated by peer-to-peer lenders. **Peer-to-peer lenders** underwrite borrowers but don't fund the loans directly. Instead, they act as intermediaries between borrowers and individuals or borrowers and institutional investors. Funding Circle, Lending Club, and StreetShares are examples of peer-to-peer lenders. Similar to online lenders, the thing to watch out for when considering peer-to-peer loans is the annual percentage rate, which in many cases is very high.[44]

There are still other options for financing that entrepreneurs can consider. **Vendor credit** (also known as trade credit) is the credit extended to a business by a vendor in order to allow the business to buy its products and/or services up front but defer payment until later. The practice is especially common in retail, but it can be seen in other businesses as well. An example of vendor credit occurs when a retailer orders product from a vendor that ships it on net 30 terms. This means that the retailer has 30 days to submit payment for the product. The idea is that the retailer doesn't have money to pay for the product until it is sold; as such, the vendor agrees to wait on payment to give the retailer enough time to sell the product and collect the money needed to pay the bill. Some retailers will negotiate up to net 90 terms, meaning that they have 90 days to make payment.

Although not really debt financing, factoring is another way that businesses generate cash. **Factoring** is a financial transaction whereby a business sells its account receivable to a third party, called a factor, at a discount in exchange for cash.[45] Dealstruck, BlueVine, and Fundbox are examples of factoring companies.

Creative Sources of Financing and Funding

LEARNING OBJECTIVE

7. Describe several creative sources of financing entrepreneurial firms may choose to use.

Because financing and funding are difficult to obtain, particularly for start-ups, entrepreneurs often use creative ways to obtain financial resources. Even for firms that have financing or funding available, it is prudent to search for sources of capital that are less expensive than traditional ones. The following sections discuss five of the more common creative sources of financing and funding for entrepreneurial firms.

Crowdfunding

A popular creative source of funding for new businesses is crowdfunding. **Crowdfunding** is the practice of funding a project or new venture by raising monetary contributions from a large number of people, typically via the Internet.

There are two types of crowdfunding sites: rewards-based crowdfunding and equity-based crowdfunding. **Rewards-based crowdfunding** allows entrepreneurs to raise money in exchange for some type of amenity or reward. Kickstarter and Indiegogo are the most popular rewards-based crowdfunding sites. These sites allow entrepreneurs to create a profile, list their fund-raising goals, and provide an explanation (typically via video) of how the funds will be used. Individuals then pledge money in exchange for some type of amenity, such as being one of the first 100 people to obtain the company's product. The site takes a small percentage of the funds raised by the individuals for their service. For most entrepreneurs, running a crowdfunding campaign achieves two goals. The first is to raise money. Most Kickstarter projects raise less than $10,000, but a growing number have raised substantial funding. For example, COOLEST, which makes a high-performance cooler that has a built-in blender, Bluetooth speakers, and a USB charger, raised $13.2 million from 62,642 donors on Kickstarter. The second reason is to gain exposure for a new product. Running a successful crowdfunding campaign enables business founders to reach an audience of early adopters, grow a community for a product, validate a market, get customer feedback and insight, and generate publicity and buzz.[46]

Currently, there are over 2,000 crowdfunding platforms worldwide. Some, such as Kickstarter and Indiegogo, help fund a wide range of creative projects and business start-ups. Others, such as Giveforward are narrow in scope. Giveforward utilizes crowdfunding to help people raise money for personal, medical, and charitable causes. If you're not familiar with how crowdfunding works, go to www.kickstarter.com and type "COOLEST Cooler" into the search engine. Although the campaign is over, Kickstarter leaves the campaign profiles up on its site indefinitely. Looking at COOLEST's campaign will provide you a good sense of how rewards-based crowdfunding campaigns work. Additional information on rewards-based crowdfunding is provided in Case 10.2, which focuses on Kickstarter, the most popular crowdfunding platform.

The second type of crowdfunding is equity-based crowdfunding. **Equity-based crowdfunding** helps businesses raise money by tapping individuals and professional investors who provide funding in exchange for equity in the business. Four of the more popular equity-based crowdfunding sites are MicroVentures, Fundable, Crowdfunder, and CircleUp. The catalyst for the advent of equity-based crowdfunding was the JOBS Act, which was passed in April of 2012. When equity-based crowdfunding was first introduced, it was limited to accredited investors. An **accredited investor** is a person who is permitted to invest in higher-risk investments such as business start-ups. In the United States, a person must have a net worth of at least $1 million (not including the value of their house) or have an income of at least $200,000 each year for the past two years (or $300,000 together with their spouse if married) and have the expectation to make the same amount in the current year. On

May 16, 2016, a revision of the JOBS Act was approved, which opened equity crowdfunding to individuals regardless of net worth or income.

Equity-based crowdfunding has taken time to gain traction, but is now gaining momentum. Over $300 million has been invested via CircleUp since 2012. Similarly, over $85 million has been invested through MicroVentures since 2009.

Leasing

A **lease** is a written agreement in which the owner of a piece of property allows an individual or business to use the property for a specified period of time in exchange for payments. The major advantage of leasing is that it enables a company to acquire the use of assets with very little or no down payment. Leases for facilities and leases for equipment are the two most common types of leases that entrepreneurial ventures undertake.[47] For example, many new businesses lease computers from Dell Inc. or other PC manufacturers. The advantage for the new business is that it can gain access to the computers it needs with very little money invested up-front.

There are many different players in the leasing business. Some vendors, such as Dell, lease directly to businesses. As with banks, the vendors look for lease clients with good credit backgrounds and the ability to make the lease payments. There are also **venture-leasing firms** that act as brokers, bringing the parties involved in a lease together. These firms are acquainted with the producers of specialized equipment and match these producers with new ventures that are in need of the equipment. One of the responsibilities of these firms is conducting due diligence to make sure that the new ventures involved will be able to make timely payments on their leases.

Most leases involve a modest down payment and monthly payments during the duration of the lease. At the end of an equipment lease, the new venture typically has the option to stop using the equipment, purchase it at fair market value, or renew the lease. Lease deals that involve a substantial amount of money should be negotiated and entered into with the same amount of scrutiny as when getting financing or funding. Leasing is almost always more expensive than paying cash for an item, so most entrepreneurs think of leasing as an alternative to equity or debt financing. Although the down payment is typically lower, the primary disadvantage is that at the end of the lease, the lessee doesn't own the property or equipment.[48] Of course, this may be an advantage if a company is leasing equipment, such as computers or copy machines, which can rather quickly become technologically obsolete.

SBIR and STTR Grant Programs

The Small Business Innovation Research (SBIR) and the Small Business Technology Transfer (STTR) programs are two important sources of early-stage funding for technology firms. These programs, as offered by the United States government, provide cash grants to entrepreneurs who are working on projects in specific areas. The main difference between the SBIR and the STTR programs is that the STTR program requires the participation of researchers working at universities or other research institutions. For the purpose of the program, the term *small business* is defined as an American-owned for-profit business with fewer than 500 employees. The principle researcher must also be employed by the business.[49]

The **SBIR Program** is a competitive grant program that provides over $2.5 billion per year to small businesses for early-stage and development projects. Each year, 11 federal departments and agencies are required by the SBIR to reserve a portion of their research and development funds for awards to small businesses. Table 10.5 shows the agencies that participate, along with the types

TABLE 10.5 Small Business Innovation Research: Three-Phase Program

Phase	Purpose of Phase	Duration	Funding Available (Varies by Agency)
Phase I	To demonstrate the proposed innovation's technical feasibility.	Up to 6 months	Up to $150,000
Phase II	Available to successful Phase I companies. The purpose of a Phase II grant is to develop and test a prototype of the innovation validated in Phase I.*	Up to 2 years	Up to $1 million
Phase III	Period in which Phase II innovations move from the research and development lab to the marketplace.	Open	No SBIR funding available; however, federal agencies may award non-SBIR-funded follow-on grants or contracts for products or processes that meet the mission needs of those agencies, or for further R&D.

*Some agencies have a fast-track program in which applicants can submit Phase I and Phase II applications simultaneously. Government agencies that participate in this program include the following: Department of Agriculture, Department of Commerce, Department of Defense, Department of Education, Department of Energy, Department of Health and Human Services, Department of Homeland Security, Department of Transportation, Environmental Protection Agency, NASA, National Institutes of Health, and National Science Foundation.

of areas that are funded. Guidelines for how to apply for the grants are provided on each agency's website, along with a description of the types of projects the agencies are interested in supporting. The SBIR is a three-phase program, meaning that firms that qualify have the potential to receive more than one grant to fund a particular proposal. These three phases, along with the amount of funding available for each phase, are as follows:

- **Phase I** is a six-month feasibility study in which the business must demonstrate the technical feasibility of the proposed innovation. Funding available for Phase I research is up to $150,000.
- **Phase II** awards for up to $1 million are granted for as long as two years to successful Phase I companies. The purpose of a Phase II grant is to develop and test a prototype of Phase I innovations.
- **Phase III** is the period during which Phase II innovations move from the research and development lab to the marketplace. No SBIR funds are involved. At this point, the business must find private funding or financing to commercialize the product or service. In some cases, such as with the Department of Defense, the government may be the primary customer for the product.

Historically, less than 15 percent of all Phase I proposals are funded, and about 30 percent of all Phase II proposals are funded. The payoff for successful proposals, however, is high. The money is essentially free. It is a grant, meaning that it doesn't have to be paid back and no equity in the firm is at stake. The recipient of the grant also retains the rights to the intellectual property developed while working with the support provided by the grant. The real payoff is in Phase III if the new venture can commercialize the research results.

The **STTR Program** is a variation of the SBIR for collaborative research projects that involve small businesses and research organizations, such as universities or federal laboratories. The main differences between the SBIR and the STTR offerings is that the STTR program requires the company to have a partnering research institution which must be awarded a minimum of 30 percent of the total grant funds.

More information about the SBIR and the STTR program can be obtained at www.sbir.gov.

Other Grant Programs

There are a limited number of other grant programs available to entrepreneurs. Obtaining a grant takes a little detective work. Granting agencies are, by nature, low-key, so they normally need to be sought out. A typical scenario of a small business that received a grant is provided by Rozalia Williams, the founder of Hidden Curriculum Education, a for-profit company which offers college life skills courses. To kick-start her business, Williams received a $72,500 grant from Miami-Dade Empowerment Trust, a granting agency in Dade County, Florida. The purpose of the Miami-Dade Empowerment Trust is to encourage the creation of businesses in disadvantaged neighborhoods of Dade County. The key to Williams's success, which is true in most grant-awarding situations, is that her business fit nicely with the mission of the granting organization, and she was willing to take her business into the areas the granting agency was committed to improving. After being awarded the grant and conducting her college prep courses in four Dade County neighborhoods over a three-year period, Williams received an additional $100,000 loan from the Miami-Dade Empowerment Trust to expand her business.[50] There are also private foundations that grant money to both existing and start-up firms. These grants are usually tied to specific objectives or a specific project, such as research and development in a specific area.

The federal government has grant programs beyond the SBIR and STTR programs described previously. The full spectrum of grants available is listed at www.grants.gov. State and local governments, private foundations, and philanthropic organizations also post grant announcements on their websites. Finding a grant that fits your business is the key. This is no small task. It is worth the effort, however, if you can obtain some or all of your start-up costs through a granting agency.

One thing to be careful of is grant-related scams. Business owners often receive unsolicited letters or e-mail messages from individuals or organizations that assure them that, for a fee, they can help the business gain access to hundreds of business-related grants. The reality is that there aren't hundreds of business-related grants that fit any one business. Most of these types of offers are scams.

Strategic Partners

Strategic partners are another source of capital for new ventures.[51] Indeed, strategic partners often play a critical role in helping young firms fund their operations and round out their business models.

Biotechnology companies, for example, rely heavily on partners for financial support, as illustrated in the nearby "Savvy Entrepreneurial Firm" feature. As mentioned in the feature, a small biotech firm would rarely have access to sufficient financial capital and other resources to take a new discovery from the lab all the way to market. It just takes too much time, capital, and other resources to pull off. As a result, small biotech firms rely on deep-pocketed strategic partners to perform parts of the process. Many strategic partnerships are also formed to gain access to a particular resource or to facilitate speed to market.[52] In exchange for access to plant and equipment and established distribution channels, new ventures bring an entrepreneurial spirit and new ideas to these partnerships. These types of arrangements can help new ventures lessen the need for financing or funding.

SAVVY ENTREPRENEURIAL FIRM

Working Together: How Biotech Firms and Large Drug Companies Bring Pharmaceutical Products to Market

Large firms and smaller entrepreneurial firms play different roles in business and society and can often produce the best results by partnering with each other rather than acting as adversaries. The pharmaceutical industry is an excellent example of how this works.

It is well known that barriers to entry in the pharmaceutical industry are high. The average new product takes between 10 and 15 years from discovery to commercial sale. The process of discovering, testing, obtaining approval, manufacturing, and marketing a new drug is long and expensive. How, then, do biotech start-ups make it? The answer is that few biotech firms actually take their products to market. Here's how it works.

Biotech firms specialize in discovering and patenting new drugs—it's what they're good at. In most cases, however, they have neither the money nor the know-how to bring the products to market. In contrast, the large drug companies, such as Johnson & Johnson, Pfizer, and Merck, specialize in developing and marketing drugs and providing information to doctors about them. It's what they are good at. But these companies typically don't have the depth of scientific talent and the entrepreneurial zeal that the small biotech firms do. These two types of firms need one another to be as successful as possible. Often, but not always, what happens is this. The biotech firms discover and patent new drugs, and the larger drug companies develop them and bring them to market. Biotech firms earn money through this arrangement by licensing or selling their patent-protected discoveries to the larger companies or by partnering with them in some revenue-sharing way. The large drug companies make money by selling the products to consumers.

The most compelling partnership arrangements are those that help entrepreneurial firms focus on what they do best, which is typically innovation, and that allow them to tap into their partners' complementary strengths and resources.

Questions for Critical Thinking

1. In your opinion, what factors in the business environment encourage firms to partner to compete?
2. What risks do small firms face when partnering with large, successful companies? What risks do large companies take when they rely on small firms as a source of innovation?
3. How might government policies affect partnering actions between small and large firms in the pharmaceutical industry?
4. If you worked for an entrepreneurial venture, what would you want to know about a large company before recommending that your firm form a partnership with it?

Chapter Summary

LO1. Commonly, entrepreneurs discover that trying to operate their business without borrowed funds or invested capital is difficult. Because of this, entrepreneurs need to understand the different approaches available to them to gain access to the amount of capital needed to successfully support their ventures in the pursuit of organizational success.

LO2. For three reasons—cash flow challenges, capital investment needs, and the reality of lengthy product development cycles—most new firms need to raise money at some point during the early part of their life. Firm growth can generate cash flow problems, typically because of the lag between the need to spend capital to generate additional revenue and the time required to earn positive returns from those investments. Founders of entrepreneurial ventures may be able to fund their firm's initial capital investment needs. But, larger investments are required to support firm growth that is the foundation for long-term success. In some instances, the time required for a product to be introduced can be lengthy. When this happens, additional investments are necessary to keep a firm going during what may be a lengthy product development cycle.

LO3. Personal funds, friends and family, and bootstrapping are the three sources of personal financing available to entrepreneurs. It is very common for entrepreneurs to use their own funds to invest in their ventures while simultaneously providing their "sweat equity" (or hard work) to keep the firm going. Entrepreneurs also receive support through funds provided by members of their family and their friends. These investments come in various forms, including loans and gifts. When bootstrapping, entrepreneurs find ways to avoid the need for external funding. Exercising their creativity and ingenuity and finding ways to reduce their firm's costs are examples of what entrepreneurs do to reduce the need for support from external funding sources. Indeed, entrepreneurs are often very creative in finding ways to bootstrap to raise money or cut costs. Additional examples of bootstrapping include minimizing personal expenses and putting all profits back into the business, establishing partnerships and sharing expenses with partners, and sharing office space and/or employees with other businesses.

LO4. The three steps involved in properly preparing to raise debt or equity financing are: Determine precisely how much money is needed, determine the type of financing or funding that is most appropriate, and develop a strategy for engaging potential investors or bankers. Cash flow statements are helpful to efforts to determine the amount of capital a firm requires at a point in time. When deciding how to finance their venture, entrepreneurs commonly choose between equity financing (in which partial ownership of the firm is exchanged for financial support) and debt financing (in which the entrepreneurs gain access to capital by taking out a loan). Entrepreneurs then develop an elevator pitch (which is a brief, carefully constructed statement outlining a business opportunity's merits), identify the best prospects to contact to seek financing, and prepare themselves to present a potential investor with an effectively developed business plan.

LO5. Business angels, venture capital, and an initial public offering (IPO) are the three most important sources of equity funding available to entrepreneurs. Business angels are individuals who invest their personal capital directly in start-ups. These investors tend to be high-net-worth individuals who generally invest between $10,000 and $500,000 in a single company. Venture capital is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential. Typically, venture capitalists invest at least $1 million in a single company. An initial public offering (IPO) is an important milestone for a firm for four reasons: It is a way to raise equity capital, it raises a firm's public profile, it is a liquidity event, and it creates another form of currency (company stock) that can be used to grow the company.

LO6. The sources of debt available to entrepreneurs include commercial banks, SBA guaranteed loans, and other sources such as vendor credit, factoring, peer-to-peer lending, and crowdfunding. Historically, commercial banks have been reluctant to loan funds to entrepreneurial ventures, largely because they are risk averse and because lending to smaller firms is less profitable for them compared to lending to large, established organizations. The main SBA program available to small businesses is the 7(A) Loan Guaranty Program. This program operates through private-sector lenders providing loans that are guaranteed by the SBA. The loans are for small businesses that are unable to secure financing on reasonable terms through normal lending channels. A relatively new source of funding is provided when entrepreneurs raise money through crowdfunding by generating contributions from a large number of individuals. Commonly, the Internet is used to generate funds in this manner.

LO7. Leasing and SBIR and STTR grant programs, along with other types of grant programs, are examples of creative opportunities entrepreneurs can pursue to obtain financial resources. A lease is a written agreement in which the owner of a piece of property allows an individual or business to use the property for a specified period of time in exchange for payments. The major advantage of leasing is that it enables a company to acquire the use of assets with very little or no down payment. The SBIR and STTR grant programs are important sources of early-stage funding for technology-based ventures.

Key Terms

7(A) Loan Guaranty Program, **388**
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business angels, **381**
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MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

10-1. Why do start-up firms need capital investment? Can they sustain themselves without it?

10-2. What is meant by the term *burn rate*? What are the consequences of experiencing a negative burn rate for a relatively long period of time?

10-3. What are the different stages involved in venture capital funding? Briefly describe each one.

✪ 10-4. To what extent do entrepreneurs rely on their personal funds and funds from friends and families to finance their ventures? What are the three rules of thumb that a business owner should follow when asking friends and family members for start-up funds?

10-5. What sources of personal financing are available to entrepreneurs?

10-6. Describe the three steps involved in properly preparing to raise debt or equity financing.

10-7. What is the difference between equity funding and debt financing?

10-8. What are the most common sources of equity funding?

10-9. Describe the most common sources of debt financing.

10-10. What should an entrepreneur do before approaching a potential investor for funding?

10-11. Why is it so important to get a personal introduction before approaching a potential investor or banker?

10-12. What are the three steps required to effectively engage potential investors or bankers?

10-13. What are the three most common sources of equity funding?

✪ 10-14. Describe the nature of business angel funding. What types of people typically become business angels, and what is the unique role that business angels play in the process of funding entrepreneurial firms?

10-15. What is meant by the term *venture capital?* Where do venture capital firms get their money? What types of firms do venture capitalists commonly want to fund? Why?

10-16. Describe the purpose of an initial public offering (IPO). Why is an initial public offering considered to be an important milestone for an entrepreneurial firm?

10-17. What is the purpose of the investment bank in the initial public offering process?

10-18. What is the difference between rewards-based crowdfunding and equity-based crowdfunding?

10-19. Briefly describe the SBA's 7(A) Loan Guaranty Program. Do most start-up firms qualify for an SBA guaranteed loan? Why or why not?

10-20. What is a Small Business Innovation Research (SBIR) grant? Why would a firm want to apply for such a grant if it qualifies for it?

Application Questions

10-21. Referring to You Are the VC 10.1, would you consider licensing the Keza dining app in another capital city outside the UAE?

10-22. Samantha Smith, a friend of yours, was recently telling you about a company that her father is starting in the solar power industry. Samantha's father is using a technology he developed, which has received favorable write-ups in several technical publications. He has been approached by two angel investors who are eager to invest in his proposed venture. He's also been offered a spot in a prestigious technology incubator, where he can maintain an office and a lab to work on his project. Samantha says that her dad has turned away the potential investors and is opting to work out of a shop on some property he owns, rather than move into the incubator. He'll be able to fund the company from personal savings, at least for the first two years. Do you think Samantha's dad is making good decisions? What are the pluses and minuses of his decisions?

10-23. Jim Carter, a classmate of yours, is preparing to launch an e-commerce company to sell home repair guidebooks, tools, how-to videos, and related material for home repair and remodeling projects. He just told you that he talked to his paternal grandmother over the weekend, and she has agreed to lend him $25,000 to launch the firm. When you asked Jim what arrangements he has made with his grandmother to formalize the loan, he looked puzzled and said, "She plans to send me a check in a week or so—she just needs to get the money out of her savings account." Jim seemed concerned by the worried look on your face and said, "Tell me what you're thinking. I really want to do the right thing here." What would you say to Jim?

10-24. Kathy Baker is in the midst of starting a computer hardware firm and thinks she has identified a real problem that her company will be able to solve. She needs investment capital, but doesn't know much about the process and doesn't know where to begin. She's turned to you for advice. Write Kathy a 250- to 300-word e-mail message introducing her to the process of raising investment capital.

10-25. Imagine you invented a new type of car seat for children, which is lighter and safer than the car seats currently on the market. You have a business plan and have won two business plan contests based on your idea. You also have a working prototype. You'd like to find an angel investor to fund the launch of your firm. Describe how you'd go about finding an angel investor in the area in which you live. Make a list of the specific steps you'd take, and the specific people you'd talk to, to try to locate an appropriate angel investor.

10-26. During an entrepreneurship class for final-year students, one of the students made a presentation on a biodiesel technology that may bring down the cost of a manufacturing firm by half. You feel that this student could propose her idea to the government and other private agencies if she had the funding, as the technology has the potential to be developed into a successful product. As her lecturer, advise her on the SBIR Program, the three phases, and with the amount of funding available for each phase.

10-27. Brenda White has been running a beauty parlor for the last three years. It has many celebrity patrons and is well-known within her neighborhood. Throughout the three years, she has been sustaining her parlor by herself without any financial assistance. However, due to the recent economic downturn, she is finding it difficult to continue alone and is seeking a funder who is willing to share equity with her. Advise her on the types of funding available for her venture.

YOU BE THE VC 10.1 COMPANY: Keza

• **Web: www.keza.it** • **Instagram: @KezaArabia** • **Twitter: @KezaArabia**

Business Idea: A UAE-based food app, subscription service, and business supply-chain solutions.

The Pitch: A few years ago, Nida Sumar had a bad experience at one of Dubai's top restaurants because the order and service was poorly handled. Sumar is a trained chef but studied to be a financial analyst, and the experience gave her an idea that would save time and avoid confusion through an app. Sumar thus created Keza, a dining app that allows diners to interact with restaurants. After downloading and registering, users are able to view and review dishes, book a table, contact the restaurant's staff, split the restaurant bill, and pay for it.

Dubai was the first choice for the launch of Keza because of its broad and diverse food culture, from street food to Michelin-star restaurants. The next city to be included in the Keza app system will be Karachi, Pakistan. As of November 2017, Keza has a team of nine employees operating out of Dubai and India.

However, the Keza app is just one of four services offered by the business. Snackerx is a monthly subscription service for healthy snacks, which are all created with sustainable and local produce. Alongside these two customer-facing services is the Keza Cloud, which is a point-of-sale and inventory management system designed to be used by hotels and restaurants to help improve customer service and boost customer loyalty. The final service, the Keza Marketplace, is a discrete B2B supply-chain management system designed to link business customers with a range of food-and-beverage suppliers.

Sumar has been featured in *Entrepreneur Middle East* as one of the region's Achieving Women's Who's Who. She is something of a rarity in the UAE as one of the few—but growing—number of female CEOs. Sumar and her company support women's welfare and empowerment, sponsoring the education of girls and supporting women who have escaped abusive relationships.

Keza is unusual in more than one way; not only does it have a female CEO, but it has not chosen to focus on one particular niche to grow in over time. Instead, it has taken a different route, offering a series of solutions to different parts of the food-and-beverage market. By late 2017, Keza had secured 107 paying businesses for its support services, including some of the major brands in the MENA region such as Al Rawabi and Emirates Poultry.

Development of the services is a slow and involved process as the systems are complex and demanding. Digitizing and streamlining these services will mean huge savings and improved systems for their customers.

10-28. Based on the material covered in this chapter, what questions would you ask the firm's founder before making your funding decision? What answers would satisfy you?

10-29. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 10.2 COMPANY: Lumo Bodytech

• **Web: www.lumobodytech.com** • **Facebook: Lumo Bodytech** • **Twitter: @lumobodytech**

Business Idea: Design and develop two small, unobtrusive wearable devices. The first device monitors and improves the user's posture—which allows the user to sit straighter, stand taller, and look better. The second device analyzes the user's running form and offers personalized coaching to help the user exceed his or her running goals.

Pitch: The first device, the Lumo Lift, is a tiny posture coach and activity tracker. Most fitness trackers only keep track of your movement, such as the number of steps taken and distance covered. The Lumo Lift does that too; but, its main purpose is to pay attention to your posture—how you sit and stand. Here's how it works. The device clips onto the inside or outside of your shirt using a magnetic clasp. You place the device directly beneath your collarbone. Once it is in place, you get into your desired posture. You then calibrate the device and go about your day and the Lift will track your posture and movement. The device will gently vibrate when you slouch, reminding you to correct your posture. The Lift sends the data it collects to a smartphone app, where you can see your daily statistics, including your activity level and your posture performance. The problem the Lumo Lift solves is back pain caused by poor posture. It also helps its users sit straighter, stand taller, and gain confidence. Imagine walking down the street or a hallway with your shoulders back and your head held up high (i.e., perfect posture). That's a recipe for feeling more confident.

The second device Lumo Bodytech has developed is the Lumo Run. There are many devices that track a runner's distance, pace, and heart rate. The Lumo Run goes beyond that. It's a small clip that is attached to the back of your running shorts that uses sensors to track how your body moves when it runs. As you run, the Lumo Run's sensors track your cadence, bounce, braking, pelvic rotation, stride, and ground contact with each step, and gives you live audio coaching via a smartphone app to adjust your form for better performance and injury prevention. For example, the app may tell you that you're moving your hips too much from side to side while running and work on your cadence. If you're uncomfortable running with your phone, you can sync data from the sensor after your run. The Lumo Run acts as a coach, and gives you charts of your performance after each run. To prepare for your next run, the app helps you set goals to improve your form. It also suggests exercises that can help you reach your goals (and helpful videos to teach you the exercises).

The problem the Lumo Run solves is preventing injury and improving your form. Poor form leads to all sorts of problems with your back, pelvis, and knees. Improving your form can not only prevent injury, but improve your race time and enhance the enjoyment of your runs.

10-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

10-31. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 10.1

Revolights: Using Multiple Sources of Funding to Bring Its Innovative Bicycle Lighting System to Life

• Web: Revolights:www.revolights.com • Facebook: Revolights • Twitter: @Revolights

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

One evening in October 2010, Kent Frankovich was riding his bike home from work. He was completing a research project at Stanford and was running back and forth to the lab a lot at night. The area in front of him was partially illuminated by his handle-mounted bike light. He entered a particularly dark stretch and hit a pothole. It nearly threw him off his bike. It got him thinking that there must be a better way to illuminate the path in front of his bike.

He decided against buying a better handle-mounted light. Why is the light up so high, he thought, if what he's trying to illuminate is directly in front of him? So he decided to do some research. He looked at the lights on cars and the design work that went into them. Many new cars had wraparound lights so the car could be seen from the side as well as the front. In addition, unlike bikes, car headlights are at the front and are fairly low so they can best illuminate the road. Frankovich decided that bike lights should be put where they're needed the most—at the wheel.

This conclusion posed a design challenge. Obviously the wheels on a bike rotate, so a light can't be mounted on the wheel. After giving the matter some thought, Frankovich came up with a solution. He distributed small LED lights all the way around the wheel and timed them so they'd only illuminate when facing forward. Thus, only about a third of the wheel would be illuminated at any given time—the third lighting the path in front of the bike. The whole wheel couldn't be illuminated because the spinning light would interfere with the rider's eyesight.

Frankovich built a prototype and started riding at night. He found that the arch of light not only lit the path in front of him, but made him hugely visible from all sides. That's a big deal. In some archival research Frankovich had done, he found some interesting statistics about bikes. About one third of Americans own bikes, but only 1 percent of trips are made by bike. The top four reasons that people don't ride their bikes more often are (1) car traffic, (2) weather, (3) lack of bike lanes, and (4) darkness. The thing these four reasons have in common is personal safety. Frankovich realized that not only could his solution provide for a better bike light, but it could help people feel safer riding their bike because they would be more visible. According to government surveys, about 70 percent of bike traffic accidents are attributed to a lack of side visibility. In addition, the majority of bike accidents happen between 4:00 pm and 4:00 am—which is late afternoon to dusk to darkness.

Frankovich used this insight to improve on the initial prototype. To provide for more side visibility at night, he decided to not only mount lights on the front tire but on the back tire as well. To make it not only functional but super cool, the design was for white lights on the front tire and red lights on the back. The result was 360 degrees of illumination, offering not only improved lighting (for the person riding the bike) but improved visibility from all sides.

Next Steps

After settling on the initial design, Frankovich met Adam Pettler at a friend's get-together. Pettler was completing an MBA from the University of California, As seen in this photo, a bicycle equipped with the Revolights system is much more visible from the front and the side than a bike with a traditional handlebar-mounted light.

John Kent Frankovich/Revolights

Davis. According to an interview with Frankovich and Pettler on the Core77 website (Core77 is a site for industrial designers), Frankovich told Pettler about his idea, and pulled out his phone and played a video of the prototype. "Dude," Pettler reportedly said, "We should start a business." Coincidentally, Pettler had to write a business plan for a class and was looking for an idea. The two hit it off and formed a partnership.

Over the next several months, Frankovich and Pettler produced several iterations of the original idea. They formed a company named Revolights. At this point, the Revolights bike lighting system consisted of two narrow rings of LED lights that mounted directly to each bike wheel using a series of rim-specific clips. They started showing videos of their most recent prototype to bike shop owners. The response was very positive. They felt that they were on to something but still couldn't be absolutely sure that such was the case.

To test the waters in a substantive fashion, they decided to launch a Kickstarter campaign. The campaign launched in mid-2011 with a $43,500 goal. The money would be spent on the final design and development work for the Revolights system and on the first production run. At this juncture, put the case aside for a moment and go to Kickstarter.com. Type "Revolights" into the search bar, and select the Revolights campaign that was funded on September 27, 2011 (Revolights ran two subsequent Kickstarter campaigns). Watch the 2-minute, 50-second video pitch. You'll see Revolights's original pitch. The video also provides a nice demonstration of the Revolights' system. The Kickstarter campaign raised $215,621 from 1,442 backers (496 percent of the original goal). That success provided Frankovich and Pettler the confidence to proceed with Revolights and make it an all-out effort.

Funding Journey

Frankovich and Pettler proceeded to build Revolights. Because the Revolights system is a physical product, inventory must be bought and paid for before the product is sold. As a result, scaling the company has required Frankovich and Pettler to raise money. The nearby table shows the funding that has taken place.

Revolights' Funding Journey

Date	Source of Funding	Use of Funds	Amount of Funding
2011	Kickstarter Campaign	Finish design and development work and pay for initial production run	$215,621
2011	SBA Loan	Fund additional production	$250,000
2013	Kickstarter Campaign	Fund the company's second-generation product, Revolights City	$94,793
2013	*Shark Tank*	Fund R&D and production	$300,000
2014	Series A Round Led by Sierra Angels	Expand the team, grow sales and marketing, and expand product line	$1 million (includes $300,000 *Shark Tank* commitment)

Date	Source of Funding	Use of Funds	Amount of Funding
2015	Additional Series A Led by VA Angels	Continue to expand team, grow sales and marketing, and expand product line	Not disclosed
2015	Indiegogo Campaign	Fund Revolights Eclipse	$258,131

As mentioned, the first funding was the initial Kickstarter campaign. Buoyed by a positive response, Frankovich and Pettler decided to expand the production run and took out a $250,000 SBA loan. In early 2013, they ran a second Kickstarter campaign. The $14,500 goal was easily met—they raised $94,793 from 233 backers. The differences in the videos that accompanied the 2011 and 2013 Kickstarter campaigns showed how much the company had matured. The purpose of the 2013 campaign was to fund the company's second-generation product, Revolights City. Revolights City fit more bike rims and would make Revolights more widely accessible. The company also announced a partnership with Mission Bike Company, which would start selling a family of bikes with Revolights lights built in.

The next round of funding was a bold one. Frankovich decided to take his chances on *Shark Tank*. The advantages of appearing on *Shark Tank* are threefold: first, the possibility of raising money; second, the potential to get an investment from a high-profile investor, such as Mark Cuban, Barbara Corcoran, or Robert Herjavec; third, the exposure an appearance brings. In 2013, each episode averaged over six million viewers. Appearing on *Shark Tank* also exposes a product's company, like Revolights, to potential retailers, distributors, and business partners.

The *Shark Tank* episode was filmed in late 2013 and aired on March 7, 2014 (Season 5, Episode 19). Frankovich asked for $150,000 in exchange for 10 percent of the company. The sharks were impressed with the product and upped the ante. Frankovich received three offers. He eventually said yes to Robert Herjavec's offer of $300,000 for a 10 percent stake in Revolights. Emboldened by his *Shark Tank* success, Frankovich raised a $1 million Series A round in May, 2014. The round was led by Sierra Angels and Sacramento Angels. Robert Herjavec's $300,000 commitment was folded into the round. The money was raised to expand Revolights' team, grow marketing and sales, and expand the product line.

Frankovich and Pettler had one hiccup in their funding journey. Between the time the *Shark Tank* episode aired and they raised their Series A round of funding, they ran a third Kickstarter campaign. The goal was $100,000. A total of $78,017 was pledged and the campaign failed.

In late 2015, Revolights raised a second Series A round, this time from VA Angels. The amount of funding was not disclosed. VA Angels is one of Canada's leading angel groups with 130+ active angel investors. Shortly after the VA Angels round was closed, Revolights ran an Indiegogo crowdfunding campaign to launch Revolights Eclipse, its next generation product. You can see the video pitch and campaign by going to Indiegogo and typing Revolights into the search bar. Revolights Eclipse was an improved version of its existing product. Along with upgrading several aspects of the product, it connected a rider's Revolights lights to his or her smartphone via Bluetooth and an app. The app displays real-time battery life, senses the time of day and turns your Revolights lights on if it senses you are about to ride, and provides weather alerts. The app also displays speed and distance covered when riding.

Road Ahead

Like all start-ups, Revolights' road ahead remains uncertain. While all signs are positive, the two Series A investment rounds will force Revolights to sustain a rapid growth mode.

As of the time this case was written (May 2017), Revolights was growing dramatically. Its products are now available in numerous stores throughout the United States and the company has customers in many foreign locations including Canada, Mexico, Ecuador, Spain, the United Kingdom, Japan, and Malaysia. In fact, under the About Us tab on the firm's website, Revolights has a section called "Revoworld" where a world map identifies the countries Revolights has penetrated along with a photo of a Revolights customer in each country. Revolights has also expanded its product line as described above.

An uncertainty surrounding Revolights is the prices of its products. The company is clearly trying to drive down its prices to appeal to a broader market. It now has three products, the Skyline, the Eclipse, and the Eclipse+ . The Skyline, which is priced at $149, is made for 26-inch and 27.5-inch wheels, which fit mountain bikes and e-bikes. The Eclipse, which is also priced at $149, is made for standard wheels. The Eclipse+ , which was introduced via the Indiegogo campaign, is $249. Previous versions of Revolights cost as much as $399. All three current models mount to the spokes of a bike (Revolights no longer sells tires with the lights built it), feature 360-degree visibility, and are sold as a set—meaning they include Revolights for both the front wheel and the rear wheel of a bike. Revolights has been able to sustain growth at these price points. The uncertainty is whether it will be able to continue to grow its markets and whether it will need to raise additional funding to do so.

Revolights continues to generate publicity and make heads turn. In 2013, it was a James Dyson Award International Finalist. It also won a Core77 Design Award and was named the Best Bicycle Lighting System in the World by *Men's Journal*. In 2013, Frankovich did a

TEDx Sacramento talk about Revolights. The talk has generated over 63,200 views. Frankovich's *Shark Tank* episode was viewed by 7.69 million people. In 2016, Revolights was named one of the 10 best innovative bike lights for 2016 by *The Telegraph* in the United Kingdom.

Discussion Questions

10-32. The following sentence appears early in this chapter: "There are three reasons that most entrepreneurial ventures need to raise money during their early life: cash flow challenges, capital investments, and lengthy product development cycles." Evaluate Revolights' need to raise money in each of these areas.

10-33. In response to a request from Kent Frankovich and Adam Pettler, write a 60-second elevator pitch about Revolights' current product.

10-34. Do you think Revolights will need to raise additional capital? If so, why? Using Table 10.2 in the chapter as a guide, if Revolights raises additional capital, what would be the most appropriate source of financing or funding? Explain your answer.

10-35. To what degree do you think Revolights will be able to reach mainstream markets and sustain its growth? How successful do you believe the firm will be? Justify your answer based on criteria introduced in earlier chapters of this book and your own intuition.

Sources: Revolights website, www.revolights.com (accessed April 23, 2017); VA Angels Homepage, www.vaangels.com (accessed April 23, 2017); "Revolights Bicycle Lights Raised $1 Million After Shark Tank," 2Paragraphs in Business Spotlight, available at https://2paragraphs.com/2016/10/revolights-bicycle-lights-raised-1-million-after-shark-tank/ (posted October 18, 2016, accessed April 23, 2017); M. Khan, "Revolights Update—See What Happened After Shark Tank," Gazetterreview.com, available at https://gazettereview.com/2015/11/revolights-update-see-happened-shark-tank/ (posted November 11, 2015, accessed April 23, 2017); K. Frankovich, "Kickstarting a Bicycle Safety Revolution: Kent Frankovich at TEDx Sacramento TEDx City 2.0," available at https://www.youtube.com/watch?v=axAx_Dq3rn8 (posted November 4, 2013, accessed April 23, 2017); Core77 website, available at https://www.core77.com/blog/core77_design_awards/core77_design_awards_2012_the_revolights_bike_lighting_system_professional_winner_for_transportation_23048.asp (posted August 1, 2012, accessed April 23, 2017).

CASE 10.2

Kickstarter: An Increasingly Important Forum for Raising Seed Capital

• Web: www.kickstarter.com • Facebook: Kickstarter • Twitter: @kickstarter

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Kickstarter is a crowdfunding platform. The idea behind crowdfunding is to raise money from the public (i.e., the crowd) rather than through traditional means. Kickstarter's stated mission is to bring creative projects to life. The platform was started in April 2009 by Perry Chen, Charles Adler, and Yancy Strickler. As of April 2017, it had helped raise $3 billion in pledges from 12.7 million donors to fund 123,387 projects. Kickstarter is open to projects based in 21 countries, including the United States, Canada, the United Kingdom, Hong Kong, Singapore, and Australia. Backers can come from anywhere in the world. While most people think of Kickstarter as a website, it launched a mobile app in February 2013.

How It Works

Kickstarter funds creative projects. Anyone who meets the company's creator requirements is eligible to launch a project on Kickstarter. A project must fit into one of Kickstarter's 13 categories and 36 subcategories. The 13 categories include Art, Comics, Dance, Design, Fashion, Film and Video, Food, Games, Journalism, Music, Photography, Publishing, Technology, and Theater. Business start-ups are eligible if they fit a category. For example, a company that's creating a new type and style of denim jeans would fit into the fashion category. Of the categories, Film and Video and Music are the largest and are the ones around which the largest amount of money has been raised.

Once accepted, a person uses tools provided by Kickstarter to set up a fund-raising campaign. The campaign, which is displayed on Kickstarter.com and can be accessed via the mobile app, includes a description of the project, a video pitch (not required but recommended), the fund-raising goal, the deadline, and a list of the incentives that are provided in exchange for pledges. If the minimum isn't reached by the deadline, the campaign fails and pledgers get their money back. Pledges are tiered ($25, $50, $75, etc.), with each tier earning a certain incentive. Some incentives are merely thank you acknowledgments. For example, a $25 pledge may earn a thank you note from the person running the campaign. In contrast, some pledges result in nice

Ramin Talaie/Getty Images

This photo depicts an assortment of Pebble Smartwatches. Pebble raised over $10 million on Kickstarter. Pebble smartwatches use Bluetooth technology to connect to smartphones.

rewards. For example, COOLEST Cooler ran the second most successful Kickstarter campaign to date by raising $13.3 million from 62,642 pledgers. A $165 pledge earned the pledger one of the coolers the campaign was designed to help manufacture. A COOLEST Cooler now retails for $399.99.

Kickstarter has taken several steps to govern the integrity of its campaigns. Money pledged by donors is collected using Amazon Payments. Kickstarter claims no ownership over the projects and the work they produce. It makes money by retaining 5 percent of the funds raised. An additional 3 percent to 5 percent goes to Amazon Payments. Kickstarter has added requirements for hardware products. It is possible to run a Kickstarter campaign to build a prototype, but if the finished product is one of the pledger awards, then you can't launch with only an idea. You need to describe the prototype's current state (including photos and videos) and submit a production plan and estimated timeline. These requirements help ensure that the device will actually be built and that pledgers will receive the promised incentives.

While Kickstarter is a fundraising platform, most Kickstarter campaigns have multiple objectives. Running a successful campaign enables business founders to reach an audience of early adopters, grow a community for a product, validate a market, get customer feedback and insight, and generate publicity and buzz. For example, say a food start-up ran a Kickstarter campaign to introduce a new type of organic coffee. It could use the campaign to reach out to bloggers and journalists who write about organic products and coffee to try to rally support for its campaign. If the campaign was successful and raised $200,000 from 2,000 backers, the start-up would have a much stronger story to tell potential investors in that 2,000 people essentially gave the product a thumbs-up as a result of their participation in the campaign. That's strong validation of a potential market for a product. The 2,000 people who participated in the campaign will most likely become the company's first customers and will tell others about the product. Thus, the start-up now has a community forming around its product. In addition, pledgers are able to leave a company comments on its Kickstarter page. Many of the comments provide useful suggestions for improving a product.

The seven most successful Kickstarter projects to date are shown in the table below. You can look at each of the projects by going to Kickstarter's website and typing the project name in the search box. Kickstarter archives all projects indefinitely.

Seven Most Successful Kickstarter Projects to Date

Rank	Total Raised	Project Name	Description	Backers
1.	$20,338,986	Pebble Time	Improved Pebble Smartwatch	78,471
2.	$13,285,226	COOLEST Cooler	Cooler that includes a built-in blender, Bluetooth speakers, a USB charger, and other features	62,642
3.	$10,266,845	Pebble Technology	Original Pebble Smartwatch for iPhone and Android	68,929

(*continued*)

Rank	Total Raised	Project Name	Description	Backers
4.	$9,192,055	The World's Best Travel Jacket/BAUBAX	Travel jacket that comes equipped with 15 features including a neck pillow, an eye mask, and pockets for technology	44,949
5.	$8,782,571	Exploding Kittens	Card game	219,383
6.	$8,596,474	Ouya	Videogame console made on the Android platform for users to hook up to their TVs	63,316
7.	$6,333,295	Shenmue3	Highly anticipated installment to the Shenmue video game franchise	69,320

Typical Kickstarter Project

Here's a typical Kickstarter campaign. Wiivv, which is the focal firm in Chapter 2's "Opening Profile," is a company started in 2014 by Shamil Hargovan and Louis-Victor Jadavij. The pair's business idea was to create 3D printed customized, affordable insoles for people who have trouble with their feet. Wiivv launched a Kickstarter campaign in 2016 to bring their idea to market. The campaign raised $235,054 via 2,765 backers. Wiivv is now a successful firm but is growing and at the time this case was written (May 2017) had just finished a second Kickstarter campaign to raise money to produce 3D printed custom fit sandals. You can look at the campaign by going to Kickstater.com and typing Wiivv in the search bar.

The campaign includes a 4-minute 24-second video pitch. The video starts with a nostalgic theme, reminding the viewer that sandals are the most comfortable footwear that people wear, and we all have memories of wearing sandals throughout our lives. The problem is, sandals are normally bad for your feet. They are mass manufactured, made for no one in particular, and they use the cheapest materials manufacturers can find. Wiivv is setting out to fix that by introducing the world's first, custom-fit sandals captured from your smartphone. Using photos submitted through the company's app, Wiivv's technology digitally maps each of a customer's feet on over 200 points. This data is used to create a sandal that perfectly fits the customer's feet. The sandals are 3D printed at Wiivv's lab in San Diego ensuring quick manufacturing and delivery. According to the video, Wiivv spent the last 15 months creating the sandal. The company now needs funds to bring the sandal to market.

The Kickstarter campaign had a goal of raising $250,000. The campaign raised $566,401 dollars from 4,829 backers. Along with the financial support, the Kickstarter community left Wiivv 213 comments on the project. Some of the comments are kudos for surpassing their goal, others are questions about the product or suggestions for improvements. If you look at the comments, you'll see that when a pledger asked a question, Wiivv responded with a polite and informative reply.

To encourage people to participate in its Kickstarter campaign, Wiivv offered tiered incentives. A sample of the incentives, along with the pledge amount required to earn the incentive, are shown in the table below.

A Sample of the Incentives Offered for Pledging Money to Wiivv's Kickstarter Campaign

Pledge Amount	Incentive
$20 or more	Get ready for the summer with your choice of a sweet Wiivv t-shirt, beach towel, water bottle, hat, or beach ball, available exclusively on Kickstarter.
$79 or more	Be the first in the world to get one pair of Wiivv Customer Fit Sandals with your choice of customizable straps.
$99 or more	Be among the first in the world to get one pair of Wiivv Custom Fit Sandals and your choice of two different customizable straps, plus your choice of one sweet Wiivv summer swag item.
$135 or more	Be the first in the world to get two pairs of Wiivv Customer Fit Sandals. It's super easy to gift a pair to a friend! Each pair comes with your choice of one set of customizable straps.
$275 or more	For those who want a beyond-customized experience: get one pair of Special-Edition Custom Fit Sandals with a full leather midsole and leather strap, handmade by San Francisco master shoemaker, Frank Beneduci.
$300 or more	Get four pairs of Wiivv Custom Fit sandals with customizable straps. To sweeten the deal, we're throwing in your choice of four pieces of Wiivv summer swag!
$5,000 or more	Ok, this is super cool. We're going to put your corporate logo on them! You get 50 pairs of Wiivv Custom Fit Sandals and 50 customizable straps (one per pair) with your company logo on it. To sweeten the deal, we're throwing in your choice of $500 of Wiivv summer swag!

Pledge Amount	Incentive
$10,000 or more	3D Printing Weekend in San Diego. Every wonder how 3D printing works? Now you can find out. We'll fly you and three friends down to San Diego for a weekend. You will meet Wiivv's cofounders, run our printers, print your own Wiivv Custom Fit Sandals, and enjoy the beach in your very own Wiivvs made by you. You get four airline tickets, two hotel rooms for 3 nights, four pairs of Wiivvs with customizable straps, swag, free Wiivv Custom Fit Insoles, and one super memorable weekend.

How to Run a Successful Kickstarter Campaign

There are several things that people who have run successful Kickstarter campaigns learn. First, Kickstarter shouldn't be thought of as a tool for funding one-off projects or events. Instead, it's best to think of it as a mechanism for providing seed capital to help a project or event get up and running, and then grow it from there. Second, it's important that the person or organization that initiates a Kickstarter campaign promote it. Most people who contribute to a specific campaign don't find it by chance. Instead, they go to Kickstarter.com looking for it. In the nearby table, several techniques for promoting a Kickstarter campaign are listed.

Third, the majority of donations are made at the beginning and the end of campaigns. As a result, shorter campaigns are typically more effective than longer ones. A Kickstarter campaign can last between one and 60 days. Campaigns lasting less than 30 days have the highest success rates. If a campaign is too long, people lose interest. Fourth, it's important to not set your financial goal too low. If a Kickstarter campaign is successful, it tends to quickly lose momentum once it reaches 100 percent of its goal—even though more money can be collected. Finally, it's imperative that a video pitch be included. It's much easier to donate money to a person or organization's project if you can hear someone talking about it and see the passion in their eyes.

What's Ahead?

Kickstarter has no immediate plans to broaden the scope of its platform. It does have a growing number of competitors in that there are now over 2,000 crowdfunding platforms. Some, such as Indiegogo, are broad-based platforms like Kickstarter. Others focus on specific industries, such as PledgeMusic, which helps musicians raise money for albums, concerts, and music DVDs. There are areas in which Kickstarter is becoming more adventurous. For example, it periodically hosts film festivals that feature animations, short films, documentaries, and more, all funded on Kickstarter.

Techniques for Promoting a Kickstarter Campaign

Platform	Execution
E-mail	Send an e-mail to your e-mail distribution list, describing the campaign. Kickstarter campaigns aren't funded entirely by strangers. Instead, they're often funded largely by the campaign initiator's friends, family, business associates, existing customers, and so forth.
Twitter and Facebook	Reach out to both your Twitter and Facebook audiences. Provide frequent updates. Try to find the balance between saturating your Twitter followers and Facebook friends with Kickstarter info and providing them with timely reminders.
Blogs and media	Reach out to bloggers and news outlets in the industry on which your campaign focuses. Ask that they mention your campaign and offer support. Wiivv's product crosses several industries—3D printing, healthcare, and athletics (customized insoles and sandals are good for foot strength and health). It would make sense for Wiivv to reach out to bloggers and journalists who write about each area.

Discussion Questions

10-36. Do you think Kickstarter is a viable alternative to raising equity funding or debt financing? If so, under what circumstances?

10-37. Kickstarter is not the first crowdfunding platform, yet it is the most successful. List five reasons that you believe account for Kickstarter's success.

10-38. Cities are able to set up Kickstarter pages that list all the active Kickstarter projects from their community. For example, the Kickstarter page for Nashville, TN is available at https://www.kickstarter.com/discover/places/nashville-tn. How should cities go about promoting their Kickstarter pages?

10-39. Wiivv raised $566,401 from 4,829 backers in the Kickstarter campaign described in this case. What benefits, if any, other than raising money did Wiivv glean from the campaign? If one of the cofounders of Wiivv told you, "I'm very satisfied with the money we raised via the Kickstarter campaign, but raising money wasn't the primary reason we did it," what do you think the primary reason was?

Sources: Kickstarter website, www.kickstarter.com (accessed April 22, 2017); Wikipedia, Kickstarter, www.wikipedia.com (accessed April 22, 2017); R. DiResta, B. Forrest, and R. Vinyard, *The Hardware Startup* (Sabastopol, CA: O'Reilly Media, 2015).

ESSAY QUESTIONS

1. Many governments offer start-up grants or loans for new businesses. There is often funding available for specific industries or markets. In some countries, funds are offered to entrepreneurs in rural areas, areas with high unemployment, and regions that have lost traditional industries. In one or two paragraphs, outline any national or regional grants or loans offered to start-ups in your own country and comment on their value to the entrepreneur.
2. Jackson Peterson has launched a firm selling swimming pool supplies. Most of his clients are local swimming pool builders and smaller firms that serve homeowners and a few businesses by cleaning their pools on a regular basis. While Jackson's firm is generating a reasonable amount of business, cash flow is a problem. A main reason for this, he thinks, is that most of his customers are also small companies and are struggling to have enough cash on-hand to operate themselves. In listening to Jackson, you determine that factoring might be a way for him to raise cash for his business. When you mention this possibility to him, he looks puzzled and says: "I do not know what you are talking about. What is factoring and why should I consider using it?" Write a paragraph or two to fully answer Jackson's question.

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PART 4 Managing and Growing an Entrepreneurial Firm

Owlet Baby Care, Inc.

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Getting Personal with REAL TIME CASES

Real Time Cases Inc./Photo Credit: Jake Schaufeld

Cofounders

ANDREW POHLE

BS, Bioengineering, Lehigh University, 2011

JAKE SCHAUFELD

BA, Earth and Environmental Science, Lehigh University, 2015

JORDAN LEVY

BS, Accounting and Finance, Lehigh University, 2014

Dialogue *with* Andrew Pohle

MY FAVORITE SMARTPHONE APP
Snapchat

FAVORITE PERSON I FOLLOW ON INSTRAGRAM
Elon Musk

BEST ADVICE I'VE RECEIVED
Going out and doing/trying something is better than thinking about anything. Think before you act but make sure you act. Until you try something, you will never know anything real about it

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
Learning how much other entrepreneurs want to help you

FAVORITE BAND ON MY SMARTPHONE LIST
Luke Bryan

MY ADVICE FOR NEW ENTREPRENEURS
There is so much drama, headache, frustration . . . etc. involved with starting a company. Definitely, make sure you find some mentors who have been there before to help you navigate the issues you'll undoubtedly encounter

CHAPTER 11

Unique *Marketing* Issues

MyLab Entrepreneurship

Improve Your Grade!

If your instructor is using MyLab Entrepreneurship, visit **www.pearson.com/mylab/entrepreneurship** for videos, simulations, and writing exercises.

OPENING PROFILE

REAL TIME CASES

Creating a New Brand in Business Cases via Guerilla Marketing Techniques

• *Web: www.realtimecases.com* • *Facebook: Real Time Cases* • *Twitter: @RTCases*

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain the three steps (segmenting the market, selecting a target market, and establishing a unique market position) entrepreneurial firms use to identify their customers.
2. Define a brand and explain why it is important to an entrepreneurial firm's marketing efforts.
3. Identify and explain the 4Ps of marketing activities (product, price, promotion, and place) used by entrepreneurial firms.
4. Describe the seven-step sales process an entrepreneurial firm uses to identify prospects and close sales.

Andrew Pohle, Jordan Levy, and Jake Schaufeld met at Lehigh University. Lehigh is located in Bethlehem, PA., which is in the Lehigh Valley region of eastern Pennsylvania. While the three had different majors they shared a similar experience. They all took classes that involved business case studies, and in each instance thought the cases were too dated and not vibrant enough to be useful. During this time, Levy and Schaufeld were in an entrepreneurship class where they were required to create a business. They thought about their experience with cases and came up with the idea for Real Time Cases. Real Time Cases would produce business cases that would be delivered in real time, and would allow students to interact with companies about challenges they are currently facing. The case studies would be current, relevant, interactive, and fun.

The three decided to explore the idea beyond Levy and Schaufeld's class. They took two additional entrepreneurship classes—ENTP 311: The Garage: Launching Entrepreneurial Ventures 1 and ENTP 312: The Garage: Launching Entrepreneurial Ventures 2. Both classes allowed them to further flesh out the idea for Real Time Cases. The underlying premise for Real Time Cases is to improve the student experience. If students had access to "real time" cases, they reasoned, where they would become familiar with a company and then help the company assess its opportunities and grapple with its challenges that would improve the student experience. It would also help bridge the gap between an academic environment and "the real world." Additionally, the entrepreneurs thought that their cases would give students a realistic preview of what to expect when they graduated and better prepare them for the challenges ahead.

In February 2015, Pohle, Levy, and Schaufeld incorporated Real Time Cases and committed to the firm on a full-time basis. To market their company, they took a four-pronged approach, all of which are forms of guerrilla marketing. First, they decided to attend educational conferences to meet educators and tell them about Real Time Cases face-to-face. They found some conferences to be better than others. Not surprisingly, the conferences attended by the professors who would use Real Time Cases in their classes were the best investment of their time. Conferences that attracted administrators and Deans were not as useful. Some conferences invited them to sit on panels, where they would contribute to discussions about innovation in higher education. Attending conferences provided an opportunity for Real Time Cases to win sales but also affirmed the need for the firm's product. In fact, many professors told them that they've stopped using cases because they just didn't think they were current or relevant.

The second way the entrepreneurs marketed Real Time Cases was to issue press releases through local and regional news outlets. The purpose was to build the Real Times Cases' brand and to enhance familiarity with what the company was doing. Issuing press releases also helps build an archive of information about a company. When someone does a Google search on a company, the company wants a number of articles to pop up, to demonstrate that they are active and to spread the word. Press releases are helpful in creating a critical mass of search results.

The third way that Real Time Cases has marketed itself is to apply for every start-up competition and pitch event that is available. The competitions get the company in front of investors, potential mentors, and members of the press. The feedback that's received via these types of events is also useful. Pohle, Levy, and Schaufeld have honed their pitch for Real Time Cases as a result of the competitions. In some cases, there is also prize money or in-kind services that can be won.

Along with utilizing these techniques, Pohle, Levy, and Schaufeld have marketed and promoted Real Time Cases in other ways. They got their first clients by reaching out to their personal networks and asking friends and former classmates if they could recommend a professor that they knew who might benefit from their product. They also built a professional website that makes a good first impression and explains Real Time Cases in a straightforward manner. The website contains several aspects that are very beneficial, including example cases and client testimonials. The example cases are in two forms—short videos and written summaries. The short videos feature businesspeople talking about an opportunity or a challenge that their company is currently facing, and provide a taste of what Real Time Cases would bring to the classroom. The short summaries are of cases in Real Time Cases' library. The summaries cover multiple disciplines including entrepreneurship, marketing, supply chain and logistics, human resource management, and ethics and corporate social responsibility. For example, Real Time Cases has several cases that focus on KIND Healthy Snacks. One of the cases talks about a new product the company has introduced, and asks students for assistance in terms of the product's branding strategy. The client testimonials are from college professors who have used Real Time Cases in their classes. Real Time Cases is also very active on social media including Facebook, Twitter, LinkedIn, YouTube, and Google+.

Along with its marketing efforts, Real Time Cases is also working hard to establish its brand. Its goal is to draw a clear distinction between what it does—bring Real Time Cases into the classroom—and the type of case study that professors are used to. A challenge that the company has had is that the term "case study" is a turnoff for some professors, creating a need to establish Real Time Cases as something that's more valuable and relevant.

Today, Real Time Cases' cases are being used at over 40 colleges and universities, including Lehigh, Georgetown, Virginia Tech, the University of Michigan, and the Air Force Academy. The company will continue to find ways to spread the word through the most effective marketing techniques and channels available.

In this chapter, we'll look at the marketing challenges confronting entrepreneurial firms. Marketing is a broad subject, and there are many books and websites dedicated to marketing and its subfields. However, in this chapter, we zero in on the marketing challenges that are most pressing for young entrepreneurial firms. The reason for doing this is that marketing is an essential component of a start-up firm's success.[1]

We begin this chapter by discussing how firms define and select their target markets. Next, we discuss how a firm establishes a brand. We then consider the four key aspects of marketing as they relate to young entrepreneurial firms. These four aspects, commonly referred to as the "4Ps" of marketing, are product, price, promotion, and place (or distribution). We conclude the chapter with a discussion of the sales process, which consists of the steps a company goes through to establish relationships with customers and close sales. Many new ventures do a good job of developing products and defining the size of their markets, but do a poor job of dealing with the practicalities of how the products will be sold. It is imperative that a new business have a plan that details how it will sell its product within the confines of a reasonable budget.

Selecting a Market and Establishing a Position

LEARNING OBJECTIVE

1. Explain the three steps (segmenting the market, selecting a target market, and establishing a unique market position) entrepreneurial firms use to identify their customers.

To succeed, a new firm must know who its customers are and how to reach them. A firm uses a three-step process to determine who its customers are. These steps, which are shown in Figure 11.1, include segmenting the market, selecting a target market, and crafting a unique position within the target market.

As noted in Chapter 3, a firm's target market is the limited group of individuals or businesses to which it attempts to appeal. It is important that a new venture choose its target market and position inside its target market quickly because virtually all of its marketing choices hinge on these critical initial choices. For example, GreatCall makes cell phones designed specifically for older people. If GreatCall had designed a distribution strategy, for example, prior to determining that it would target older people, it might have designed a strategy that placed its phones in retail outlets not frequented by older people. Its decision to target older people will have a bearing on every element of its marketing plan.

Segmenting the Market

The first step in selecting a target market is to study the industry in which the firm intends to compete and determine the different potential target markets in that industry. This process is called **market segmentation**, as explained in Chapter 6. Market segmentation is important because a new firm typically has only enough resources to target one market segment, at least initially.[2] Markets can be segmented in many ways, such as by geography (city, state, country), demographic variables (age, gender, family size, income), psychographic variables (personality, lifestyle, values), behavioral variables (benefits sought, product usage rates, brand loyalty), and product type (varies by product). For example, the computer industry can be segmented by product type (i.e., handheld computers, tablet computers, laptops, PCs, work stations, minicomputers, mainframes, and super computers) or customers served (i.e., individuals, businesses, schools, and government).

FIGURE 11.1
The Process of Selecting a Target Market and Positioning Strategy

Sometimes a firm segments its market on more than one dimension to drill down to a specific market segment that the firm thinks it is uniquely capable of serving. For example, GreatCall probably segmented its market by age and benefits sought. Its ideal customer is someone who is older (age) and is looking for a cell phone that's easy to use (benefits sought).

To test whether you have segmented your market successfully, consider these requirements for successful market segmentation:

- Homogeneity of needs and wants appears within the segment.
- Heterogeneity of needs and wants exists between the segments.
- Differences within the segment should be small compared to differences across segments.
- The segment should be distinct enough so that its members can be easily identified.
- It should be possible to determine the size of the segment.
- The segment should be large enough for the firm to earn profits.

If an entrepreneur is not familiar with how to segment a particular market, IBISWorld, Mintel, and BizMiner, which are online databases often available through large university libraries, provide suggestions. They even show the size of the segments. For example, IBISWorld segments the gym, health, and fitness club industry (NAICS 71394) by service provided. The $26.5 billion industry is 65 percent gyms and fitness centers, 10 percent other, 7 percent dance centers, 7 percent swimming pools, 6 percent ice and roller rinks, and 5 percent tennis centers.[3]

Despite its importance, market segmentation is a process entrepreneurs commonly overlook. Overlooking this step can result in a faulty assessment of the size of the potential market for a new product or service. If a start-up planned to open a chain of tennis centers, for example, it would be incorrect to say that the total market potential is $26.5 billion. Tennis centers are 5 percent of the larger $26.5 billion gym, health, and fitness club industry, which equates to a $1.3 billion market. This doesn't mean that a tennis center business couldn't be profitable or that the new business couldn't expand the market for tennis—it just means that the entrepreneur should enter the business with a realistic assessment of the size of its market.

Selecting a Target Market

After a firm has segmented the market, the next step is to select a target market. As discussed in previous chapters, the market must be sufficiently attractive, and the firm must be able to serve it well. Typically, a firm (especially a start-up venture) doesn't target an entire segment of a market because many market segments are too large to target successfully. Instead, most firms target a niche market within the segment. For example, within the dance studio market, there are several small niche markets that companies can choose to target. A **niche market** is a place within a market segment that represents a narrow group of customers with similar interests. For example, Broadway Dance Center in New York City targets serious dancers who aspire to earn a living dancing in Broadway plays.[4] That's an entirely different niche than a studio teaching ballroom dancing or a studio teaching ballet to young girls. By focusing on a clearly defined market, a firm can become an expert in that market and then be able to provide its customers with high levels of value and service.

A firm's choice of target markets must also be in sync with its business model and the backgrounds and skills of its founders and other employees. A firm must also continually monitor the attractiveness of its target market. Societal preferences change, a fact that sometimes causes a target market to lose its attractiveness for a firm and the product or service it has to offer customers.

Crafting a Unique Market Position

After selecting a target market, the firm's next step is to establish a "position" within it that differentiates it from competitors. As we discussed in Chapter 5, position is concerned with how the firm is situated relative to competitors. For example, in Pittsburgh, PA, Art & Style Dance Studio specializes in Latin and Ballroom dancing.[5] That's a different position than the Arthur Murray Dance Studio in Pittsburgh that offers instruction in Salsa, Fox Trot, Cha-Cha, Waltz, Swing, Tango, Disco/The Hustle, Mambo, Merengue, Rumba, and Quickstep.[6] A firm's market position is defined by its products or services. Determining which position in a market to occupy and in which to compete is a strategic call on the part of a company based on its mission, its overall approach to the marketplace, and its competitive landscape.

After a company has identified its position and primary points of differentiation, a helpful technique is to develop a **product attribute map**, which illustrates a firm's positioning strategy relative to its major rivals. A product attribute map for Casper is shown in Figure 11.2. As described in Case 5.2, Casper sells mattresses along with several other sleep-related products. The product attribute map focuses on Casper's mattresses. Casper sells a single mattress in seven different sizes (twin, full, queen, king, etc.). As mentioned in Chapter 5, its queen mattress costs $950. Casper sells exclusively online, its mattresses are delivered in a box about the size of a small mini-fridge, its mattresses have received high praise for comfort and support, and it provides a 100-night full-refund guarantee. Casper's product attribute map is based on the two primary attributes that people consider when they buy a mattress—perceived value (a combination of product and price) and the mattress buying experience. The idea is to assess Casper's strengths and/or weaknesses in each of these categories and plot them on the map. The same is done for Casper's major competitors. The results are shown in Figure 11.2. Casper compares favorably on perceived value with its major competitors and has a distinct advantage in terms of the mattress buying experience (i.e., no pushy salespeople, single choice, single price point, free delivery, 100-night guarantee). As a result, in its advertising, it stresses the advantage of buying from Casper rather than its competitors. It also does not give ground in terms of perceived value, although the quality of its mattresses objectively is not directly comparable to high-end mattresses. In regard to perceived quality, Casper appeals to the consumer who is looking for the best quality mattress in Casper's price range.

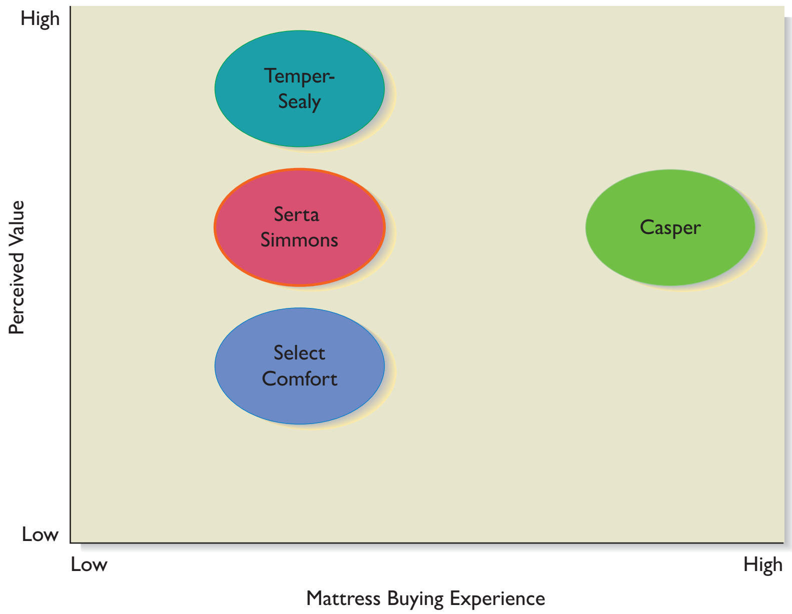


FIGURE 11.2
Product Attribute Map for Casper

Casper's product attribute map has two takeaways. One, it demonstrates the area in which Casper has carved out its competitive advantage—people looking for a better mattress buying experience. And second, it explains in part why Casper has been so successful. It has a distinct advantage in one of the two most important areas that people consider when buying a mattress—the mattress buying experience—and compares fairly favorably in terms of perceived value. There is one caveat to achieving a clear competitive advantage in an industry, which Casper is experiencing. It attracts competitors. As illustrated in Case 5.2, several mattress companies have launched which are trying to imitate Casper's advantage. These competitors include Yogabed, Tuft & Needle, and Saatva. Tuft & Needle, for example, offers a similar buying experience as Casper, at a lower price point. It is trying to essentially "out Casper Casper" in the exciting new segment in the mattress industry that Casper created.[7]

To support their positioning strategy, firms often develop a tagline. Casper's tagline is "Live the Dream." A **tagline** is a catchy phrase that's used consistently in a company's literature, advertisements, stationery, and even invoices, and thus becomes associated with that company—to reinforce the position it has staked out in the market. Table 11.1 is a short matching quiz that asks you to match companies featured in this book with their taglines. A company has created a successful tagline if the message makes you think of its products or services and the position it has established in its market.

A concern that retail start-ups have is whether they'll be able to compete successfully against big-box stores like Walmart, Best Buy, and Home Depot. It's a legitimate concern, and the ability of a start-up to compete effectively against a big-box store often boils down to positioning. The nearby "Savvy Entrepreneurial Firm" feature focuses on how retail start-ups compete against Walmart and other big-box retailers.

Branding

LEARNING OBJECTIVE

2. Define a brand and explain why it is important to an entrepreneurial firm's marketing efforts.

A **brand** is the set of attributes—positive or negative—that people associate with a company. These attributes can be positive, such as trustworthy, innovative, dependable, or easy to deal with. Or they can be negative, such as cheap, unreliable, arrogant, or difficult to deal with. The customer loyalty a company

TABLE 11.1 Match the Company to Its Tagline

Company	Tagline
Wild Friends Foods	Live Better, Together!
Wiivv	Rest Assured
Patients Like Me	Write Better. Write Smarter
Billy Goat Ice Cream	Real Companies, Real Cases in Real Time
Prynt	Making Food Friendly
Rover.com	Explore. Pain-Free
Write Lab	Health is in your hands
Real Time Cases	The New Era of Photography
Owlet Baby Care	Be Good. *Eat Ice Cream.*
Tyto Care	Love your dog. Love your life

SAVVY ENTREPRENEURIAL FIRM

How Retail Start-ups Compete Against Walmart and Other Big Box Retailers

One of the main fears that retail start-ups have is whether they'll be able to compete against Walmart, Home Depot, and the other big-box stores. It's a legitimate fear. The big-box stores continue to grow, particularly in terms of product line and geographic breadth. There are now big-box stores in towns with populations of 10,000 or less. We've all heard stories about big-box stores moving into small towns and driving local merchants out of business. So it's no wonder that someone with an idea for a men's clothing store or a pet store might wonder "but will I really be able to compete against Walmart?" Couple this fear with the fear of competing with e-commerce sites and it's easy to see why someone might pass on a potentially attractive business idea.

Still, many businesses do compete successfully against big-box stores. Their success, however, is not by chance. Although impossible to compete against Walmart and the others on price, price isn't everything. There are many other forms of competition including product quality, customer service, product knowledge, ties to the local community, and so forth. The following is an analysis of how big-box retailers compete, what their vulnerabilities are, and strategies for competing directly against big-box retailers.

How the Big-Box Retailers Compete

The big-box retailers, such as Walmart, Target, and Costco, compete primarily on price and selection. The stores advertise "everyday low prices" and carry a wide selection of merchandise. The average Walmart store stocks about 125,000 items. The category killers, such as PetSmart, Home Depot, and Best Buy, also compete primarily on price and selection, but have the advantage of zeroing in on a single category and providing better product knowledge. Behind the scenes, the lower prices the big-box stores offer are made possible by volume sales, supply chain efficiencies, favorable terms from suppliers, and low overhead relative to sales. They are also nearly everywhere. For example, as of January 31, 2017, Walmart had established a total of 5,332 units in the United States. (This total includes all forms of Walmart stores such as Supercenters, Discount Stores, Neighborhood Markets, and Sam's Clubs.)

Vulnerabilities of the Big-Box Stores

The big-box stores have vulnerabilities. The general merchandisers, like Walmart, feature a product strategy that is a mile wide and an inch deep. The basic idea is to sell the most popular product in as many categories as possible. While this approach is what enables general merchandisers to achieve economies of scale, it leaves gaps in the marketplace. Walmart can't stock the same amount of fishing gear, for example, as a local sporting goods store. The stores themselves also have inherent disadvantages. Customers complain of crowded aisles, long checkout lines, and an inability to find help if they're looking for something in the store. While the category killers, like Home Depot and PetSmart, are better at customer service and product knowledge, they're still trying to sell the most popular products to mainstream customers. For example, although Academy offers an impressive selection of sporting goods, clothing, and outdoor gear, it can't offer everything. This leaves an opening for a store like TrackShack, which is a locally-owned running shoe and running gear store in Orlando, FL.

TrackShack offers a wider selection of running shoes and deeper product knowledge than Academy or DICK'S Sporting Goods could offer. Pause for a moment and look at TrackShack's website (www.trackshack.com). This store is owned by local entrepreneurs—John and Betsy Hughes. If you compare TrackShack to Academy on running shoes, Academy may win on price, but TrackShack wins on selection, product quality, product knowledge, customer service, convenience, and ties to the local community. That's a pretty compelling set of advantages to build upon.

Strategies for Competing against Big-Box Stores

Here are three common strategies for competing against big-box stores:

Operate in a Niche Market. A niche market is a place within a market segment that represents a narrow group of customers with similar needs. It's smart for a business competing against a big-box retailer to operate in a niche market, and position itself as the "go-to" place for a particular product or service. This is what TrackShack has done. TrackShack is also a place that runners can go to get advice if they're experiencing foot pain or similar symptoms when they're running. No one would think to go to Academy or Walmart for that type of advice. The same philosophy can be pursued in almost any category. Both Walmart and Costco sell guitars, yet Bentley Guitar Studios, a privately-held single location guitar retailer and studio in Kansas City, MO exists. The store complements its guitar sales with extensive product knowledge and music lessons, something Walmart and Costco can't offer.

Differentiate. Once a business selects a niche market, it must differentiate itself from its competitors. The biggest mistake that small businesses trying to compete against big-box stores make is that they try to be little versions of the big-box store. Instead, it's important to differentiate along lines that are important to customers. For example, TrackShack has knowledgeable salespeople. A customer can spend an hour with a TrackShack sales associate trying on different shoes. You don't get that at a big-box store. Similarly, along with guitar lessons, Bentley Guitar

Studios has an Acoustic Room which is a performing venue for local and touring artists as well as workshops and student performances. It also offers lessons for piano, drums, trumpet, and several other instruments. In other words, Bentley is everything that Costco and Walmart aren't.

Stress "Locally Owned." The third thing to do is to stress the locally owned nature of your business. This approach tugs at the heart strings of people who are loyal to their local community and have a desire to shop local when they can. This is why local businesses place signs in their windows or stores that say "locally owned business" or "crafts made by local artisans" or something similar. A 2015 Yodle survey of 6,000 U.S. adults found that a majority of respondents consider local businesses to be more trustworthy and deliver better quality than big-box stores. Stressing the local nature of a business can also be helpful in building its brand. It not only ties into consumer preferences for shopping local but draws attention to favorable product attributes like freshness, wholesomeness, and supporting the local economy. The big-box stores themselves are starting to carry more locally produced products to capture the same advantage.

Questions for Critical Thinking

1. What does this feature teach us about the importance of "crafting a unique market position" when launching a retail entrepreneurial venture?
2. Spend some time looking at TrackShack's website at www.trackshack.com. Make a list of the reasons that someone interested in running shoes might shop at TrackShack instead of Academy, even if the shoes the consumer buys at TrackShack may be more expensive than comparable shoes at Academy.
3. Suggest a fourth strategy that small retailers can employ to compete against big-box stores.
4. Identify a locally owned business in the city or community in which you live. Describe how the business is competing against big-box stores.

Sources: TrackShack, www.trackshack.com (accessed March 14, 2017); Bentley Guitar Studios, www.bentleyguitars.com, (accessed March 14, 2017); Survey: Consumers Prefer to Shop Local but Expect Digital Sophistication, Screenwerk, available at https://screenwerk.com/2015/07/17/survey-consumers-prefer-to-shop-local-but-expect-digital-sophistication/ (posted July 17, 2015, accessed March 14, 2017); B. Barringer and R. D. Ireland. *What's Stopping You?* Upper Saddle River, NJ: FT Press, 2008.

creates through its brand is one of its most valuable assets. Lending support to this sentiment, Russell Hanlin, the CEO of Sunkist Growers, said, "An orange is an orange . . . is an orange. Unless . . . that orange happens to be a Sunkist, a name 80 percent of consumers know and trust."[8] By putting its name on an orange, Sunkist is making a promise to its customers that the orange will be wholesome and fresh. It is important that Sunkist not break this promise. Some companies monitor the integrity of their brands through **brand management**, which is a program used to protect the image and value of an organization's

wavebreakmedia/Shutterstock

These two entrepreneurs have just opened a café and wine bar. They plan to sell specialty sandwiches, soups, and salads, along with wine and an assortment of craft beers. An important task they have ahead of them is building a brand for their company. A brand is the set of attributes that people associate with a business.

brand in consumers' minds. This means that if Sunkist discovered that some of its oranges weren't fresh, it would take immediate steps to correct the problem.

Table 11.2 lists the different ways people think about the meaning of a brand. All the sentiments expressed in the table are similar, but they illustrate the multifaceted nature of a company's brand.

Start-ups must build a brand from scratch; this process begins with selecting the company's name, as described in Chapter 7's appendix. One of the keys to effective branding is to create a strong personality for a firm, designed to appeal to the chosen target market.[9] Southwest Airlines, for example, has created a brand that denotes fun. This is a good fit for its historical and current primary target market: people traveling for pleasure rather than business. Similarly, Starbucks and Panera Bread have each created a brand that denotes an experience framed around warmth and hospitality, encouraging people to linger and buy additional products. A company ultimately wants its customers to strongly identify with it—to see themselves as "Southwest Airlines flyers" or as "Panera Bread diners." People won't do this, however, unless they see a company as being different from competitors in ways that create value for them.

So how does a new firm develop a brand? On a philosophical level, a firm must have meaning in its customers' lives. It must create value—something for which customers are willing to pay. Imagine a father shopping for airline tickets so that he can take his three children to see their grandparents for Christmas. If Southwest Airlines can get his family to their destination for $75 per ticket cheaper than its competitors, Southwest has real meaning in the father's life. Similarly, if a young couple invites neighbors to play Cranium, a group board game, and playing the game results in lasting friendships, Cranium will have a special place in their hearts.

On a more practical level, brands are built through a number of techniques, including advertising, public relations, sponsorships, support of social causes, social media, and good performance. A firm's name, logo, website design, Facebook page, Instagram account, and even its letterhead are part of its brand. It's important for start-ups, particularly if they plan to sell to other businesses, to have a polished image immediately so that they have credibility when they approach their potential customers.

Most experts warn against placing an overreliance on advertising to build a firm's brand. A more affordable approach is to rely on word of mouth, the media, and ingenuity to create positive buzz about a company. Creating **buzz** means creating awareness and a sense of anticipation about a company and its offerings.[10] This process can start during feasibility analysis, when a company shows its concept statement or product prototype to prospective buyers or

TABLE 11.2 What's a Brand? Different Ways of Thinking about the Meaning of a Brand

- A brand is a promise to serve stakeholders' interests.
- A brand is a firm's guarantee of a level of performance.
- A brand indicates the promises a firm makes to those it serves.
- A brand expresses a firm's reputation.
- A brand presents a firm's credentials.
- A brand is an indicator of trust and reduced risk.
- A brand describes a company's nature.
- A brand serves as a handshake between a firm and its customers.

Source: Adapted from *Emotional Branding* by Daryl Travis, copyright © 2000 by Daryl Travis. Used by permission of Pima Publishing, a division of Random House, Inc.

industry experts. Unless a company wants what it is doing to be kept secret (to preserve its proprietary technology or its first-mover advantage), it hopes that people start talking about it and its exciting new product or service. As illustrated in the "Partnering for Success" feature in Chapter 6, creating buzz also helps a firm establish a community of true believers and early evangelists for a product or service. Several of the start-ups described in this book, including SoulCycle, Rent the Runway, Casper, and Birchbox did an excellent job of converting early testers and early users of their offerings into product evangelists. In each case, the early evangelists persuaded others to try the company's product or service which helped establish momentum. Obtaining favorable press is also a good way to create buzz for a product or service. Newspapers, magazines, blogs, and trade journals are always looking for stories about interesting companies. Wild Friends Foods, the subject of the "Opening Profile" for Chapter 9, was greatly assisted when a popular food blogger, Kath Unger, wrote a short piece about the firm's product. The piece led to hundreds of orders. An even bigger boost was experienced a month later when Wild Friends Foods was featured in *Oprah* Magazine. Similarly, Rent the Runway received a big boost the day of the firm's launch when an early tester put in a good word about the firm at *The New York Times* and they were featured on the front page of the paper's business section.

Focusing too much on the features and benefits of their products is a common mistake entrepreneurs make when trying to gain attention from the media. Journalists are typically skeptical when entrepreneurs start talking about how great their products are relative to those of their competitors. What journalists usually prefer is a human interest story about why a firm was started or a story focused on something that's distinctly unique about the start-up.

Ultimately, a strong brand can be a very powerful asset for a firm. Over 50 percent of consumers say that a known and trusted brand is a reason to buy a product.[11] As a result, a brand allows a company to charge a price for its products that is consistent with its image. A successful brand can also increase the market value of a company by 50 to 75 percent.[12] This increased valuation can be very important to a firm if it is acquired, merges with another firm, or launches an initial public offering (IPO). **Brand equity** is the term that denotes the set of assets and liabilities that are linked to a brand and enable it to increase a firm's valuation.[13] It is important for firms to understand brand equity and how to use it to create value.

Although the assets and liabilities that make up a firm's brand equity will vary from context to context, they usually are grouped into the following five categories:

- Brand loyalty
- Name recognition
- Perceived quality (of a firm's products and services)
- Brand associations in addition to quality (e.g., good service)
- Other proprietary assets, such as patents, trademarks, and high-quality partnerships

One aspect of branding that start-ups should be alert to is the possibility of forming co-branding relationships. Co-branding is when two companies form a partnership to combine their brands. The objective is to combine the strengths of the brands. A co-branding relationship can be short term, to promote a specific event or product launch, or can be long term, such as opening co-branded stores. Two examples of co-branding relationships are provided in the nearby "Partnering for Success" feature. The co-branding relationships are between GoPro and Red Bull and Pottery Barn and Sherwin-Williams.

PARTNERING FOR SUCCESS

Two Examples of Successful Co-Branding Partnerships

Co-branding is when two companies from a partnership to work together. The idea is to create marketing synergy. Synergy is the concept of 2 + 2 = 5. Synergy is achieved in a co-branding relationship when two brands working together achieve more than the brands could have cumulatively achieved on their own. This is possible, in a successful co-branding relationship, when each brand benefits from the brand loyalty and the reputation of the other.

The following are two examples of successful co-branding partnerships.

GoPro and Red Bull

GoPro doesn't sell energy drinks and Red Bull doesn't sell cameras. Yet both companies have established themselves as lifestyle brands—in particular, a lifestyle that's action-packed. The companies also share the same vision—to inspire the world to live a more adventurous life. The way the co-branding relationship works is that Red Bull sponsors extreme sports events, and GoPro is present and equips athletes with cameras to capture their experiences. Because of the capabilities that GoPro cameras have, audiences can now see views of athletic performances never seen before (such as what a snowboarder sees when he or she does a flip on a jump).

In 2016, GoPro and Red Bull took their co-branding relationship a step further and are now strategic partners. As part of the agreement, GoPro will become Red Bull's exclusive point-of-view camera provider and Red Bull will receive an equity stake in GoPro. These two firms will continue to cross-promote their products and will collaborate on product innovation.

Pottery Barn and Sherwin-Williams

Both Pottery Barn and Sherwin-Williams have similar goals—to help consumers create beautiful, coordinated furnished spaces in their homes. Pottery Barn makes furniture and home accessories and Sherwin-Williams is the U.S.' largest specialty retailer of paint and painting supplies. As part of their co-branding partnership, Pottery Barn will feature room vignettes that pair furniture and décor with Sherwin-Williams colors and Emerald Paint in their catalogues, websites, and stores. Emerald Paint is Sherwin-William's brand of premium interior paint.

The way the partnership works is that a consumer can go to Pottery Barn's website, for example, and easily find the Sherwin-Williams color palettes that coordinate with Pottery Barn's latest collections. At the time this feature was written, the new color palettes included Latte (SW 6108), Halcyon Green (SW 6213), and Rosy Outlook (SW 6316). A consumer can then go to a Sherwin-Williams store and get the paint that will exactly match their Pottery Barn home décor.

Questions for Critical Thinking

1. Make a list of the pluses and minuses of the co-branding relationship between GoPro and Red Bull. Indicate whether you think the potential pluses outweigh the potential minuses. Explain your answer.
2. To what degree do you believe brand management is more difficult in a co-branding relationship?
3. Do some research so you can identify and be able to discuss two additional examples of co-branding. Describe the rationale behind each co-branding relationship you found through your research.
4. Examine the "You Be the VC 11.1" feature which focuses on Barnana, a company that produces a healthy snack made out of partially dehydrated bananas. Suggest come potential co-branding relationships for Barnana.

Sources: "Why is GoPro (GRPO) Stock Up 6% Today?" Zachs, available at https://www.zacks.com/stock/news/218394/why-is-gopro-gpro-stock-up-6-today (posted May 25, 2016, accessed March 14, 2017); Pottery Barn, www.potterybarn.com (accessed March 14, 2017); L. Kolowich, "8 Examples of Successful Co-Branding Partnerships (And Why They're So Great)," HupSpot boog, available at https://blog.hubspot.com/marketing/best-cobranding-partnerships\#sm.00bntr1o100eflv10ty2a14bvflpr (posted March 8, 2016, accessed March 14, 2017).

The 4Ps of Marketing for New Ventures

LEARNING OBJECTIVE

3. Identify and explain the 4Ps of marketing activities (product, price, promotion, and place) used by entrepreneurial firms.

Once a company decides on its target market, establishes a position within that market, and establishes a brand, it is ready to begin planning the details of its marketing mix. A firm's **marketing mix** is the set of controllable, tactical marketing tools that it uses to produce the response it wants in the target market.[14] Most marketers organize their marketing mix into four categories: product, price, promotion, and place (or distribution). For an obvious reason, these categories are commonly referred to as the 4Ps.

The way a firm sells and distributes its product dramatically affects its marketing program. This effect means that the first decision a firm has to make is its overall approach to selling its product or service. Even for similar firms, the marketing mix can vary significantly, depending on the way the firms do business. For example, a software firm can sell directly through its website or through retail stores, or it can license its product to another company to be sold under that company's brand name. A start-up that plans to sell directly to the public would set up its promotions program in a much different way than a firm planning to license its products to other firms. A firm's marketing program should be consistent with its business model and its overall business plan.

Let's look more closely at the 4Ps. Again, these are broad topics on which entire books have been written. In this section, we focus on the aspects of the 4Ps that are most relevant to entrepreneurial ventures.

Product

A firm's **product**, in the context of its marketing mix, is the good or service it offers to its target market. Technically, a product is something that takes on physical form, such as an Apple iPhone, a bicycle, or a solar panel. A **service** is an activity or benefit that is intangible and does not take on a physical form, such as an airplane trip or advice from an attorney. But when discussing a firm's marketing mix, both products and services are lumped together under the label "product."

Determining the product or products to be sold is central to the firm's entire marketing effort. As stressed throughout this book, the most important attribute of a product is that it adds value in the mind of its target customers. Let's think about this by comparing vitamins with pain pills, as articulated by Henry W. Chesbrough, a professor at Harvard University:

> We all know that vitamins are good for us and that we should take them. Most of us, though, do not take vitamins on a regular basis, and whatever benefits vitamins provide do not seem to be greatly missed in the short term. People therefore pay relatively very little for vitamins. In contrast, people know when they need a pain killer. And they know they need it now, not later. They can also tell quite readily whether the reliever is working. People will be willing to pay a great deal more for a pain reliever than they pay for a vitamin. In this context, the pain reliever provides a much stronger value proposition than does a vitamin—because the need is felt more acutely, the benefit is greater and is perceived much more quickly.[15]

This example illustrates, at least in part, why investors prefer to fund firms that potentially have breakthrough products, such as a software firm that is working on a product to eliminate e-mail spam or a biotech firm that is working on a cure for a disease. These products are pain pills rather than vitamins because their benefits would be felt intensely and quickly. In contrast, a new restaurant start-up or a new retail store may be exciting, but these types of firms are more akin to a vitamin than a pain pill. The benefits of these businesses would not be felt as intensely.

As the firm prepares to sell its product, an important distinction should be made between the core product and the actual product. While the core product may be a CD that contains a tax preparation program, the actual product, which is what the customer buys, may have as many as five characteristics: a quality level, features, design, a brand name, and packaging.[16] For example, TurboTax is an actual product. Its name, features, warranty, ability to upgrade, packaging, and other attributes have all been carefully combined to deliver the benefits of the product: helping people prepare their federal and state tax returns while receiving the largest refund possible. When first introducing a product to the market, an entrepreneur needs to make sure that more than the core product is right. Attention also needs to be paid to the actual product—the features, design, packaging, and so on that constitute the collection of benefits that the customer ultimately buys. Anyone who has ever tried to remove a product from a frustratingly rigid plastic container knows that the way a product is packaged is part of the product itself. The quality of the product should not be compromised by missteps in other areas.

The initial rollout is one of the most critical times in the marketing of a new product. All new firms face the challenge that they are unknown and that it takes a leap of faith for their first customers to buy their products. Some start-ups meet this challenge by using reference accounts. A **reference account** is an early user of a firm's product who is willing to give a testimonial regarding his or her experience with the product. For example, imagine the effect of a spokesperson for Apple Inc. saying that Apple used a new computer hardware firm's products and was pleased with their performance. A testimonial such as this would pave the way for the sales force of this new firm's hardware, and the new firm could use it to reduce fears that it was selling an untested and perhaps ineffective product.

To obtain reference accounts, new firms must often offer their product to an initial group of customers for free or at a reduced price in exchange for their willingness to try the product and for their feedback. There is nothing improper about this process as long as everything is kept aboveboard and the entrepreneur is not indirectly "paying" someone to offer a positive endorsement. Still, many entrepreneurs are reluctant to give away products, even in exchange for a potential endorsement. But there are several advantages to getting a strong set of endorsements: credibility with peers, non-company advocates who are willing to talk to the press, and quotes or examples to use in company brochures and advertisements.

Price

Price is the amount of money consumers pay to buy a product. It is the only element in the marketing mix that produces revenue; all other elements represent costs.[17] Price is an extremely important element of the marketing mix because it ultimately determines how much money a company can earn. The price a company charges for its products also sends a clear message to its target market. For example, Oakley positions its sunglasses as innovative, state-of-the art products that are both high quality and visually appealing. This position in the market suggests the premium price that Oakley charges. If Oakley tried to establish the position described previously and charged a low price for its products, it would send confusing signals to its customers. Its customers would wonder, "Are Oakley sunglasses high quality or aren't they?" In addition, the lower price wouldn't generate the sales revenue Oakley requires to continuously differentiate its sunglasses from competitors' products in ways that create value for customers.

Most entrepreneurs use one of two methods to set the price for their products: cost-based pricing or value-based pricing.

Cost-Based Pricing. In **cost-based pricing**, the list price is determined by adding a markup percentage to a product's cost. The markup percentage may be standard for the industry or may be arbitrarily determined by the entrepreneur. The advantage of this method is that it is straightforward, and it is relatively easy to justify the price of a good or service. The disadvantage is that it is not always easy to estimate what the costs of a product will be. Once a price is set, it is difficult to raise it, even if a company's costs increase in an unpredicted manner. In addition, cost-based pricing is based on what a company thinks it should receive rather than on what the market thinks a good or service is worth. It is becoming increasingly difficult for companies to dictate prices to their customers, given customers' ability to comparison shop on the Internet to find what they believe is the best combination of a product's features, including price, for them.[18]

Value-Based Pricing In **value-based pricing**, the list price is determined by estimating what consumers are willing to pay for a product and then backing off a bit to provide a cushion. What a customer is willing to pay is determined by the perceived value of the product and by the number of choices available in the marketplace. Sometimes, to make this determination, a company has to work backwards by testing to see what its target market is willing to pay. A firm influences its customers' perception of the value through positioning, branding, and the other elements of the marketing mix. Most experts recommend value-based pricing because it hinges on the perceived value of a product or service rather than cost plus pricing, which, as shown previously, is a formula that ignores the customer.[19] A gross margin (a company's net sales minus its costs of goods sold) of 60 to 80 percent is not uncommon in high-tech industries. An Intel chip that sells for $300 may cost $50 to $60 to produce. This type of markup reflects the perceived value of the chip. If Intel used a cost-based pricing method instead of a value-based approach, it would probably charge much less for its chips and earn less profit.

Most experts also warn entrepreneurs to resist the temptation to charge a low price for their products in the hopes of capturing market share. This approach can win a sale but generates little profit. In addition, most consumers make a **price-quality attribution** when looking at the price of a product. This means that consumers naturally assume that the higher-priced product is also the better-quality product.[20] If a firm charges a low price for its products, it sends a signal to its customers that the product is low quality regardless of whether it really is.

A vivid example of the association between price and quality is provided by SmugMug (www.smugmug.com), an online photo-sharing site that charges a $5.99 per month base subscription fee ($3.99 per month if paid annually). According to its website, the company has "Billions of Happy Photos" and "Millions of Happy Customers." What's interesting about the company is that most of its competitors, including 500 Pixels, Flickr, and Facebook, offer a similar service for free. Ostensibly, the reason SmugMug is able to charge a fee is that it offers higher levels of customer service, more storage capacity in some cases, and has a more user-friendly interface (in terms of how you view your photos online) than its competitors. But the owners of SmugMug feel that its ability to charge goes beyond these obvious points. Some of the free sites have closed abruptly, and their users have lost photos. SmugMug, because it charges, is seen as more reliable and dependable for the long term. (Who wants to lose their photos?) In addition, the owners believe that when people pay for something, they innately assign a higher value to it. As a result, SmugMug users tend to treat the site with respect, by posting attractive, high-quality photos that are in good taste. SmugMug's users appreciate this facet of the site, compared to the free sites, where unseemly photos often creep in.[21]

The overarching point of this example is that the price a company is able to charge is largely a function of (1) the objective quality of a product or service and (2) the perception of value that is created in the minds of customers relative to competing products in the marketplace. These are issues a firm should consider when developing its positioning and branding strategies.

Price is such an important element of the marketing mix that, if a company gets it wrong, it can be extremely damaging to both the company's short-term profits and future viability. The "What Went Wrong?" feature in this chapter, that is located nearby, focuses on marketing missteps at JCPenney. In 2011–2012, JCPenney, under the leadership of then CEO Ron Johnson, made critical mistakes in the areas of branding, testing (or the lack thereof), and pricing. The mistakes provide lessons for start-ups of marketing miscues they should be particularly on guard to avoid in their own situations.

WHAT WENT WRONG?

What Start-Ups Can Learn about Marketing from Missteps at JCPenney

• *Web: www.jcpenney.com* • *Facebook: JCPenney* • *Twitter: @jcpenney*

After successful stretches at Target and Apple, it seemed as though Ron Johnson was a master marketer. But things went sour quickly after JCPenney hired Johnson as its CEO. Johnson's attempt to reinvent JCPenney's brand, change its pricing strategy, and overhaul the way the company did business all fell flat. In fact, during Johnson's 17-month tenure, JCPenney's sales fell quickly, loyal customers deserted the company, and employee morale hit an all-time low.

JCPenney hired Johnson in June 2011. The idea was to bring in a marketing wiz to revitalize JCPenney's tired brand. Johnson seemed to have all the right credentials. At Target, he was vice president of merchandising, where he was responsible for launching the Michael Graves line of consumer products that enhanced Target's image. His most recent job prior to joining JCPenney was senior vice president of retail operations at Apple, where he was largely responsible for the sleek look and solid success of Apple stores.

Johnson hit the ground running at JCPenney with bold plans. His goal was to revitalize the firm by breathing new life into its stores and brand. When he was brought in, JCPenney was an unremarkable but solid chain of 1,100 stores serving "middle" America. Sales were around $17.5 billion a year. When he left sales had plummeted to $13 billion on an annual basis and JCPenney was running low on cash. What went wrong?

According to a general consensus, Johnson made three primary mistakes during his stint at JCPenney. The mistakes involve various facets of marketing, and they are mistakes that yield important lessons for start-ups.

Mistake #1—Fair and Square Pricing. In early 2012, Johnson announced that JCPenney would no longer offer merchandise on "sale." Instead, the company would offer "fair and square" everyday low pricing. The idea was to offer a fair price from the get-go, rather than marking a product high and then cutting the price several times before eventually getting to the fair price.

The strategy didn't work. It turns out shoppers like looking for bargains. It's somewhat of a game—shoppers see a new shirt or blouse priced at $50, and then wait for it to go on "sale" for $35 before buying. None of the shirts or blouses sell for $50, so Johnson figured why play games, just list the shirt or blouse for $35 from the outset. But it turns out that shoppers are accustomed to and like playing the game. There is a certain satisfaction in "saving" $15 on a shirt or blouse that a shopper doesn't get paying the same price initially. As a result, loyal JCPenney shoppers left in droves for T.J.Maxx, Kohl's, and Macy's, where the game was ongoing.

Terminology was also a problem. As part of fair and square pricing, JCPenney had two tiers of pricing for a period of time: red tickets indicated that the items were "everyday" merchandise pricing, and clearance items had blue stickers that designated "best price." The result was widespread customer confusion. Shoppers didn't understand what the terms meant. It was another reason to abandon JCPenney and go to a different store.

In fairness to Johnson, fair and square pricing had worked at Apple. Apple doesn't price computers, iPhones, or iPads at one price and then slash the price and offer the product on sale. The mistake Johnson made was to equate the way people buy technology products with the way people buy clothing and other products sold at JCPenney. Consumers are accustomed to paying full freight for technology products, but not for clothing. By the time JCPenney tried to reverse its pricing strategy, significant damage had been done.

Mistake #2—No Testing of Ideas in Advance. The reason Johnson wasn't able to anticipate the negative response to fair and square pricing is because it wasn't tested in advance. When Johnson proposed his bold new strategy, he was asked about the possibility of trying it out on a limited test basis. According to several published reports, Johnson shot down the idea by saying that he didn't test at Apple.

Imagine what could have been learned by simply testing fair and square pricing at a handful of stores before rolling it out system-wide. The fact is that JCPenney's loyal customers loved sales and the prospect of finding a "steal" via rounds of markdowns. Also, a simple trial period should have revealed the type of confusion resulting from the new terminology that was put in use.

Mistake #3—A Total Misread of JCPenney's Brand. Perhaps the most damaging mistake was a total misread of JCPenney's brand. Johnson envisioned JCPenney stores having "stores within the stores," which would be boutiques where people could buy specialty merchandise or get their nails done. He wanted JCPenney to be Americans' "favorite place to shop." His goal was for people to show up and hang out at JCPenney stores, like people hang out at Apple stores, and gladly pay a full but fair price. It never happened. JCPenney's core clientele was thrift-minded shoppers who brought impatient kids into the store to buy school clothes. They also tended to move through the stores quickly when shopping alone. The consensus view is that Johnson wanted JCPenney shoppers to be something they weren't. He wanted them to be more like Apple shoppers. Instead, there was more overlap with T.J. Maxx or even Walmart.

The Ron Johnson era ended in January 2013, just 17 months after it began. He was replaced by his predecessor, Mike Ullman. Marvin Ellison is JCPenney's current CEO.

Questions for Critical Thinking

1. How does a start-up establish a "brand"? What do we learn from JCPenney's miscues about the importance of branding?

2. Although the concept of selecting a target market and establishing a unique position is not specifically mentioned in the feature, what do we learn about these two topics from JCPenney's miscues?
3. What type of testing should a start-up do to ensure that its initial customers see its brand in the way the company intended?
4. Do a little Internet or gumshoe research on JCPenney today. Where does the company stand in terms of how it prices its products? What does the company's brand mean to consumers today?

Sources: "5 Critical Errors That Triggered Ron Johnson's Removal at JCPenney," *Chief Executive*, available at https://chiefexecutive.net/5-critical-errors-that-triggered-ron-johnsons-removal-at-jc-penney (posted April 18, 2013, accessed September 3, 2014); J. Aisner, "What Went Wrong at JC Penney? *Forbes*, August 21, 2013; Ron Johnson (businessman), Wikipedia, www.wikipedia.org (accessed September 3, 2014).

Promotion

Promotion refers to the actions the firm takes to communicate the merits of its product to its target market. Ultimately, the goal is to persuade people to buy the product. There are a number of these actions, but most start-ups have limited resources, meaning that they must carefully study promotion activities before choosing the one or ones they'll use. Let's look at the most common actions entrepreneurs use to promote their products.

Advertising. **Advertising** is making people aware of a product in hopes of persuading them to buy it. Advertising's major goals are to:

- Raise customer awareness of a product
- Explain a product's comparative features and benefits
- Create associations between a product and a certain lifestyle

These goals can be accomplished through a number of media including direct mail, magazines, newspapers, radio, the Internet, blogs, television, and billboard advertising. The most effective ads tend to be those that are memorable and support a product's brand. However, advertising has some major weaknesses, including the following:

- Low credibility
- The possibility that a high percentage of the people who see the ad will not be interested

Monkey Business Images/Shutterstock

Many businesses, including start-ups, use digital ads on Facebook, Google, YouTube, and other online platforms to promote their products. This young man is looking at a Facebook ad posted by Verizon, one of the largest advertisers on the social network.

- Message clutter (meaning that after hearing or reading so many ads, people simply tune out)
- Relative costliness compared to other forms of promotions
- The perception that advertising is intrusive[22]

Because of these weaknesses, most start-ups do not advertise their products broadly. Instead, they tend to be very frugal and selective in their advertising efforts or engage in hybrid promotional campaigns that aren't advertising per se, but are designed to promote a product or service.

Along with engaging in hybrid promotional campaigns, many start-ups advertise in trade journals or utilize highly focused pay-per-click advertising provided by Google, Bing, or another online firm to economize the advertising dollars. Pay-per-click advertising represents a major innovation in advertising and has been embraced by firms of all sizes. Google has two pay-per-click programs—AdWords and AdSense. AdWords allows an advertiser to buy keywords on Google's Homepage (www.google.com), which triggers text-based ads to the side (and sometimes above) the search results when the keyword is used. So, if you type "soccer ball" into the Google search bar, you will see ads that have been paid for by companies that have soccer balls to sell. Many advertisers report impressive results utilizing this approach, presumably because they are able to place their ads in front of people who are already searching for information about their product. AdSense is Google's other pay-per-click program. It is similar to AdWords, except the advertiser's ads appear on other websites instead of Google's Homepage. For example, an organization that promotes soccer might allow Google to place some of its client's ads on its website. The advertiser pays on a pay-per-click basis when its ad is clicked on the soccer organization's site. Google shares the revenue generated by the advertisers with the sponsoring site. Table 11.3 provides a summary of the Google AdWords and Google AdSense programs. Yahoo and Microsoft's joint program, which is very similar to Google's, is called the Yahoo Bing Network. The Yahoo Bing Network is a joint venture between Yahoo and Microsoft to sell pay-per-click ads on both the Yahoo and the Microsoft Bing search engines.

As an aside, online advertising in general allows people who know a lot about a particular topic to launch a website, populate it with articles, tips, videos, and other useful information, and make money online by essentially selling access to the people attracted to the website. For example, Paul Roman has a love for woodworking. He became frustrated with the lack of quality information on the craft, so he started creating publications with woodworking-related articles, tips, and how-to guides. In 2005, he launched a members-only site named FineWoodworkingNetwork.com, which for $34.95 per year provides access to high-quality woodworking related material. This site has been followed by membership sites for three magazines Roman and his wife Jan publish—*Fine Homebuilding*, *Threads*, and *Fine Gardening*. They also run several blogs, including Job Site Diaries and Tool-Tech. The blogs generate income via online advertising.[23]

Another medium for advertising, which is growing in popularity, is social media sites, such as Facebook. The advantage of Facebook, in particular, is that it allows companies to deliver highly targeted ads based on where people live and how they describe themselves on their Facebook profiles. For example, a company that sells licensed sports apparel for the Boston Red Sox can deliver a highly targeted ad to the people most likely to buy its products. The company could deliver ads exclusively to men who live in Massachusetts and cite the Boston Red Sox in their Facebook profiles. Any company can identify its ideal potential customer and deliver targeted Facebook ads in the same manner.

The steps involved in putting together an advertisement are shown in Figure 11.3. Typically, for start-up firms, advertisements are the most effective if they're part of a coordinated marketing campaign.[24] For example, a print ad

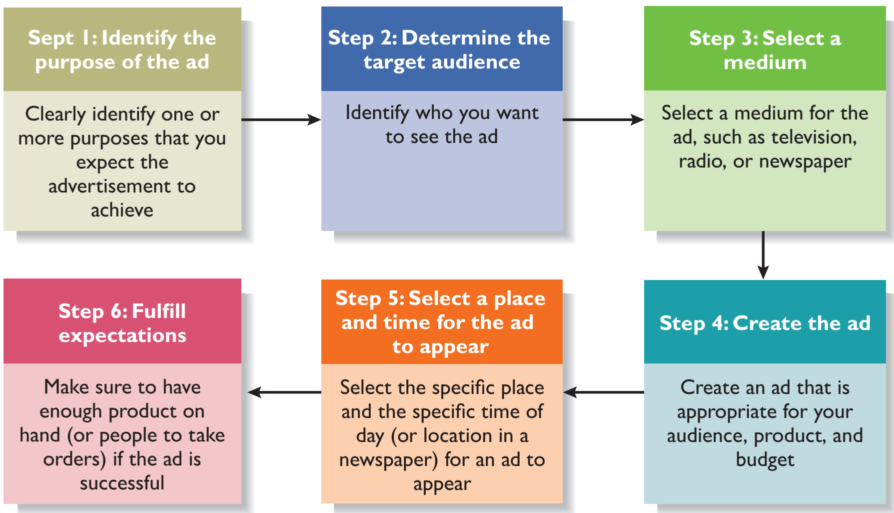
TABLE 11.3 Descriptions of Google AdWords and AdSense Programs for Advertisers and Website Owners

AdWords	AdSense
Allows advertisers to buy keywords on the Google Homepage.	Allows advertisers to buy ads that will be shown on other websites instead of Google's Homepage.
Triggers text-based ads to the side (and sometimes above) search results when the keyword is used.	Google selects sites of interest for the advertiser's customers.
Advertisers are charged on a pay-per-click basis.	Advertisers are charged on a pay-per-click or per-thousand-impression basis.
The program includes local, national, and international distribution.	Advertisers are not restricted to text-based ads. Choices include text, image, and video advertisements.
Advertisers specify the maximum amount they are willing to pay per click. The ordering of the paid listings on the search results depends on other advertisers' bids and the historical click-through rates of all ads shown for a given search.	Advertisers benefit because their ads are seen as less intrusive than most banner ads, because the content of the ad is often relevant to the website.
Advertisers have the option of enabling their ads to be displayed on Google's partner network. This network includes AOL, Ask.com, and Netscape.	Website owners benefit by using the service to monetize their websites.
Advertisers benefit because they are able to place their ads in front of people who are already searching for information about their product.	A companion to the regular AdSense program, AdSense for Search lets website owners place the Google search box on their website. Google shares any ad revenues it makes from those searches.

might feature a product's benefits and direct the reader to a website or Facebook page for more information. The website or Facebook page might offer access to coupons or other incentives if the visitor fills out an information request form (which asks for name, address, and phone number). The names collected from the information request form could then be used to make sales calls.

Public Relations One of the most cost-effective ways to increase the awareness of the products a company sells is through public relations. **Public relations** refers to efforts to establish and maintain a company's image with

FIGURE 11.3
Steps Involved in Putting Together an Advertisement



the public. The major difference between public relations and advertising is that public relations is not paid for directly. The cost of public relations to a firm is the effort it expends to network with journalists, blog authors, and other people to try to interest them in saying or writing good things about the company and its products. Several techniques fit the definition of public relations, as shown in Table 11.4.

Many start-ups emphasize public relations over advertising primarily because it's cheaper and helps build the firm's credibility. In slightly different words, it may be better to start with public relations rather than advertising because people view advertising as the self-serving voice of a company that's anxious to make a sale.[25] A firm's public relations effort can be oriented to telling the company's story through a third party, such as a magazine or a newspaper. If a magazine along the lines of *Inc.*, *Entrepreneur*, *Business Insider*, or *Fortune* publishes a positive review of a new company's products, or a company is profiled in a prominent blog, consumers are likely to believe that those products are at least worth a try. They think that because these magazines and blogs have no vested interest in the company, they have no reason to stretch the truth or lie about the usefulness or value of a company's products. Technology companies, for example, that are featured on TechCrunch, Gizmodo, or Engadget, three popular technology blogs, typically see an immediate spike in their web traffic and sales as a result of the mention.

TABLE 11.4 Public Relations Techniques

Technique	Description
Press release	An announcement made by a firm that is circulated to the press. Start-ups typically circulate a press release when something positive happens, such as the launch of a new product or the hiring of a new executive.
Traditional media coverage	Any coverage in print or broadcast media. In most cases, start-ups try to cultivate media coverage, as long as it is positive.
Social media coverage	Start-ups use social media (Facebook, Twitter, Instagram, Pinterest) as a way of communicating and building rapport with customers, and also covet positive mentions in the social media efforts of others. For example, a positive mention by someone who posts on Twitter and has a large number of followers can positively impact a start-up.
Articles in industry press and periodicals	Articles in industry press and periodicals are particularly coveted because they are read by people already interested in the industry in which the start-up is participating.
Blogging	Companies benefit from blogging in three ways: First, by writing their own blog, as a way of building rapport with customers and the general public. Second, by commenting on entries contained in other companies' or people's blogs. Third, by contacting bloggers and asking them to comment on a company's product or service. The general rule of thumb in blogging is that thoughtful and substantive contributions are fine. Outwardly talking about the merits of a company's products is inappropriate, unless it's on the company's own blog.
Monthly newsletter	Many companies stay in touch with their potential target audience by producing and distributing a monthly or quarterly newsletter. Along with containing updates on a firm's products and services, the newsletter should contain more general information of interest to the reader. Companies should avoid sending out newsletters that simply brag about their products. These types of newsletters are often seen as too self-serving.
Civic, social, and community involvement	Start-ups often try to create a positive image of their organization by sponsoring local events or asking their employees to be involved in civic clubs such as the Chamber of Commerce or the Rotary Club.

There are many ways in which a start-up can enhance its chances of getting noticed by the press, a blogger, or someone who is influential in social media. As mentioned previously, journalists and others are typically not interested in overtly helping a firm promote its product. Instead, what they prefer is a human interest story about why a firm was started or a story that focuses on something that is particularly unique about the start-up. For example, Nest Labs, the focus of Case 11.1, was launched for the purpose of designing and producing what were "unloved" household products in ways that would cause homeowners to "love" those products. Another technique is to prepare a **press kit**, which is a folder that contains background information about the company and includes a list of its most recent accomplishments. The kit is normally distributed to journalists and made available online. Attending trade shows can also contribute to a firm's visibility. A **trade show** is an event at which the products or services in a specific industry are exhibited and demonstrated. Members of the media often attend trade shows to get the latest industry news. For example, the largest trade show for consumer electronics is International CES, which is held in Las Vegas every January. Many companies wait until this show to announce their most exciting new products. They do this in part because they have a captive media audience that is eager to find interesting stories to write about.

Social Media Use of social media consists primarily of blogging and establishing a presence and connecting with customers and others through social networking sites such as Facebook, Twitter, Instagram, or Snapchat. A good example is ModCloth (www.modcloth.com), an e-commerce site that sells a full range of vintage and vintage-inspired apparel products for women. ModCloth maintains an active blog, has two separate Twitter accounts (one for general product information and one that is more fashion oriented), maintains an energetic Facebook page, and also has a presence on Google+, Instagram, Pinterest, and YouTube.

The idea behind blogs is that they familiarize people with a business and help build an emotional bond between a business and its customers.


Noam Armonn/Shutterstock

Many businesses connect with their customers via social media. Here, a young girl is showing her grandparents Instagram photos of a product she'd like to have for an upcoming birthday.

ModCloth's blog (http://blog.modcloth.com), for example, draws attention to the company's products, but also posts fun, entertaining, and informative articles, features, and photos of interest to ModCloth's target market—18- to 32-year-old women. The blog also features contests that provide cash prizes, posts photos of customers wearing ModCloth products, and provides behind-the-scenes glimpses of what it's like to work at ModCloth. For example, employees are allowed to bring dogs to work; they are called ModDogs. Periodically, one of the dogs is featured on the blog. To expand its product lines and to increase its understanding of using social media to reach specific target customers, Walmart acquired ModCloth in March of 2017. Initial expectations were that the firm would operate as an independent entity under Walmart's ownership.

The key to maintaining a successful blog is to keep it fresh and make it informative and fun. It should also engage its readers in the "industry" and "lifestyle" that a company promotes as much as a company's products. For example, in early December, 2016, ModCloth posted the following on its blog:

> Do you have a winter wedding in the works? From the dress down to the finer details, we have some stylish suggestions to help keep you warm, cozy, and utterly radiant for a snowy ceremony.[26]

The blog went on to suggest appropriate winter wedding attire (including photos) and accessories. This is the type of feature that ModCloth customers probably enjoy seeing. It's also the type of material a person might forward to someone who is planning a winter wedding.

Many start-ups also benefit from establishing a presence on social networking sites like Facebook, Twitter, Instagram, and Pinterest. The total number of Facebook accounts is huge, which makes it particularly attractive. Facebook allows anyone in the world that is 13 years old or older to become a registered user. As of the fourth quarter of 2016, Facebook had 1.86 billion monthly active users. The company has also made itself more attractive to businesses since launching a family of social plug-ins in April 2010. **Social plug-ins** are tools that websites can use to provide their users with personalized and social experiences. Facebook's most popular social plug-ins, which a website can install, include the Like button, the Share button, and the Comments box. These social plug-ins allow people to share their Facebook experiences with their friends on Facebook. The Share button, for example, lets users share pages from a company's website on their Facebook page with one click. As a result, a young woman who just bought a dress from ModCloth's website, because ModCloth has placed the Facebook Share plug-in on its site, can immediately post a picture and description of the dress on her Facebook page and write a comment about the purchase. She might say, "Hey everyone, look at the cool dress I just bought at www.modcloth.com." This is tantamount to free advertising for ModCloth.

Along with taking advantage of social plug-ins, businesses establish a presence on Facebook, Twitter, Instagram, Snapchat, and other social media platforms to build a community around their products and services. The benefits include brand building, engaging customers, and getting customer leads as well as online sales. In regard to branding, a Facebook page or Twitter account can allow a firm to post or tweet material that's consistent with its brand. For example, Beyond Meat, the subject of the "You Be the VC 6.1" feature, is producing plant-based substitutes for meat products, such as Chicken-Free Strips (which are made from plant-based proteins but taste just like traditional chicken strips), frequently posts material on Twitter that pertains to nutrition, cooking, healthy recipes, plant-based substitutes for meat products, and so on. By doing this, Beyond Meat establishes itself as an expert on healthy eating and healthy lifestyles.

In regard to engagement, many companies use social networks to strengthen their relationships with customers by soliciting feedback, running contests, or posting fun games that pertain to a company's product. For example, ModCloth uses Twitter to do several things. First, the firm posts fun facts, polls, and even recipes it thinks its customers will like. Second, ModCloth encourages questions from customers, and usually provides a response in a matter of minutes. Third, the firm posts photos of the most popular ModCloth apparel and behind-the-scenes photos of ModCloth employees, offices, and events. What isn't done is to overdo promotions. The firm keeps its Twitter account upbeat, fun, and light. In terms of Facebook, ModCloth posts photos and comments about its products to spark conversations with customers. For example, in spring, as summer approaches, a photo of warm-weather ModCloth apparel and accessories might be posted along with the following question: "What warm-weather accessories are the most important to you?" The firm will then engage with ModCloth followers, who send in comments just like any Facebook friend would do. ModCloth also makes effective use of Pinterest. Among other things, it posts photos of its clothing matched up with accessories and shoes that the firm sells. It's a great way to show customers how they can buy ModCloth products and mix and match to create multiple outfits and looks.

There is a potpourri of additional social media outlets from which firms can benefit. For example, many businesses post videos on YouTube. YouTube offers users the ability to create a YouTube channel to archive their videos and to create their own YouTube site. An example is GoPro's YouTube channel at www.youtube.com/gopro. Businesses can also establish a presence on niche social networking sites that are consistent with their mission and product offerings. An example is ActiveRain (www.activerain.com), which is a social network for real estate agents, brokers, home stagers, inspectors, and lenders. ActiveRain now has over 284,000 members who can network with each other, create blogs to share their expertise and experiences, and participate in groups.

Other Promotion-Related Activities There are many other activities that help a firm promote and sell its products. Some firms, for example, give away free samples of their products. This technique is used by pharmaceutical companies that give physicians free samples to distribute to their patients as appropriate. A similar technique is to offer free trials, such as a three-month subscription to a magazine or a two-week membership to a fitness club, to try to hook potential customers by exposing them directly to the product or service.

A fairly new technique that has received quite a bit of attention is **viral marketing**, which facilitates and encourages people to pass along a marketing message about a particular product. A well-known example of viral marketing is Hotmail. When Hotmail first started distributing free e-mail accounts, it put a tagline on every message sent out by Hotmail users that read "Get free e-mail with Hotmail." Within less than a year, the company had several million users. Every e-mail message that passed through the Hotmail system was essentially an advertisement for Hotmail. The success of viral marketing depends on the pass-along rate from person to person. Very few companies have come close to matching Hotmail's success with viral marketing. However, the idea of designing a promotional campaign that encourages a firm's current customers to recommend its product to future customers is well worth considering.

A technique related to both viral marketing and creating buzz is guerrilla marketing. **Guerrilla marketing** is a low-budget approach to marketing that relies on ingenuity, cleverness, and surprise rather than traditional techniques. The point is to create awareness of a firm and its products, often in unconventional and memorable ways. The term was first coined and defined by Jay Conrad Levinson in the 1984 book *Guerrilla Marketing*. Guerrilla marketing is particularly suitable for entrepreneurial firms, which are often on a tight budget but have creativity, enthusiasm, and passion to draw from.

Place (or Distribution)

Place, or distribution, encompasses all the activities that move a firm's product from its place of origin to the consumer. A **distribution channel** is the route a product takes from the place it is made to the customer who is the end user.

The first choice a firm has to make regarding distribution is whether to sell its products directly to consumers or through intermediaries such as wholesalers or distributors. Within most industries, both choices are available, so the decision typically depends on how a firm believes its target market wants to buy its product. For example, it would make sense for a music studio that is targeting the teen market to produce digital recordings and sell the recordings directly over the web. Most teens have access to a computer or smartphone and know how to download music. In contrast, it wouldn't make nearly as much sense for a recording company targeting retirees to use the same distribution channel to sell its music offerings. A much smaller percentage of the retiree market knows how to download music via the web. In this instance, it would make more sense to produce CDs and partner with wholesalers or distributors to place them in retail outlets where retirees shop.

Figure 11.4 shows the difference between selling direct and selling through intermediaries. Let's look at the strengths and weaknesses of each approach.

Selling Direct Many firms sell directly to customers. Being able to control the process of moving products from their place of origin to the end user instead of relying on third parties is a major advantage of direct selling. Examples of companies that sell direct are Abercrombie & Fitch, which sells its clothing through company-owned stores, and Fitbit, which sells its exercise and sleep monitoring device through its website and through retail outlets.

The disadvantage of selling direct is that a firm has more of its capital tied up in fixed assets because it must own or rent retail outlets, must maintain a sales force, and/or must support an e-commerce website. It must also find its own buyers rather than have distributors that are constantly looking for new outlets for the firm's products.

The advent of the Internet has changed how many companies sell their products. Many firms that once sold their products exclusively through retail stores are now also selling directly online. The process of eliminating layers of middlemen, such as distributors and wholesalers, to sell directly to customers is called **disintermediation**.

Selling Through Intermediaries Firms selling through intermediaries typically pass off their products to wholesalers or distributors that place them in retail outlets to be sold. An advantage of this approach is that the firm does

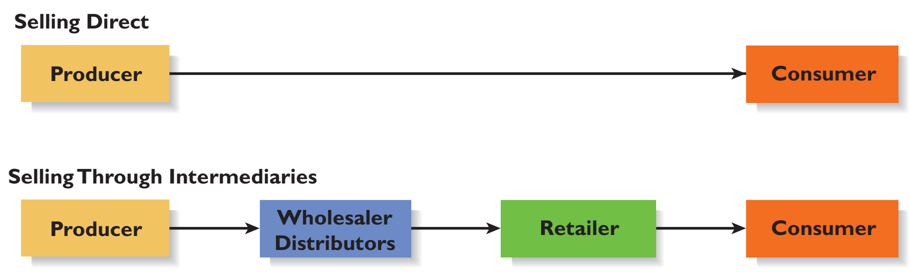


FIGURE 11.4
Selling Direct versus Selling Through Intermediaries

not need to own as much of the distribution channel. For example, if a company makes car speakers and the speakers are sold through retail outlets such as Best Buy and Walmart, the company avoids the cost of building and maintaining retail outlets. It can also rely on its wholesalers to manage its relationship with Best Buy and Walmart and to find other retail outlets in which to sell its products. The challenge to successfully using this approach is to find wholesalers and distributors that will represent a firm's products. A start-up must often pitch wholesalers and distributors much like it pitches an investor for money in order to win their support and cooperation.

The disadvantage of selling through intermediaries is that a firm loses a certain amount of control of its product. Even if a wholesaler or distributor places a firm's products with a top-notch retailer like Best Buy or Walmart, there is no guarantee that Best Buy's or Walmart's employees will talk up the firm's products as much as they would if they were employees in the firm's own stores. Selling via distributors and wholesalers can also be expensive, so it is best to carefully weigh all options. For example, a firm that sells an item for $100 on its website and makes $50 (after expenses) may only make $10 if the same item is placed by a distributor into a retail store. The $40 difference represents the profits taken by the distributor and the retailer.

Some firms enter into exclusive distribution arrangements with channel partners. **Exclusive distribution arrangements** give a retailer or other intermediary the exclusive rights to sell a company's products. The advantage to giving out an exclusive distribution agreement is to motivate a retailer or other intermediary to make a concerted effort to sell a firm's products without having to worry about direct competitors. For example, if Samsung granted T-Mobile the exclusive rights to sell a new type of smartphone, T-Mobile would be more motivated to advertise and push the phone than if many or all cell phone companies had access to the same phone.

One choice that entrepreneurs face when selling through intermediaries is how many channels to sell through. The more channels a firm sells through, the faster it can grow. But there are problems associated with selling through multiple channels, particularly early in the life of a firm. A firm can lose control of how its products are being sold. For example, the more retailers through which Ralph Lauren sells its clothing, the more likely it is that one or more retailers will not display the clothes in the manner the company wants.

Sales Process and Related Issues

LEARNING OBJECTIVE

4. Describe the seven-step sales process an entrepreneurial firm uses to identify prospects and close sales.

A firm's **sales process** depicts the steps it goes through to identify prospects and close sales. It doesn't matter whether a firm is selling directly to customers or through intermediaries; it still has a process through which it makes sales. If it's selling through an intermediary, like a distributor, it has to convince the distributor to carry its products and has to offer the distributor varying levels of support.

Some companies simply wing it when it comes to sales, which isn't recommended. It's much better to have a well-thought-out approach to prospecting customers and closing sales. A formal sales process involves a number of identifiable steps. Although the process varies by firm (and industry), it generally includes seven steps, as shown in Figure 11.5. Following a formal or structured process to generate and close sales benefits a firm in two ways. First, it enables a firm to fine-tune its approach to sales and build uniformity into the process. Second, it helps a firm qualify leads, so the firm can spend its time and money pursuing the most likely buyers of its products or services. The most frustrating thing a salesperson encounters is spending time and effort working with a potential buyer, only to discover that the buyer doesn't have the money or the authority to make a purchase. A well-thought-out sales process has triggers that

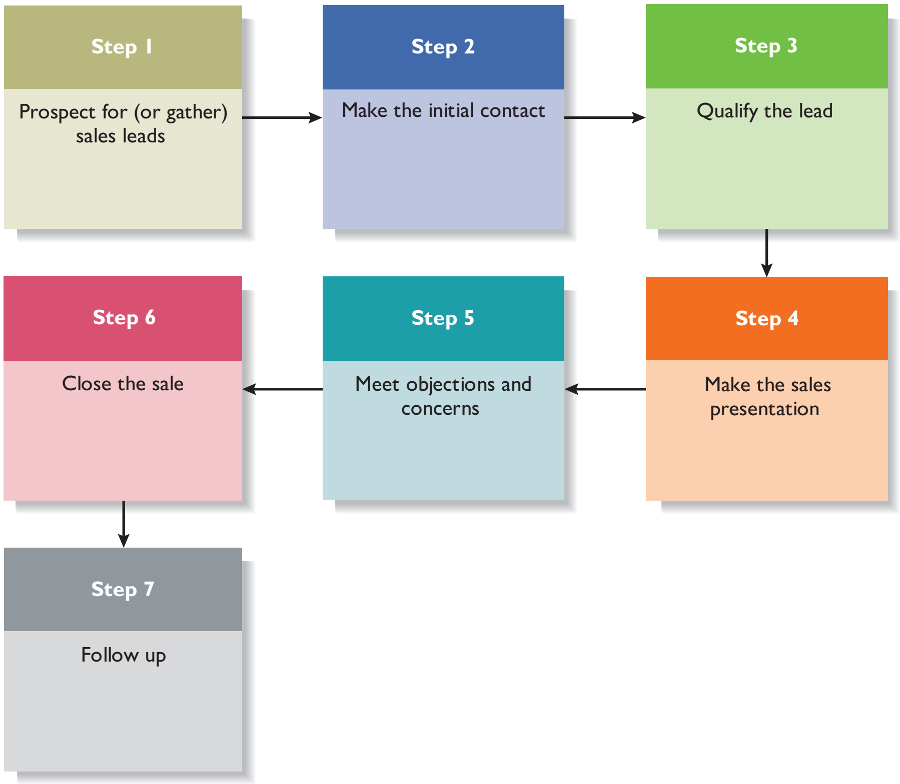


FIGURE 11.5
Sales Process

help a salesperson discern whether spending time with a particular prospect is a good use of his or her time.

Some firms implement their sales strategy by listing the seven steps in the process, and then writing procedures for how each step will be implemented. In fact, some new ventures include this material in their business plan, to provide the reader confidence that they've thought through how they'll close sales. An example of a sales process, with accompanying action steps, for a fictitious business named Prime Adult Fitness is shown in Table 11.5. The example comes from the book *Preparing Effective Business Plans*, Second Edition, by Bruce R. Barringer (co-author of this book). Prime Adult Fitness is a fitness center for people 50 years old or older. Its mission is to make exercise and fitness a vibrant and satisfying part of the lives of people who are 50 years old and older. The company will start with a single fitness center located in Oviedo, FL, a suburb of Orlando. The steps shown in Table 11.5 outline the process the company will use to recruit members and is the method that the in-house staff will follow when people walk into the center and inquire about membership. At times the process will take weeks to unfold, for example, if Prime Adult Fitness employees have multiple contacts with a prospect, and at times the process will take only a few minutes, such as when an employee provides a prospect a tour of the facility and answers specific questions. Prime Adult's sales process is offered only as an example. Individual firms can use this example as a template for developing a sales process that fits their individual products and circumstances.

Mapping the sales process in the manner shown in Table 11.5 provides a standard method for a firm's employees to use, and provides a starting point for careful analysis and continuous improvement. Often, when companies lose an important sale and reflect on what went wrong, they'll find that an important step in the sales process was missed or mishandled. This is where having a well-thought-out sales process, with accompanying action steps and appropriate employee training, can dramatically improve a company's sales performance.

TABLE 11.5 Sales Process for Prime Adult Fitness

Stage in Process	Ways Prime Adult Fitness Will Support Each Phase of the Process
1. Prospect (or sales lead)	■ Referrals from current members. ■ Direct mail (targeting households that meet Prime Adult Fitness's demographic profile). ■ Partnership with Central Florida Health Food. ■ Partnership with Oviedo Doctor's and Surgeon's Medical Practice. ■ Downloads from company website. ■ Responses from the company's radio and print advertisements.
2. Make the initial contact	■ All employees will be provided training in building rapport with prospects. ■ Prospects are provided an information packet about Prime Adult Fitness. ■ Radio and print ads will direct prospects to Prime Adult Fitness's website, which contains a short video and other promotional material.
3. Qualify the lead	■ All employees will be trained to assess whether a prospect represents a qualified lead. Prospects that are qualified as good leads will be offered a tour of Prime Adult Fitness's facilities. ■ If a qualified lead does not join initially, he or she will be contacted by phone as a follow-up three days after the visit.
4. Make the sales presentation	■ Qualified leads will be provided a facility tour. ■ Qualified leads will be shown a short film (nine minutes) featuring Prime Adult Fitness's facility and programs and the benefits of fitness for older people. ■ A packet of testimonials will be developed over time and provided to prospects as part of the sales presentation process.
5. Meet objections and concerns	■ Employees will be trained on how to meet the most common and obvious objections and concerns. ■ In regard to price objections, a brochure has been prepared that compares (1) Prime Adult Fitness's initial (one-time) enrollment fee and monthly membership fee to other fitness centers and (2) the cost of joining and belonging to a fitness center as opposed to other forms of recreation and entertainment (e.g., boating, golfing). ■ A similar brochure has been prepared to compare Prime Adult Fitness's amenities to the amenities of other fitness centers.
6. Close the sale	■ All employees will be trained to ask qualified prospects to join.
7. Follow-up	■ Each new member will be contacted by phone 30 days after joining as a courtesy to see how things are going. After that, each new member will be contacted by phone once a year. Each phone call will also be used to ask for names of referrals. ■ Prime Adult Fitness will produce a monthly newsletter that will be sent (by mail or electronically) to each member. ■ Prime Adult Fitness's staff and employees will be trained to engage members and to thank them for their membership and solicit suggestions for improvement on a continual basis.

Source: B. R. Barringer, *Preparing Effective Business Plans: An Entrepreneurial Approach* 2e, © 2015. Reprinted by permission of Pearson Education, Inc., Upper Saddle River, NJ (Upper Saddle River, NJ: Pearson Prentice-Hall, 2014).

Chapter Summary

LO1. The first step in selecting a target market is to study the industry in which the firm intends to compete and determine the different potential target markets within that industry. This process is called market segmentation. Markets can be segmented in a number of ways, including product type, price point, distribution channels used, and customers served.

After markets are segmented, the firm selects its target market, or the group it intends to serve. The next step is to establish a unique position in that market—one that differentiates the entrepreneurial firm from its competitors. The term *position* was introduced in Chapter 5, where it was emphasized that a firm's position in the marketplace determines how it is situated relative to competitors. From a marketing perspective, this translates into the image of the way a firm wants to be perceived by its customers. Importantly, position answers the question, "Why should someone in our target market buy our product or service instead of our competitor's?"

Also important to these three steps is the development of a product attribute map, which illustrates a firm's position in its industry relative to its major rivals. It is used as a visual illustration of a firm's positioning strategy and helps a firm develop its marketing plan.

LO2. A company's brand is the set of attributes people associate with it. When positive and effective, a brand can create loyal customers for the entrepreneurial firm. On a philosophical level, a firm builds a brand by having it create meaning in customers' lives. It must create value. On a more practical level, brands are built through advertising, public relations, sponsorships, supporting social causes, and good performance. Creating a strong and identifiable personality for the firm is a key to effectively developing a strong brand.

LO3. A firm's marketing mix is the set of controllable, tactical marketing tools that it uses to produce the response it wants in its target market. Most marketers organize their marketing mix around the 4Ps: product, price, promotion, and place (or distribution). In the context of the marketing mix, a product is a good or service the firm offers in the market it has chosen to serve. Technically, a product is something the firm sells that takes on a physical form, while a service is an activity or a benefit the firm provides that does not take on a physical form. The most important attribute of the product a firm sells is its ability to create value for customers. Price is the amount of money customers are willing to pay to purchase a product. Typically, entrepreneurs use one of two methods to set the price of their product. With cost-based pricing, the list price for a product is determined by adding a markup percentage to the product's cost. When using value-based pricing, the firm determines the price of its product by estimating what consumers are willing to pay for a product and then backing off a bit to provide a cushion. Promotion is concerned with the actions the firm takes to communicate the value its product creates for customers. Several actions are taken to do this. Advertising, for example, is an action taken to make people aware of a good or service the firm hopes to persuade customers to buy. Public relations refers to efforts to establish and maintain a company's image with the public. The major difference between the two is that advertising is paid for and public relations isn't—at least directly. The cost of public relations to a firm is the effort it expends to network with journalists and other people to try to interest them in saying and/or writing good things about the company. Social media consists primarily of blogging and establishing a presence and connecting with people through social networking sites like Facebook and Twitter. Businesses blog and engage in social media to build a community around their products and services. The benefits include brand building, engaging customers, and getting customer leads as well as online sales.

The first choice a firm makes regarding place or distribution is whether to sell its products directly to consumers or through intermediaries (e.g., wholesalers and retailers). An advantage of selling direct is that it allows a firm to maintain control of its products rather than relying on third parties. The disadvantage is that it ties up more capital in fixed assets because the firm must own (or rent) retail outlets or must field a sales force to sell its products. An advantage of selling through intermediaries is that a firm doesn't have to own much of its distribution channel (e.g., trucks and retail outlets). A disadvantage of this approach is that a firm loses some control of its product, in that there is no guarantee that the retailers it sells through will talk up and push its products as much as the manufacturer would if it had its own stores.

LO4. A firm's sales process depicts the steps it goes through to identify leads and close sales. The seven-step sales process includes the following steps: Step 1: Prospect for (or gather) sales leads; Step 2: Make the initial contact; Step 3: Qualify the lead; Step 4: Make the sales presentation; Step 5: Meet objections and concerns; Step 6: Close the sale; and Step 7: Follow up.

Key Terms

advertising, **426**
brand, **416**
brand equity, **420**
brand management, **418**
buzz, **419**
cost-based pricing, **423**
disintermediation, **433**
distribution channel, **433**
exclusive distribution arrangements, **434**
guerilla marketing, **432**
market segmentation, **413**
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niche market, **414**
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viral marketing, **432**

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Review Questions

11-1. What is a target market? What are the factors that need to be considered when selecting a market?
✪ 11-2. Explain the importance of market segmentation. What are several ways markets can be segmented?
11-3. How should a firm go about constructing a product attribute map?
11-4. What is a niche market?
11-5. What is meant by a firm's positioning strategy?
11-6. What is the use of a tagline?
11-7. What is a brand? Provide an example of a brand that you buy frequently and describe the mental image that pops into your mind when you hear or see the brand's name.
✪ 11-8. What is the purpose of brand management?
11-9. What is meant by creating "buzz" for a company? Provide an example of a firm that has created effective buzz for its product or service.
11-10. What is meant by the term *brand equity*?
11-11. What are the four elements of a firm's "marketing mix"?
11-12. Describe the difference between a core product and an actual product.
11-13. How can a firm obtain a unique market position?
11-14. Contrast cost-based pricing and value-based pricing.
11-15. What is meant by the phrase "price-quality attribution"? How does an understanding of this phrase help an entrepreneur know how to price a product?
11-16. What are the different ways people think about the meaning of a brand?

11-17. Contrast the roles of advertising and public relations in promoting a firm and its products.
11-18. What is the purpose of writing a blog and establishing a presence on Facebook and Twitter?
11-19. Why do firms focus on promotional activities?
11-20. What is the purpose of having an organized sales process?

Application Questions

11-21. Reread this chapter's "Opening Profile." After doing this, make a list of all the things that you think that Andrew Pohle, Jake Schaufeld, and Jordan Levy have done well to build an effective marketing program for Real Time Cases.
11-22. If you decided to start a small-business consulting service in Columbus, OH, how would you approach the following topics: market segmentation, selecting a target market, and developing a positioning strategy?
11-23. Imagine you're opening a tutoring service near the college or university you attend. What would be the characteristics of a comprehensive social media strategy that you could employ to build your brand, engage customers, and generate leads and sales revenue?
11-24. Spend some time looking at Red Bull's website (www.redbull.com). Comment on each element of Red Bull's marketing mix (product, price, promotion, and place in terms of distribution and sales). If you need additional information, conduct Internet or library research to obtain it. Using a scale of 1 to 10 (10 is high), what rating would you use to assess the strength of Red Bull's overall marketing plan? What evidence would you provide to support your rating?
11-25. Shannon Garza has developed a new type of space heater that is quieter and safer than previous generations of space heaters and is specifically geared to people who live in small spaces, such as apartments or dorm rooms. Shannon doesn't know how to price this product. Describe to Shannon the two most common methods of pricing as explained in this chapter. Which of these pricing methods would you suggest Shannon use, and why?
11-26. Read the You Be the VC 11.2 feature that deals with Open Farm Community. What marketing actions would you recommend this firm to take in order to grow, improve customer loyalty, and establish a reputation in the market?
11-27. Eatsee, an app that allows diners to see what dishes really look like by using their mobile phones to scroll through the beautifully shot visuals of a restaurant menu, is the subject firm described in the "You Be the VC 9.2" feature (from Chapter 9). Reread that feature. What types of public relations activities, from among those considered in this chapter, would you recommend this company undertake to successfully promote the business?

YOU BE THE VC 11.1 COMPANY: Barnana

• Web: www.barnana.com • Facebook: Barnana • Twitter: @barnana

Business Idea: Produce a healthy snack that consists of bite-sized morsels of partially dehydrated bananas, which are easy to carry and are potassium-rich.

Pitch: In 2001, Caue Suplicy moved to the United States to pursue a career as a professional triathlete. He often carried with him small squares of dehydrated bananas, made from a family recipe he learned in Brazil. The small squares were an excellent source of potassium and other nutrients. After 10 years of competing at an elite level, he retired from his professional racing career. In 2010, Suplicy created Barnana to share his special snack with others.

Barnana is the perfect snack for athletes or anyone with an interest in healthy food. As an alternative to traditional snacks, Barnana is pioneering the use of the banana's naturally occurring nutritional content. Grown in soil alive with nutrients and free of chemicals, Barnana has no additives or preservatives and is naturally sweet.

The Barnana treats are bit-sized morsels that can be popped into one's mouth. They are packaged in resealable plastic bags, and are easy to carry on a run, a bike ride, or simply for an afternoon snack. They are available in four varieties—Organic Original Chewy Banana Bites, Organic Chocolate Chewy Barnana Bites, Organic Coconut Chewy Barnana Bites, and Organic Peanut Butter Chewy Barnana Bites. The small morsels are partially dehydrated bananas that are soft and chewy and taste like banana bread. With only one ingredient, pure organic banana, they are an exceptional source of potassium and fiber and have over 20 vitamins and minerals. Each variety is dairy free, gluten free, non-GMO, Kosher, and vegan. Barnana Bites are perfect for people with celiac disease. Because of their fiber content, they aid in digestion, which is a property that people with celiac disease are generally looking for. Extreme care is taken in the growing of the bananas that are used to make Barnana Bites. The bananas are grown on sustainable, organic farms in South America.

Barnana Bites are also delicious. They have a chewy texture that makes them satisfying for snacking. Each morsel is flavorful and is dusted in banana powder with no added sugar. The Organic Chocolate Chewy Banana Bites are covered in 54 percent organic cacao, which contains the nutritional benefits of dark chocolate.

Barnana snacks are available across the United States at a variety of stores, including Whole Foods Markets, Wegmans, Sprouts, PCC Markets, and other local outlets. They are also available via Amazon.com and on Barnana's website.

11-28. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

11-29. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 11.2 COMPANY: Open Farm Community

• Web: www.openfarmcommunity.com • Facebook: @openfarmcommunity
• Instagram: @openfarmcommunity

Business Idea: To create self-sustaining restaurants that link local produce direct to the customer.

The Pitch: The Open Farm Community is a joint collaboration between The Spa Esprit Group, celebrity chef Ryan Clift, and food garden specialists Edible Garden. Situated close to Singapore's Botanical Gardens, it sets out to be much more than a simple restaurant: the idea is for customers to engage with the food they are eating at a more profound level, to understand how the food is grown and how it is transformed into a delicious meal. The restaurant's extensive grounds include an edible vegetable garden that is not only ideal for regular diners but also valuable for interaction and education. The service environment is specifically designed for adults to enjoy the food and drink while the children explore in safety.

The Spa Esprit Group is a Singaporean brand with a diverse portfolio mainly in the food-and-beverage markets. They own 17 lifestyle brands and have a presence in 9 global locations. CEO Cynthia Chau, a lifestyle entrepreneur, launched the business in 1996 at the age of 24. She moved into the food-and-beverage market in 2007 when she opened House in Dempsey, which was a restaurant and bar with a spa above it.

Stylistically, The Open Farm Community is rather like a glasshouse with colorful plants and decoration. There is an open kitchen that specializes in seasonal ingredients, and over 80 percent of all produce is sourced locally. The whole project is designed to be eco-friendly, aiming to connect city dwellers with local farmers and seasonal produce. Much of the food is now grown onsite, and any ingredient that isn't comes from within 400km of Singapore.

The venue is designed to cater for larger events such as wedding receptions as well as more intimate family gatherings. The grounds are split into three distinct areas to cater for the specific needs of the customers. The café terrace can hold 80 guests and is designed for parties and music events. The air-conditioned indoor restaurant can seat another 70 people; it is used for workshops, media events, product launches, wedding dinners, and more formal eating. There is also an outdoor deck area that can seat an additional 38 guests.

The restaurant opened in 2015, and partner Edible Garden has been involved in several restaurants and cafés across Singapore, including the Artichoke Café, Jamie's Italian, and Oxwell & Co. The Open Farm Community is the biggest and most ambitious so far, with a mission to encourage people to grow their own food. The whole area is a former golf driving range now filled with herbs and vegetables as well as worm and ant farms.

11-30. Based on the material covered in this chapter, what questions would you ask the firm's founder before making your funding decision? What answers would satisfy you?

11-31. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 11.1

Nest Labs

• Web: https://nest.com • Facebook: Nest • Twitter: @nest

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

In the mid-2000s, Tony Fadell was building his dream house. He was working at Apple, where he was instrumental in the launch of the Apple iPod and iPhone. Fadell took his time building the house and involved himself in every detail. One thing that frustrated him, of all things, was a lack of good choices for thermostats. Many things in the home had changed for the better over the years, Fadell thought, but thermostats had remained basically unchanged. They were ugly, difficult to program, and couldn't be adjusted remotely.

Fadell shared his frustration with Matt Rogers, a co-worker at Apple, who immediately got it. They started digging into the thermostat industry to better understand it. They looked for an attractive, easy-to-program thermostat that could be controlled remotely, and couldn't find one. A couple of other issues struck them. First, thermostats were marketed to builders and heat and air repair technicians, not homeowners. As a result, most homeowners had little choice in the thermostats that ended up in their homes. Second, the thermostat manufacturers, like Honeywell, were primarily business-to-business companies. They had little experience in designing consumer products or selling directly to end users. So even if they wanted to build the type of thermostat that Fadell and Rogers were looking for, they didn't have the capabilities to do so. All of this led to an insight on Fadell and Rogers' part. They didn't like the thermostats on the market, the thermostat makers didn't have the skills to meaningfully improve them, and new technologies were coming, such as the iPhone, which would make it possible to control almost any device in the home remotely. On top of all of that, thermostats are a large market in that 12 million of them are sold each year in the United States alone. That's more than video game systems, stoves, or refrigerators; and, thermostats control 50 percent of the energy bill in the average home.

Based on these insights, Fadell and Rogers started exploring the possibility of launching a company to make thermostats. They readily admit that their friends and family were confused. They both worked at Apple, one of the sexiest companies in the world, yet they were excited about the lowly thermostat? They started working on prototypes, with several staple design concepts in mind. They also fleshed out their mission, their business strategy, and their marketing strategy early on. Their mission would be to create a more thoughtful home. The thermostat would be attractive, easy-to-use, and sold directly to consumers. It would "learn" the behavioral patterns of its users, and would alter itself to conserve energy. It would not be marketed as a "tech" product. Instead, their company, which they decided to call Nest, would simply tell consumers the benefits of the product and convey stories about how simple it is to use, how it conserves energy, and how it helps homeowners save money.

Nest Becomes a Company

Nest was formally launched in 2010. The Nest thermostat took time to perfect. Fadell and Rogers built multiple prototypes, talked to industry experts and potential users, and even interviewed officials at the EPA. They were committed to the notion that if they couldn't build a thermostat that made a difference in terms of aesthetics, ease-of-use, energy conservation, and saving homeowners money, it wasn't worth doing. Much of the research they did affirmed their earlier suspicions. Homeowners, in general, had little affection for the thermostats that were in their homes. They were unsightly, nearly impossible to program, and people often forgot to adjust the thermostat to save money. If a family likes to keep its house at 70 degrees during the summer months, it can save considerable energy and money by turning the temperature up while everyone is gone during the day. The temperature can be turned down again when the first person arrives home.

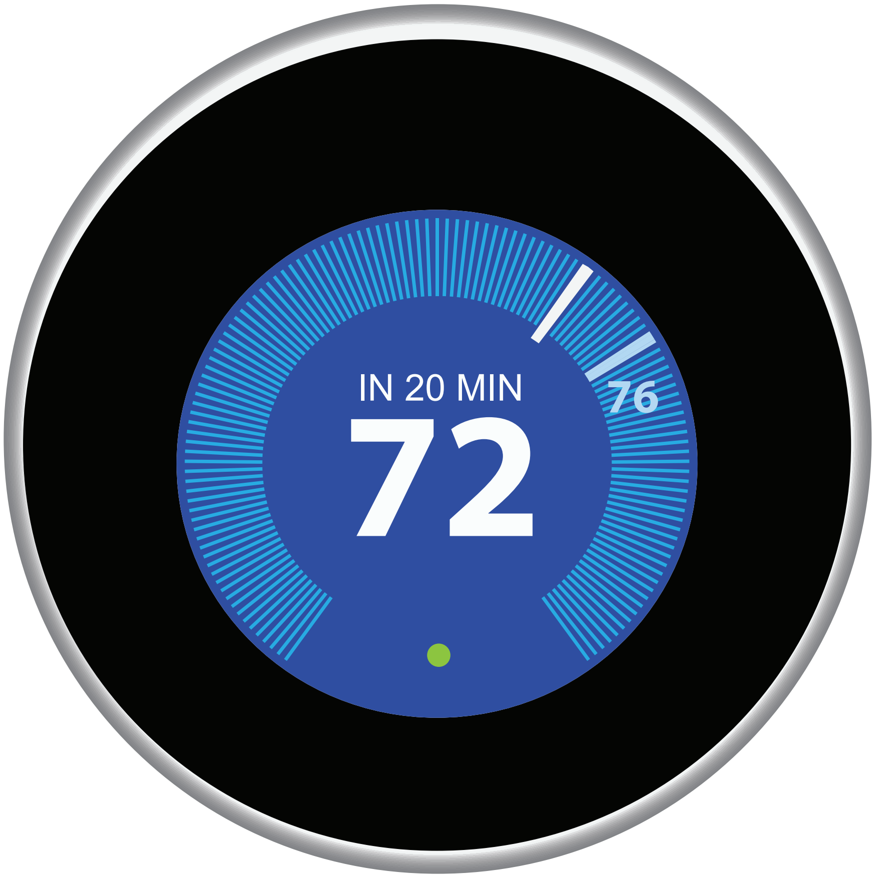
After a year of prototyping and preparation, the Nest Learning Thermostat was introduced in 2011. Although several upgrades have been made, it looks very much the same today as when it was introduced. It is a stylish, round product, about the size of a hockey puck, with a blue circle in the middle where the temperature is displayed. The temperature is adjusted manually by turning the entire device, like a dial. It is an electronic, programmable, and self-learning Wi-Fi enabled device that optimizes the heating and cooling of homes to conserve energy and save money. For the first few weeks, users have to manually regulate the thermostat in order to establish a base-line set of behaviors. Using a machine learning algorithm, the device then learns when the occupants of a home come and go and what their temperature preferences are. The thermostat then makes adjustments accordingly. Using built-in sensors, it can also tell when no one is home and shift into an energy-saving mode. It can also tell whether movement in a home is caused by a person or a cat (for example). The user can manipulate Nest's temperature or controls via the physical device or remotely on a smartphone.

The Nest Thermostat was an instant hit. At the three year mark, the firm had sold approximately one million thermostats per year. A big part of Nest's success has been its approach to marketing. The following is an analysis of various elements of Nest's marketing strategy.

Selecting a Target Market and Establishing a Position

Nest's market segmentation, its selection of a target market, and its positioning strategy were driven by its mission and product. In terms of market segmentation and defining a target market, Nest segmented the thermostat market on three dimensions: demographic, age, and lifestyle. In terms of demographic, it targets middle to upper income homeowners. Its product costs $249, so the price-point is too high for a less affluent demographic. In regard to age, it targets homeowners in the 30's to 50's age range. In terms of lifestyle, it targets energy and budget conscious consumers. As a result, Nest's target market is middle to upper income homeowners, from 30 to 60 years old, who are energy and/or budget conscious.

Nest learning thermostat.



Constantine Pankin/Shutterstock

Nest's selection of a target market is complemented by its positioning strategy. It has not positioned itself as a technology brand and doesn't want to be thought of as a company that makes whiz-bang products. Instead, it's positioned itself as a company that makes products that benefit the homeowner. All of Nest's marketing and messaging reinforce this position. For example, one of its earliest commercials was a 1 minute and 12 second spot that showed a middle-class family in a slightly upscale home learning how to use their Nest Learning Thermostat. Against a backdrop of pleasant music (there is no talking) and the family moving about and interacting with the thermostat, the commercial flashes a series of bullet points on the screen to describe what the viewer is seeing. The bullet points are shown in the nearby table. The commercial, which is pleasant and informative, does not talk about the technology behind the thermostat. It focuses strictly on how the thermostat will benefit the family. It also concisely tells Nest's story.

Early Nest Commercial (2012)

Titled: Introducing the Nest Learning Thermostat
Against a backdrop of pleasant music the commercial shows a family interacting with a Nest Learning Thermostat. The following bullet points are shown during the commercial (there is no talking).

- We didn't think thermostats mattered either.
- Until we found out they control half your energy bill.
- Introducing the Nest Learning Thermostat.
- Use it like your old thermostat, and it'll program itself.
- The Leaf helps you conserve (the leaf appears when you choose an energy-saving temperature).
- It learns every time you turn the ring.
- It keeps you comfortable at night.
- Remembers when you'll be up.
- And won't waste energy when you're out.
- Adjust Nest from anywhere. (Shot of woman holding smartphone.)
- Nest adapts to your changing life.
- It never stops learning.

To see the commercial, simply go to YouTube and type in "Introducing the Nest Learning Thermostat."

All Nest commercials and promotions follow this pattern. Integral to Nest's positioning strategy is the story the company tells. Early on, the founders and initial team spent time working on the story that would describe the thermostat and the value it provided. They also anticipated that the thermostat would be followed by other products for the home. Nest ultimately decided to portray their devices as "loved" devices in the home rather than "unloved" devices that go unnoticed and sometimes annoy. This sentiment is reflected in the following statement taken from Nest's website.

> Nest is home. We love home. It's the best place in the world. But not everything inside our homes is lovable. There are things that beep at us; fail with warning; keep us in the dark. There are things we've learned to ignore. We think they should do more. Nest is focused on making simple, human delightful things. That's how we're creating the thoughtful home: A home that takes care of the people inside it and the world around it.

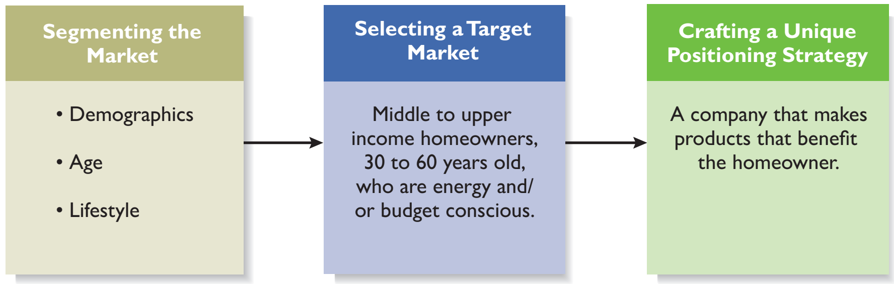
Again, the position is to be the company that benefits the consumer—the company that brings "loveable" products into the home. In future years, Nest would add the Nest Protect (2013), which is a smoke and carbon monoxide detector, and Nest Cam Indoor (2014) and Nest Cam Outdoor (2016), which are security cameras. The foundation for Nest offering security cameras was its acquisition of Dropcam, a transaction that was completed in 2014. Use your creativity to imagine a commercial to introduce the Nest Protect. The Nest Protect is a stylish product that is equipped with advanced technology to detect smoke and carbon monoxide. It gives an early warning in a female voice before the alarm goes off (i.e., "Heads up—there is smoke in the kitchen" or "There is excessive carbon monoxide in the living room—move to fresh air"). Once the danger passes, unlike a conventional smoke alarm, you don't have to get a ladder from the garage to shut the alarm off. You can go to your smartphone and silence the device. And it can send an alert, so you know what's going on even if you aren't home. Additionally, people who own conventional smoke alarms are supposed to test them monthly. Nine out of 10 people don't. The Nest Protect checks its batteries and sensors 400 times a day to make sure they're working. To make the Nest Protect loveable, when you turn off the lights to go to bed, the device emits a pleasant green glow. That's Nest's nightly promise that everything is ok.

Like the Nest Learning Thermostat, the Nest Protect benefits the consumer. Not a single promotion or commercial talks about the technology behind the device; rather, each one talks strictly about how the device helps protect and benefit your family and your home.

The nearby figure provides an overview of how Nest segmented its market, the target market it chose, and Nest's unique positioning strategy.

Product, Price, Promotions, and Place

Product. In terms of its products, Nest prioritizes clean design and smart functionality. The products have just what they need and nothing more. The products are also built with the user experience in mind. In an interview about his time at Apple, Fadell said that he not only learned product design but more importantly learned "customer experience" design. So Nest designs its products in a manner that facilitates a useful customer experience. The firm also designs products that dress-up rather than detract from the décor of a home. Nest's products are stylish and visually appealing—the types of products that people show guests when they visit their homes. Compare that philosophy to traditional thermostats, smoke detectors, and security cameras.



Price. In terms of price, Nest's products are priced higher or equal to competitors. As mentioned earlier, the Nest Learning Thermostat is priced at $249. Since it was introduced, several competitors have entered the market. The Honeywell Lyric Round 2.0 Wi-Fi Smart Programmable Thermostat, which resembles the Nest Learning Thermostat and has many of the same features, is priced at $179.95. The Ecobee3 Smart Thermostat is priced at $169 and $249, depending on the features included. The Ecobee3 also has many of the same features as Nest's products. There are many thermostats available at lower price points, but they are not directly comparable. Other Nest products follow the same pricing philosophy.

Promotions. In regard to promotions, Nest has used a number of approaches to get the word out about its products and tell its story. It has used TV commercials to reinforce its position and provide information about its products, as illustrated in the spot about the Nest Learning Thermostat highlighted above. The use of television indicates that Nest is casting a large net to reach its target customer. Nest makes extensive use of social media. Its YouTube channel contains over 250 videos, and is populated not only by Nest commercials but useful tutorials about how to use Nest products. One Nest commercial, about the Nest Protect, has been viewed over two million times. It is titled "Safe" and shows heartwarming examples of different ways parents protect their children (bicycle helmet, sweater for cold weather, goggles for swimming, umbrella to protect from rain, car seat). The commercial ends by saying "We love (referring to everyone) to keep them safe so we made the Nest Protect smoke and carbon monoxide alarm that speaks up and can alert your phone if there is a problem, or, let you know if everything is just fine—because, you know, we worry." In regard to traditional social media, Nest has a lively and informative Facebook page, Twitter account, and Instagram account. In response, it has nearly 450,000 Facebook likes, 170,000 Twitter followers, and 47,700 Instagram followers. To make things fun, Nest sponsors a contest each year called the Nestie Awards. Once a year, they encourage customers and others to submit their favorite clips captured by Nest Indoor Cams or Outdoor Cams. The winners receive Nest products in honor of the quality of their clips.

Nest is also creative in terms of its promotions. In 2013, when the company introduced the Nest Protect, it bought a fire truck on Craigslist and equipped it to promote the product. They give free rides in the firetruck at Nest promotional events in the San Francisco area. If you'd like to see what the Nest Firetruck looks like, go to Google Images and type in "Nest Firetruck."

Place. To gain access to distribution channels, Nest's cofounders met with retailers before the company launched. They considered the margins that both retailers must earn and Nest must earn in setting the price for their initial (and subsequent) products. Their first retail outlets were three Best Buy stores: one in the Bay Area, one in Chicago, and one in Austin, TX. Nest felt strongly that it couldn't sell strictly online. It felt its products needed some explaining, which could be most effectively done at the point-of-sale by its retail partners.

Nest has three distinct distribution channels. Its products can now be bought at select retail outlets, such as Home Depot, Lowe's, Best Buy, and the Apple store. They can also be bought online at www.nest.com and Amazon.com. Nest also distributes its products through companies selling electrical products. Nest has forged a number of partnerships with electric companies who are interested in helping their customers conserve energy, particularly during periods of peak energy demand. In some cases, energy companies provide their customers Nest Learning Thermostats for free when they sign up for certain plans.

The company has over 25,000 Nest Pros, who are people qualified to install Nest products. When you buy a Nest product, you can also purchase installation and a Nest Pro will come to your home or business to install the product.

Nest Moving Forward

Nest was acquired by Google in early 2014 for $3.2 billion. Nest has operated autonomously since and will continue to do so. The rationale for the acquisition was to provide Nest the horsepower to continue its expansion, in terms of products and geographical areas served. The acquisition has also freed-up the management team at Nest to focus primarily on product innovation, while Google handles administrative duties. Nest now sells its products across the United States and in a growing number of foreign countries. Nest will also maintain all of its current branding.

Nest's journey has not been without challenges. They've had some product glitches to deal with. Cofounder Tony Fadell left Nest in 2014 to pursue other opportunities within Google. It's unclear the impact that Fadell's departure will have on product innovation looking forward. Competitors are also catching up. The

Honeywell Lyric Round 2.0 Wi-Fi Smart Programmable Thermostat looks comparable and is $70 cheaper.

Although its sales remain strong, one of the most significant factors confronting Nest, and all companies that are building smart appliances for the home, is whether long-term consumers will perceive value in having their devices connected to smartphones. Fears regarding privacy, and whether smart devices are capable of tracking a person's movements and collecting other private information, are a deterrent for some buyers.

Nest remains committed to its mission of creating a more thoughtful home. It also remains committed to a market strategy that supports its mission and positions itself as a company that builds products that benefit homeowners.

Questions for Critical Thinking

11-32. Critique Nest's segmentation strategy, its selection of a target market, and its positioning strategy. To what degree are these elements of Nest's market strategy complementary and effective?

11-33. Describe Nest's brand. In what ways does Nest practice brand management?

11-34. Identify other "unloved" products in the home that Nest could convert into "loved" products and continue working toward its mission of creating a more thoughtful home.

11-35. Of the challenges facing Nest, which one do you think is the most threatening? Explain your answer.

Sources: Nest, www.nest.com (accessed March 15, 2017); R. DiResta, B. Forrest, and R. Winyard, *The Hardware Startup*, Sebastopol, CA: O'Reilly Media, 2015; Nest Labs Introduces World's First Learning Thermostat, available at https://www.youtube.com/watch?v=RVAh-pVvzuI (posted October 25, 2011, accessed March 15, 2017); The Industrialist's Dilemma: Tony Fadell, News, Stanford Graduate School of Business (podcast), available at https://www.youtube.com/results?search_query=tony+fadell+nest+labs (posted March 1, 2016, accessed March 15, 2017); M. Rogers, Stanford Seminar—Entrepreneurial Thought Leaders: Matt Rogers of Nest, Stanford Technology Ventures Partners podcast (posted October 30, 2014, accessed March 15, 2017).

CASE 11.2

Proactiv: How Three Critical Marketing Decisions Shaped a New Venture's Future

• *Web: www.proactiv.com* • *Twitter: @proactiv* • *Facebook: Proactiv*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

In 1995, two dermatologists, Dr. Katie Rodan and Dr. Kathy Fields, developed what they believed was a medical breakthrough in fighting acne. Their mission: to help millions of people rid themselves of acne and acne-related problems. They named their product Proactiv Solutions. This name was chosen because the product could heal existing blemishes and *proactively* help prevent new ones from forming.

Today, Proactiv is the number-one-selling acne product in the United States. It's a three-part acne treatment kit that includes a cleanser, toner, and treatment. It's not sold in stores. Instead, it is sold via infomercials, the company's website, a subscription service called the "Proactiv Solution Clear Skin Club," and in select upscale boutiques and kiosks. The way Proactiv reached the point it currently occupies is an interesting story. Early in its life, Proactiv was shaped by three critical marketing decisions, from which the company has not wavered, even to this day. This case recounts these decisions and discusses how the decisions shaped this entrepreneurial venture's future.

How It Started

Katie Rodan and Kathy Fields met while they were working summer jobs at a cardiovascular research lab in Los Angeles. The lab was developing a drug to treat post–heart attack patients. Both Rodan and Fields enjoyed the exciting pace of the work as well as the camaraderie they shared with the lab's researchers and doctors. After earning their college degrees, they both went to medical school and became dermatologists. They stayed in touch and often shared with one another how surprised they were at the number of acne patients they were seeing. At the time, the medical research said that only 3 percent of the adult population had acne, but Rodan and Fields became convinced that the number was higher. They were each seeing acne patients on a daily basis, and they weren't just seeing teenagers. They were seeing women in their 20s, 30s, 40s, and even in their 50s who were suffering from acne and acne-related problems.

Rodan and Fields decided to form a partnership to further investigate the acne issue. They started by talking to their patients, asking them a wide range of acne-related questions. What they found was that the vast majority of their patients hated the acne products on the market. The most common complaints were that the products were very drying and they were very irritating. Worst of all, patients told Rodan and Fields, the available products did not work. At this point, the two physicians started thinking there might be an opportunity for them to create a better product.

Rodan and Fields spent the next couple of years thoroughly investigating the acne products on the market. After testing many of the products on their patients, they made what they believed was a shocking discovery. All of the products on the market were designed to spot-treat a pimple—none were designed to stop the pimple from forming in the first place. This just didn't make sense to the two dermatologists—from both a practical and a medical standpoint. By the time you see a pimple, whatever treatment you administer, it's too little too late. In their judgment, not taking steps to prevent acne from developing was akin to not brushing your teeth and instead just going to the dentist to fill cavities. Why not brush your teeth and floss and try to prevent the cavities from developing in the first place?

This revelation motivated Rodan and Fields to start working on a product of their own—one that would be more proactive in preventing acne and acne-related problems. They hired a chemist, and the three worked together for another couple of years. Finally, they had a product they were happy with and that seemed to work and to satisfy their patients.

Important Revelations

To get ideas about how to market and develop their product, which didn't have a name yet, Rodan hosted dinner parties at her house and conducted brainstorming sessions with the guests. The guests included business executives, market researchers, marketing consultants, an FDA regulatory attorney, the chief financial officer of a major company, and others. One of the things the participants in these sessions stressed to Rodan and Fields was the importance of marketing research. In particular, the group urged Rodan and Fields to hire an unbiased third party to validate their findings. Rodan and Fields took this advice to heart and hired an outside consultant. In focus groups that the consultant led, Rodan and Fields learned two important things about older women. First, evidence suggests that many women who *do* have acne as a medical condition refuse to believe that such is the case. Second, people don't like to talk about their acne with others. Rodan and Fields also learned that their product still needed work. There were several aspects of the product that needed improvement, a need that Rodan and Fields fully intended to address and satisfy.

Three Critical Marketing Decisions That Shaped the Future of the Firm

Critical Marketing Decision 1: We're a Skin Care Company

After Rodan and Fields reformulated the product again, they hired another marketing consultant to advise them as to how they should proceed to successfully market their product. The first piece of advice they got from the consultant was to think of their product as a skin care product rather than an acne product. At the time, the acne market in the United States was about $250 million a year, a low number by consumer products standards. In contrast, the skin care market was several billion dollars a year, making it much more attractive. The consultant told Rodan and Fields to think of their product as a skin care system that just happens to treat acne, rather than an acne medication alone. This recommendation obviously caused Rodan and Fields to have a much broader vision for the scope of the market for their product.

Critical Marketing Decision 2: Our Name Is Proactiv

After Rodan and Fields started thinking of their product as part of the skin care market, they got advice from a marketing specialist about what to name their product. The name the specialist recommended was Proactiv (proactive without the *e*). Looking back, Rodan and Fields admit that initially they didn't get the reason for this recommendation. They were hoping for a more cosmetic-sounding name, like Dermo-Beautiful. The name Proactiv turned out to be perfect. It captured the essence of what Rodan and Fields were trying to accomplish—to create a product that would be *proactive* (rather than *reactive*) in dealing with acne and acne-related issues. In other words, the name Proactiv captured the entrepreneurs' interest in signaling to customers that their product was intended to prevent the occurrence of additional acne-related problems for them.

Critical Marketing Decision 3: Infomercials

To get their product on the market, Rodan and Fields initially tried to raise investment capital. They were repeatedly turned down. The biggest objection they encountered was the sentiment that if their product was so good and so obvious, why hadn't Procter & Gamble or Johnson & Johnson already thought of it? "Surely those companies must have dermatologists on their advisory boards telling them what to do," was the comment repeatedly expressed to Rodan and Fields as they talked to those with investment capital. After giving up on raising capital, Rodan and Fields approached Neutrogena to try to get a licensing deal. Neutrogena passed on the deal but did make a suggestion that resonated with Rodan and Fields. Neutrogena said that the most effective way to sell the product would be via infomercials. Initially, Rodan and Fields were shocked, because they had a fairly low opinion of infomercials. But there was one company, according to people at Neutrogena, named Guthy-Renker that made high-quality infomercials for professional products such as Proactiv. Rodan and Fields also got to thinking that an infomercial might be the best way to educate people about their product. The following list lays out the points in favor of using infomercials to sell a product in which Rodan and Fields had a great deal of confidence.

Keith Homan/Alamy Stock Photo

Proactiv skin care products.

Why Infomercials Have Worked for Proactiv (Infomercials Are 30–60 Minute Programs That Are Paid for by an Advertiser)

- People need to be re-educated about how to treat acne.
- The re-education can't be done in a 30-second or 60-second television commercial, or in a print ad.
- Acne is an embarrassing problem, so people will be most open to learning about it in the privacy of their homes.
- The demographic group that spends the most time watching infomercials, women in their 20s, 30s, and 40s, are Proactiv's market.
- Infomercials provide Proactiv the opportunity to show heartfelt testimonials of people who have used the product. Showing "before" and "after" pictures of people who have used the product and have experienced dramatic results has been a particularly persuasive tactic.

Guthy-Renker

After being turned down by Neutrogena, Rodan and Fields were about ready to throw in the towel when they met, simply by chance, a person who introduced them to Guthy-Renker, the infomercial company that people at Neutrogena recommended highly. After several meetings, Guthy-Renker offered to license Proactiv and to create an infomercial to sell the product. It also put up the money to buy the media time needed for the infomercial to be televised. The initial infomercial was targeted toward women in the age group most ignored by the present providers of acne products. The 30-minute spot carefully explained what acne is, how it can affect older women, and how Proactiv was the only product available that potentially prevented acne from occurring. It also offered a complete money-back guarantee. The first infomercial sold twice as much Proactiv as expected, and Guthy-Renker and Proactiv remain close partners today.

It was also Guthy-Renker's idea to get celebrity endorsements for Proactiv. The first celebrity endorser was Judith Light. Light was followed by Vanessa Williams, and now a number of other celebrities endorse the product.

Proactiv Today

Today, Proactiv is strong. The first Guthy-Renker infomercial ran in 1994, and the product has steadily gained market share since. The company now sells acne treatment in several varieties, including Gentle Formula, Extra Strength, and Proactiv+. Face masks, body washes, and other skin-care products are also sold under the Proactiv name. Proactiv products are now being sold worldwide. Proactiv's marketing strategy has not substantially changed since the company started. The three marketing decisions described in this case set the direction for the company, and the company remains fully committed to taking only the actions suggested by these decisions.

Discussion Questions

11-36. How has Proactiv gone about establishing its brand? To what degree do you believe Proactiv is important in its customers' lives?

11-37. Discuss the things that Rodan and Fields learned, prior to meeting Guthy-Renker that persuaded them that infomercials were the best way to sell Proactiv. If Proactiv hadn't developed infomercials in partnership with Guthy-Renker, do you think Proactiv would be in existence today? Why were infomercials a better choice than print or media advertising for Proactiv when the company was first being introduced?

11-38. Describe Proactiv's positioning strategy. To what extent did the three critical marketing decisions discussed in the case shape the evolution of Proactiv's positioning strategy?

11-39. What is the difference between Proactiv's core product and its actual product? Describe its actual product and your assessment of whether the actual product provides an attractive mix of characteristics.

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ESSAY QUESTIONS

1. Nate Jones, a friend of yours, is in the early stages of conducting a feasibility analysis for an e-commerce website that will focus on the sale of products for extreme sports, such as snowboarding, rock climbing, mountain biking, and hang gliding. Nate is familiar with the concept of branding, and he knows that because his company is new he'll have to build a brand from scratch. What actions would you suggest Nate take in order to build a brand for his planned website? Write a paragraph or two to describe the actions you would recommend to Nate.

2. A small farmer's cooperative produces cooking oil that it processes itself and delivers to a manufacturing plant in bulk. They are paid by the manufacturer, who rebrands it, breaks it down into smaller containers, and sells it to wholesalers for resale. Income is guaranteed by contract for the cooperative, but what are the marketing distribution consequences should the cooperative brand the oil itself and sell directly to customers at a higher price?

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Getting Personal with 3DERM SYSTEMS

3Derm Systems, Inc./Photo Credit: Elizabeth Asai

Cofounder

ELIZABETH ASAI

BS, Bioengineering and Biomedical Engineering, Yale University, 2013

Cofounder

ELLIOT SWART

BS, Electrical Engineering and Computer Science, Yale University, 2013

Dialogue with Elizabeth Asai

BEST ADVICE I'VE RECEIVED
Start-ups have extreme highs and extreme lows, sometimes on the same day. Don't worry, that's normal

MY FAVORITE SMARTPHONE APP
Venmo

BEST PART OF BEING A STUDENT
Our "office" had an on-site cafeteria—the dining hall

WHAT I DO WHEN I'M NOT WORKING
Spend time with friends and family

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
Everything takes a little longer in health care

MY ADVICE FOR NEW ENTREPRENEURS
Read and research—good advice is out there!

CHAPTER 12

The Importance of *Intellectual* Property

OPENING PROFILE

3DERM SYSTEMS

The Key Role of Intellectual Property Early in a Firm's Life and Its Ongoing Success

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Imagine the following. You have a rash on your skin that you're concerned about. You visit the health center on campus and the doctor you see prescribes some skin cream, but suggests that you see a dermatologist. You call a dermatologist's office to make an appointment, and the first available appointment is five weeks from now. You take the appointment but are disappointed, largely because you are truly worried about the rash on your skin and would like to get to the bottom of it.

Regrettably, this scenario is all too common. There are only about 9,600 dermatologists in the United States. As a result, they're just not able to handle all the people they'd like to see in a timely manner. Elizabeth Asai and Elliot Swart, two students at Yale University, saw the challenge that people were having scheduling appointments with dermatologists. In 2012 they launched a company, 3Derm Systems, to address the problem.

Asai and Swart met at Yale their freshmen year. As is the case with most entrepreneurial ventures, there wasn't a straight line between their original ideas and the business they actually launched. The first project they worked on together was a laparoscopic surgical probe. They approached the Dean of the engineering school and asked for $10,000 in funding. He agreed to $2,000. They eventually dropped the laparoscopic surgical probe idea, realizing it would take 10 years to bring the product to market. Several good things came from the project, however, including some work they did in the area of 3D imaging of skin tissue.

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Define the term *intellectual property* and describe its importance.
2. Explain what a patent is and describe different types of patents.
3. Describe a trademark and explain the process entrepreneurs use to obtain one.
4. Define a copyright and identify what a copyright can protect.
5. Describe a trade secret and understand the common causes of trade secret disputes.
6. Explain what an intellectual property audit is and identify the two primary reasons entrepreneurial firms should complete this type of audit.

After dropping the laparoscopic surgical probe idea, Asai and Swart segued to dermatology, an area in which both had an interest. The idea they developed was to build a handheld skin imaging system that would allow nondermatologists to take clinical-quality 3D skin images. In most cases, the user of the product would be a primary care physician, who would take the images of a patient's skin and then upload the images to a database that a dermatologist could access. The dermatologist could then make a diagnosis based on the images or suggest an in-clinic appointment for the more severe cases. This process would allow people with skin lesions or other abnormalities to be evaluated by a dermatologist much quicker than currently possible.

To test the idea, Asai and Swart entered a competition sponsored by the Center for Integration of Medicine and Innovation Technology in Boston. They made the first cut, which provided them with $10,000 and five months to build a prototype. After five months, the work they did would be evaluated for a larger prize. To build and test the prototype, Asai and Swart reached out to a dermatologist at the Yale School of Medicine. The dermatologist liked the idea, and became a mentor and advocate. A clinical study was approved by the university's IRB (Institutional Review Board), and a 50-patient study was conducted. The device proved to be accurate, safe, and reliable. Five months later, at the second phase of the competition, Asai and Swart took second place and won $100,000. During this period, they also received a Small Business Innovation Research grant from the National Science Foundation, further validating the potential of their idea.

3Derm Systems was incorporated in May 2012. To flesh out the business end of the company, Asai and Swart entered the Blue Cross Blue Shield-backed Healthbox digital health incubator in Boston in early 2013. Although affiliating with Healthbox required Asai and Swart to shuttle back and forth from New Haven to Boston, doing so proved to be worth it in that they received $50,000 in seed capital, mentorship from industry experts, help with market testing and end user research, and office space. In exchange, Healthbox received a small amount of equity in 3Derm Systems.

During the development of 3Derm Systems, Asai and Swart were very aware of the need to protect their intellectual property. In 2011, with the help of mentors, they filed a provisional patent application. The purpose of a provisional patent application is to establish an early filing date for a subsequent full utility patent application. In 2012, they filed a Patent Cooperation Treaty (PCT), which assists applicants in seeking patent protection internationally. By filing an international patent application under the PCT, applicants can simultaneously seek protection for an invention in a large number of countries. In 2013, they hired a patent attorney to file a full utility patent application in both the United States and the European Union. When asked what it's like to work with a patent attorney, Asai and Swart said that there was a lot of e-mail exchange, helping the patent attorney fully understand their technology. At the time of writing this "Opening Profile," the patent application was pending. Asai and Swart also filed a trademark application, and were awarded a U.S. trademark for "3Derm." As a result, no other medical device company can use the name "3Derm" as long as the trademark remains in use. If you'd like to see the registration of the trademark you can go to the United States Patent & Trademark website at www.uspto.gov. Click on "Trademarks" on the toolbar and access the link that says "Search trademark database." Click on the box that says "Search Trademarks" and type in 3Derm. You'll see the trademark that was awarded to 3Derm Systems.

When discussing intellectual property, Asai and Swart are quick to mention the importance of trade secrets. They indicated that they've learned much through their clinical trials and the six years they've been working on 3D Systems that provides their company a competitive advantage. Some of this knowledge is best kept as trade secrets.

The future of 3Derm Systems holds two very different paths. The company might eventually be acquired by a larger medical products supplier. An alternative path might be to build a large company, which could include additional medical devices. If this path is chosen, it will require more patent applications and additional attention to intellectual property issues.

Many entrepreneurial firms have valuable intellectual property. In fact, virtually all businesses, including start-ups, have knowledge, information, and ideas that are critical to their success.

For at least three reasons, it is important for businesses to recognize what intellectual property is and how to protect it. First, the intellectual property of a business often represents its most valuable asset.[1] Think of the value of the

Facebook and Google trademarks, the Nike "swoosh" logo, or the design of the Apple iPhone. All of these are examples of intellectual property, and because of intellectual property laws, they are the exclusive properties of the firms that own them. Second, it is important to understand what intellectual property is and how to protect it to avoid unintentional violations of intellectual property laws. For example, imagine the hardship facing an entrepreneurial start-up if it selected a name for its business, heavily advertised that name, and was later forced to change the name because it was infringing on a trademark. Finally, intellectual property can be licensed or sold, providing valuable licensing income.

We begin this chapter by defining intellectual property and exploring when intellectual property protection is warranted. There are costs involved with legally protecting intellectual property, and the costs sometimes outweigh the benefits, at least in the short term. We then describe the four key forms of intellectual property. The chapter ends with a discussion of the importance of conducting an intellectual property audit, which is a proactive tool an entrepreneurial firm can use to catalog the intellectual property it owns and determine how its intellectual property should be protected.

The Importance of Intellectual Property

LEARNING OBJECTIVE

1. Define the term *intellectual property* and describe its importance.

Intellectual property is any product of human intellect that is intangible but has value in the marketplace. It is called "intellectual" property because it is the product of human imagination, creativity, and inventiveness.[2] Traditionally, businesses have thought of their physical assets such as land, buildings, and equipment as their most important assets. Increasingly, however, a company's intellectual assets have become the most valuable.[3] In the case of 3Derm, the firm's intellectual property consists of intangible assets such as its patents (once granted), its trademark, its Internet domain name, any copyrights it has on instruction manuals or videos it distributes to the users of its product, and trade

Don Farrall/Getty Images

When you purchase prescription medicine, the amount you (and your insurance company) pay is not for the pills themselves. The value you are paying for is the access you now have to the intellectual property that equips the pills to help you feel better.

secrets. All these assets can provide a business with a competitive advantage in the marketplace, and the loss of such assets can be just as costly (if not more so) to a business as the loss of physical property or equipment.

Not all firms are as intellectual property savvy as 3Derm. In fact, common mistakes that entrepreneurial firms make are not properly identifying all their intellectual property, not fully recognizing the value of their intellectual property, not using their intellectual property as part of their overall plan of success, and not taking sufficient steps to protect it. These mistakes are presented in Figure 12.1. It can be difficult, however, to determine what qualifies as intellectual property and whether it should be legally protected. Every facet of a company's operations probably owns intellectual property that should be protected. To illustrate this point, Table 12.1 provides examples of the intellectual property that typically resides within the departments of midsize entrepreneurial firms. Intellectual property is also an important part of our nation's economy and its competitive advantage in the world marketplace. "It's a huge issue," former U.S. Commerce Secretary Carlos Gutierrez said. "There is so much of our economy that is linked to branded products, patented products, copyrights. So much of our economy thrives on creativity."[4]

The United States Patent & Trademark Office (USPTO) has several programs designed specifically to help inventors and small businesses protect their intellectual property. The help is motivated in part by the Leahy-Smith American Invents Act (AIA), which encourages the USPTO to "work with and support intellectual property laws' associations across the country in the establishment of pro bono programs designed to assist financially under-resourced independent inventors and small businesses." The first is a pro bono legal assistance program, which is being rolled out state by state. This program provides patent filing assistance to qualified applicants. You can see if the program is available in your state by going to the National Clearinghouse, which is accessible via the USPTO website at www.uspto.gov/inventors/state_resources. The second is the Inventors Assistance Center (www.uspto.gov/inventors/iac), which provides overall patent assistance and support to the general public.

FIGURE 12.1
Common Mistakes Firms Make in Regard to Intellectual Property

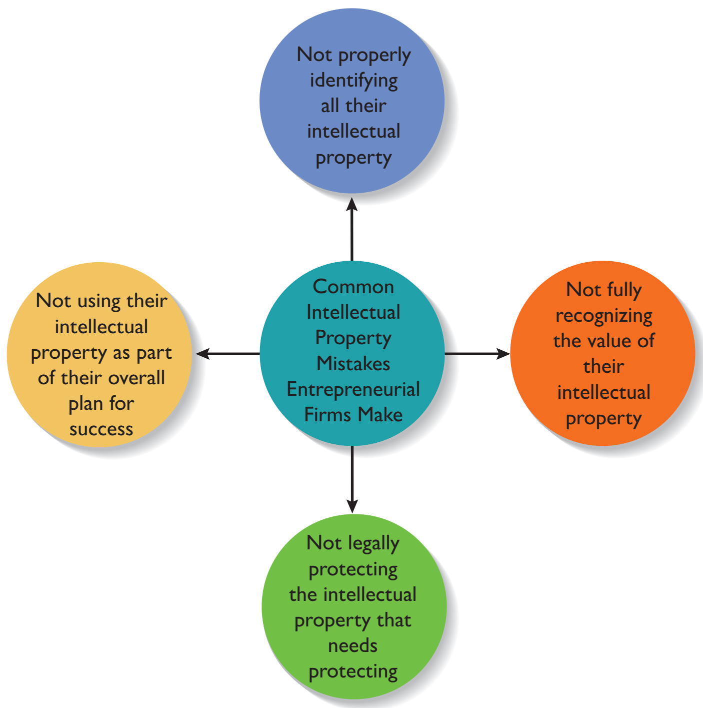


TABLE 12.1 Examples of Intellectual Property That Typically Resides within a Midsized Entrepreneurial Firm's Departments

Department	Forms of Intellectual Property Typically Present	Usual Methods of Protection
Marketing	Names, slogans, logos, jingles, advertisements, brochures, pamphlets, ad copy under development, product videos, customer lists, prospect lists, and similar items	Trademark, copyright, and trade secret
Management	Recruiting brochures, employee handbooks, forms and checklists used by recruiters in qualifying and hiring candidates, written training materials, and company newsletters	Copyright and trade secret
Finance	Contractual forms, PowerPoint slides describing the company's financial performance, written methodologies explaining how the company handles its finances, and employee pay records	Copyright and trade secret
Management information systems	Website design, Internet domain names, company-specific training manuals for computer equipment and software, original computer code, e-mail lists, name registry	Copyright, trade secret, and Internet domain
Research and development	New and useful inventions and business processes, improvements to existing inventions and processes, and laboratory notes documenting invention discovery dates and charting the progress on various projects	Patent and trade secret

Determining What Intellectual Property to Legally Protect

There are two primary rules of thumb for deciding if intellectual property protection should be pursued for a particular intellectual asset. First, a firm should determine if the intellectual property in question is directly related to its competitive advantage. For example, Amazon.com has a business method patent on its "one-click" ordering system, which is a nice feature of its website and is arguably directly related to its competitive advantage. Similarly, when PatientsLikeMe launched a social networking platform for people with serious diseases, it would have been foolish for the company not to trademark the PatientsLikeMe name. In contrast, if a business develops a product or business method or produces printed material that isn't directly related to its competitive advantage, intellectual property protection may not be warranted.

The second primary criterion for deciding if intellectual property protection should be pursued is to determine whether an item has value in the marketplace. A patent, for example, is not intrinsically valuable—it is only valuable if the underlying invention has value. A common mistake that young companies make is to invent a product, spend a considerable amount of money to patent it, and find that the market for the product does not exist or that the existing market is too small to be worthy of pursuit. As discussed in Chapter 3, business ideas should be properly tested before a considerable amount of money is spent developing and legally protecting them. Owning the exclusive right to something no one wants is of little value. Similarly, if a company develops a logo for a special event, it is probably a waste of money to register it with the USPTO if there is a good chance the logo will not be used again.

The Four Key Forms of Intellectual Property

Patents, trademarks, copyrights, and trade secrets are the four key forms of intellectual property. We discuss each form of intellectual property protection in the following sections. Intellectual property laws exist to encourage creativity and innovation by granting individuals who risk their time and money in creative endeavors exclusive rights to the fruits of their labors for a period of time. Intellectual property laws also help individuals make well-informed choices. For example, when a consumer sees a Panera Bread restaurant, she knows exactly what to expect because only Panera Bread is permitted to use the Panera Bread trademark for soups, signature sandwiches, and bakery products.

One special note about intellectual property laws is that it is up to entrepreneurs to take advantage of them and to safeguard their intellectual property once it is legally protected. Police forces and fire departments are available to quickly respond if an entrepreneur's buildings or other physical assets are threatened, but there are no intellectual property police forces or fire departments in existence. The courts prosecute individuals and companies that break intellectual property laws. However, the individual entrepreneur must understand intellectual property laws, safeguard intellectual property assets, and initiate litigation if intellectual property rights are infringed upon or violated.

There is a government-sponsored website (www.stopfakes.gov) that provides information about how to file a complaint if a business feels that a "knock off" product is infringing on its intellectual property. Increasingly, counterfeit goods are a problem for firms that have spent considerable resources to brand their products in ways that create value for customers. The top five categories of goods that are counterfeited are handbags/wallets, watches/jewelry, consumer electronics/parts, clothing/accessories, and pharmaceuticals/personal care. There are several blogs that are useful for keeping up-to-date on all aspects of intellectual property law. Two of the more popular ones are The IP Law Blog (www.theiplawblog.com) and Intellectual Property Law Blog (www.intellectualpropertylawblog.com).

While not one of the four *key* forms of intellectual property, Internet domain names are an important form of intellectual property. Having a short, easy-to-spell Internet domain name is becoming increasingly important as the Internet becomes an ever more powerful force in business. An Internet domain name is obtained through a domain name registrar like GoDaddy.com and costs around $15 per year to register. As with other forms of intellectual property, domain names can be bought and sold, and desirable names are valuable. For example, Apple reportedly paid several million dollars in 2011 to obtain the domain name www.icloud.com from its previous owner.

Patents

LEARNING OBJECTIVE

2. Explain what a patent is and describe different types of patents.

A **patent** is a grant from the federal government conferring the rights to exclude others from making, selling, or using an invention for the term of the patent.[5] The owner of the patent is granted a legal monopoly for a limited amount of time. However, a patent does not give its owner the right to make, use, or sell the invention; it gives the owner only the right to exclude others from doing so. This is a confusing issue for many entrepreneurs. If a company is granted a patent for an item, it is natural to assume that it could start making and selling the item immediately. But it cannot. A patent owner can legally make or sell the patented invention only if no other patents are infringed on by doing so.[6] For example, if an inventor obtained a patent on a computer chip and the chip needed technology patented earlier by Intel to work, the inventor would need to obtain permission from Intel to make and sell the chip. Intel may refuse permission or ask for a licensing fee for the use of its patented technology. Although this system may seem odd, it is really the only way the system could work. Many inventions are improvements on existing inventions, and the system allows the improvements to be patented, but only with the permission of the original inventors, who usually benefit by obtaining licensing income in exchange for their consent.[7]

Patent protection has deep roots in U.S. history and is the only form of intellectual property right expressly mentioned in the original articles of the U.S. Constitution. The first patent was granted in 1790 for a process of making potash, an ingredient in fertilizer. The patent was signed by George Washington and was issued to a Vermont inventor named Samuel Hopkins. Patents are important because they grant inventors temporary, exclusive rights to market their inventions. This right gives inventors and their financial backers the opportunity to recoup their costs and earn a profit in exchange for the risks and costs they incur during the invention process. If it weren't for patent laws, inventors would have little incentive to invest time and money in new inventions. "No one would develop a drug if you didn't have a patent," Dr. William Haseltine, former CEO of Human Genome Sciences, a biotech firm, once said.[8]

Since the first patent was granted in 1790, the USPTO has granted 9.6 million patents, including 334,107 in 2016 alone. The number of patents granted in 2016 was 82 percent more than the number granted in 2006, just 10 years earlier. These data suggest that a willingness to invent in the United States is strong. Interestingly, the USPTO, the sole entity responsible for granting patents in the United States, is strained, although its backlog is slowly diminishing. At the end of 2016, there were 1,070,163 patent applications pending, and it took an average of 25.3 months to get a patent application approved. Actually, the USPTO has been making strides in this area. The total time required to get a patent application approved reached a high of 35.3 months in 2010.

Some inventors and companies are very prolific and have multiple patents. There is increasing interest in patents, as shown in Table 12.2, as advances in technology spawn new inventions.

Types of Patents

There are three types of patents: utility patents, design patents, and plant patents. As shown in Figure 12.2, there are three basic requirements for a patent to be granted: The subject of the patent application must be (1) useful, (2) novel in relation to prior arts in the field, and (3) not obvious to a person of ordinary skill in the field.

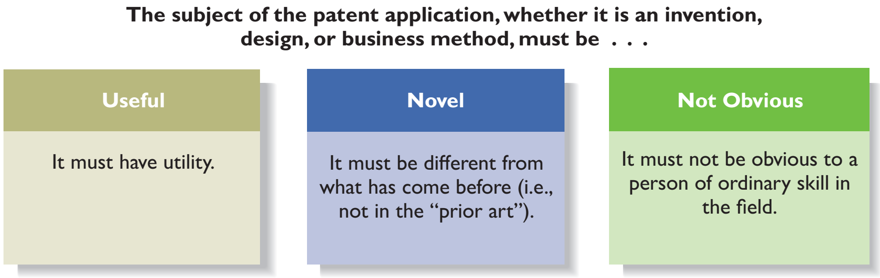
Utility patents are the most common type of patent and cover what we generally think of as new inventions. Of the 650,411 patent applications filed in 2016, 93.4 percent were for utility patents.[9] Patents in this category may be granted to anyone who "invents or discovers any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof."[10] The term of a utility patent is 20 years from the date of the initial application. After 20 years, the patent expires, and the invention falls into the public domain, which means that anyone can produce and sell the invention without paying the prior patent holder.

TABLE 12.2 Growth in Patent Applications in the United States

	2014	2015	2016
Applications received	618,457	618,062	650,411
Patents issued	329,612	322,449	334,107
Patent applications pending	1,127,701	1,099,468	1,070,163
Average time for approval	27.4 months	26.6 months	25.3 months

Source: United States Patent and Trademark Office, *Performance and Accountability Report for Fiscal Year 2016*, available at www.uspto.gov.

FIGURE 12.2
Three Basic Requirements for a Patent



Consider the pharmaceutical industry. Assume a drug produced by a large firm such as Pfizer Inc. is prescribed for you and that when seeking to fill the prescription, your pharmacist tells you there is no generic equivalent available. The lack of a generic equivalent typically means that a patent owned by Pfizer protects the drug and that the 20-year term of the patent has not expired. If the pharmacist tells you there is a generic version of the drug available, that typically means the 20-year patent has expired and other companies are now making a drug chemically identical to Pfizer's. The price of the generic version of the drug is generally lower because the manufacturer of the generic version of the drug is not trying to recover the costs Pfizer (in this case) incurred to develop the product (the drug) in question.

A utility patent cannot be obtained for an "idea" or a "suggestion" for a new product or process. A complete description of the invention for which a utility patent is sought is required, including drawings and technical details. In addition, a patent must be applied for within one year of when a product or process was first offered for sale, put into public use, or was described in any printed publication. The requirement that a patent application must be filed within one year of the milestones referred to previously is called the **one year after first use deadline**.

Recently, utility patent law has added business method patents, which have been of particular interest to Internet firms. A **business method patent** is a patent that protects an invention that is, or facilitates, a method of doing business. Patents for these purposes were not allowed until 1998, when a federal circuit court issued an opinion allowing a patent for a business method, holding that business methods, mathematical algorithms, and software are patentable as long as they produce useful, tangible, and concrete results. This ruling opened a "Pandora's box" and has caused many firms to scramble to try to patent their business methods. Since 1998, the most notable business method patents awarded have been Amazon.com's one-click ordering system, Priceline.com's "name-your-price" business model, and Netflix's method for allowing customers to set up a rental list of movies they want mailed to them (a delivery method that Netflix customers use infrequently today) or that they wish to download for streaming purposes. Activities associated with a business method patent can be an important source of competitive advantage for a firm.

Design patents are the second most common type of patent and cover the invention of new, original, and ornamental designs for manufactured products.[11] Of the 650,411 patent applications filed in 2016, 6.2 percent were for design patents.[12] A design patent is good for 14 years from the grant date. Whereas a utility patent protects the way an invention is used and works, a design patent protects the way it looks. As a result, if an entrepreneur invented a new version of the computer mouse, it would be prudent to apply for a utility patent to cover the way the mouse works and for a design patent to protect the way the mouse looks. Although all computer mice perform essentially the same function, they can be ornamentally designed in an infinite number of ways. As long as each new design is considered by the USPTO to be novel and nonobvious, it is eligible for design patent protection. This is not a trivial issue in that product design is increasingly becoming an important source of competitive advantage for many firms producing many different types of products.

Plant patents protect new varieties of plants that can be reproduced asexually. While only 1,180 of the 650,411 patent applications filed in 2016 were for plant patents,[13] these patents provide essential protection for companies specializing in plant genetics and related areas. Plants that can be reproduced asexually are reproduced by grafting or crossbreeding rather than by planting seeds. The new variety can be different from previous plants in its resistance to disease or drought or in its scent, appearance, color, or productivity. Thus, a new color for a rose or a new type of hybrid vegetable would be eligible for plant patent protection. The term for plant patent protection is 20 years from the date of the original application.

Table 12.3 provides a summary of the three forms of patent protection, the types of inventions the patents cover, and the duration of the patents.

Who Can Apply for a Patent?

Only the inventor of a product can apply for a patent. If two or more people make an invention jointly, they must apply for the patent together. Someone who simply heard about the design of a product or is trying to patent something that is in the public domain may not apply for a patent.

There are notable exceptions to these rules. First, if an invention is made during the course of the inventor's employment, the employer typically is assigned the right to apply for the patent through an **assignment of invention agreement** signed by the employee as part of the employment agreement. A second exception is that the rights to apply for an invention can be sold. This option can be an important source of revenue for entrepreneurial firms. If a firm has an invention that it doesn't want to pursue on its own, the rights to apply for a patent on the invention can be sold to another party.

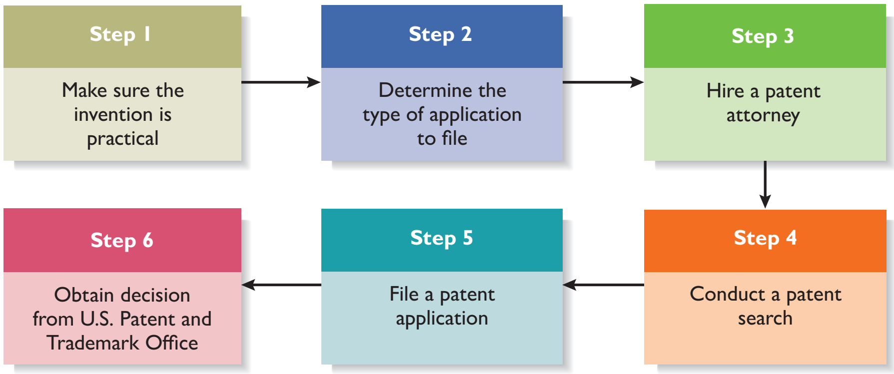
The Process of Obtaining a Patent

Obtaining a patent is a six-step process, as illustrated in Figure 12.3. The costs involved include attorney fees, fees for drawings (which are sometimes lumped together with the attorney fees), and USPTO filing and maintenance fees. For a small entity, it costs around \$800 to file a utility patent application. An additional \$480 fee is assessed when a patent is issued. Maintenance fees of \$800, \$1,800, and \$3,700 are due at the $3\,{}^1\!/_2$ year mark, the $7\,{}^1\!/_2$ year mark, and the

TABLE 12.3 Summary of the Three Forms of Patent Protection, the Types of Inventions the Patents Cover, and the Duration of the Patents

Type of Patent	Types of Inventions Covered	Duration
Utility	New or useful process, machine, manufacture, or composition of material or any new and useful improvement thereof	20 years from the date of the original application
Design	Invention of new, original, and ornamental designs for manufactured products	14 years from the date of the original application
Plant	Any new varieties of plants that can be reproduced asexually	20 years from the date of the original application

FIGURE 12.3
The Process of Obtaining a Patent



$11\frac{1}{2}$ year mark, respectively, to keep a patent in force. Additional fees may be assessed depending on the nature of the patent. Attorney fees vary depending on the complexity of the technology involved. An estimate of attorney fees to obtain a patent is provided in Table 12.4.[14]

The inventions that independent inventors create typically range from relatively simple to moderately complex. For a highly complex technology, such as a semiconductor product, the costs could substantially exceed $16,000.

The six-step process for obtaining a patent is shown next.

Step 1 **Make sure the invention is practical.** As mentioned earlier, there are two rules of thumb for making the decision to patent. Intellectual property that is worth protecting typically is directly related to the competitive advantage of the firm seeking the protection or has independent value in the marketplace.

Step 2 **Determine what type of application to file.** As mentioned, there are three types of patents: utility patents, design patents, and plant patents. The utility patent is by far the most common one.

Step 3 **Hire a patent attorney.** It is highly recommended that an inventor work with a patent attorney. Even though there are "patent-it-yourself" books on the market, it is generally naïve for an entrepreneur to think that the patent process can be successfully navigated without expert help. A correctly prepared patent application with correctly defined

TABLE 12.4 Estimates of Attorney Fees for Obtaining a Patent

Invention Type	Examples of Inventions	Fees for an Attorney's Services
Extremely simple	Electric switch, coat hanger, paper clip	$5,000 to $7,000
Relatively simple	Board game, umbrella, retractable dog leash, toothbrush	$7,000 to $8,500
Minimally complex	Power hand tool, lawn mower, camera	$8,500 to $10,000
Moderately complex	Riding lawn mower, simple RFID device, basic solar concentrator	$10,000 to $12,000
Relatively complex	Shock absorbing prosthetic device	$12,000 to $14,000
Highly complex	MRI scanner, PCR, satellite technologies	$14,000 to $16,000
Software related	Software, automated systems, business methods	$16,500+

Source: Based on G. Quinn, "The Cost of Obtaining a Patent in the US," IPWatchDog, https://www.ipwatchdog.com/2015/04/04/the-cost-of-obtaining-a-patent-in-the-us/id=56485/ (posted April 4, 2015, accessed February 28, 2017).

claims will provide the best chance for an application to be approved. In addition, a new product may have patentable features that may not be obvious to a novice in the field. As an indication of the difficulty of writing a patent application, the USPTO requires all attorneys and agents to pass a tough exam before they can interact with the agency on behalf of a client.

Step 4 **Conduct a patent search.** To be patentable, an invention must be novel and different enough from what already exists. A patent attorney typically spends several hours searching the USPTO's database (which is available online at www.uspto.gov) to study similar patents. After the search is completed and the patents that are similar to the invention in question have been carefully studied, the patent attorney renders an opinion regarding the probability of obtaining a patent on the new invention.

Step 5 **File a patent application.** The fifth step, if the inventor decides to proceed, is to file a patent application with the USPTO in Washington, D.C. Applications can be filed electronically or by mail. Unlike copyright and trademark applications, which can be prepared and filed easily by their owners, patent applications are highly technical and almost always require expert assistance. In terms of priority in filing a patent application, the United States uses a first-to-file system, as is used in all countries. The United States switched to a first-to-file system from a first-to-invent system on March 16, 2013, with the enactment of the Leahy-Smith America Invents Act. In a first-to-file system, the right to the grant of a patent for an invention lies with the first person to file a patent application for the invention, regardless of the date of the actual invention.

Step 6 **Obtain a decision from the USPTO.** When the USPTO receives a patent application, it is given a serial number, assigned to an examiner, and then waits to be examined. The patent examiner investigates the application and issues a written report ("Office Action") to the applicant's patent attorney, often asking for modifications to the application. Most of the interactions that applicants have with the USPTO are by mail or e-mail. Occasionally, an inventor and a lawyer will meet face-to-face with a patent examiner to discuss the invention and the written report. There is room to negotiate with the patent office to try to make an invention patentable. Eventually, a yes-or-no decision will be rendered. A rejected application can be appealed, but appeals are rare and expensive.

One provision of patent law that is particularly important to entrepreneurs is that the USPTO allows inventors to file a **provisional patent application** for utility patents, pending the preparation and filing of a complete application. A provisional patent application provides the means to establish an early effective filing date for a nonprovisional patent application, and allows the term "Patent Pending" to be applied. There is often confusion regarding what a provisional patent application is. It is not a provisional patent—there is no such thing. Rather, it is merely a provisional *application* for a patent, and is used to establish an early filing date for a subsequently filed full utility patent. It can actually give an entrepreneur a false sense of security if not filed correctly. The ins and outs of filing a provisional patent application are explained in the nearby "Savvy Entrepreneurial Firm" feature.

The Maker Movement in the United States refers to renewed interest in the United States and elsewhere for people to invent, design, and make things on their own.[15] In some cases, people invent things for the joy of inventing. In other

SAVVY ENTREPRENEURIAL FIRM

Knowing the Ins and Outs of Filing a Provisional Patent Application

• Web: www.uspto.gov • Facebook: United States Patent and Trademark Office • Twitter: uspto

In start-up circles, it's not uncommon to hear people say that they have a "provisional patent" or that they're protected from someone stealing their invention because a provisional patent has been filed. Neither of these statements can be true, because there is no such thing as a provisional patent. While the people who make those claims are normally well-intentioned, failing to be familiar with the basics of patent law can result in an entrepreneur inadvertently surrendering the patent rights for which he or she has an invention. If this happens, it can cripple a firm that is planning on achieving a sustainable competitive advantage via its exclusive rights on an invention.

Here's an accurate assessment of what takes place for entrepreneurs working in the United States. What's filed with the USPTO is a "provisional patent application." It includes specifications (i.e., a description and drawings of an invention), but does not require formal patent claims, inventors' oaths or declarations, or any information disclosure statement. It's not assigned to a patent examiner, and no judgment is made regarding prior art or the patentability of the invention. Its purpose, in the eyes of the USPTO, is to establish an early filing date for a subsequently filed full utility patent. What's meant by this is that if a provisional patent application is filed on December 1, 2017, and the application is completed correctly, this becomes the "priority" filing date for that invention. If someone files a utility patent application for an identical invention a month later, that person is out of luck, as long as the inventor who filed the provisional patent application follows through and files for a full utility patent within one year, and both the provisional patent application and the full utility patent application are deemed to be acceptable. A bonus attached to filing a provisional patent application, which costs $149 to file, is that the inventor can legally use the term "patent pending" in relation to the invention. This designation may provide the inventor a significant marketing advantage, if the invention is already for sale, and signal to prospective inventors that the inventor is taking steps to protect his or her patent rights.

There is a catch, however, to this scenario—the provisional patent application must be completed and filed correctly. All patent applications, including provisional patent applications, are subject to three important statutory requirements:

1. It must include an adequate written description of the invention.
2. It should enable one of ordinary skill in the art to make and use the invention.
3. It must set forth the best mode of practicing the invention contemplated by the inventor upon filing.

If any one of these requirements is not met, along with other statutory requirements the USPTO has, it is tantamount to not having filed anything at all. So it is very important that provisional patent applications be sufficiently detailed and filed correctly. Here's what can happen if they're not. Suppose Amy invents a new type of tennis racket. She files a provisional patent application on January 1, 2018, by downloading the application and filing it herself. It's inadequate because it doesn't contain an adequate written description of her invention, but the USPTO doesn't tell Amy it is inadequate because it doesn't examine provisional patent applications until a full utility patent is filed. On July 1, 2018, Amy hires a patent attorney to file for a full utility patent on her invention. After reviewing her file, the USPTO examiner rejects the application, because someone filed a utility patent application for an identical invention a month earlier, on June 1, 2018. The reason for the rejection is that Amy's provisional patent application was deemed to be invalid because the description was inadequate. The fact that Amy filed a provisional patent application on January 1, 2018, five full months before the second party filed for an identical invention, holds no weight because Amy's provisional patent application was deemed to be invalid.

Amy's story illustrates that filing a provisional patent application takes some finesse. Filing a provisional patent application has its place. It is particularly useful for an inventor who invents a new device and wants to lock in a priority filing date while additional prototyping and a feasibility analysis are conducted to decide whether it is worth the time and money to file for a full utility patent. It is a balancing act, however. An inventor needs to be far down the road before a provisional patent application makes sense. It may also make sense to hire a patent attorney to file the provisional patent application. Amy's description probably wasn't adequate because she didn't create a prototype of her new tennis racket, and thus was not able to adequately describe it. A patent attorney would have most likely told Amy that her description wasn't adequate, and suggested that more work be completed before the provisional patent application was filed. An idea can't be patented—only the specific expression of an idea, which must contain an adequate description.

The USPTO does allow additional provisional applications for a device to be filed as improvements are made. This protects inventors who are making progress on their device and want to establish priority dates for improved iterations of an invention as progress is made.

Questions for Critical Thinking

1. Briefly describe the difference between a provisional patent application and a utility patent application. If successful, which of the two applications awards an inventor a patent?
2. Can a provisional patent application be filed for a design patent? Document your research to arrive at the correct answer to this question.

3. Under what circumstances would you (1) suggest to an inventor that he or she could file a provisional patent application without a patent attorney or (2) suggest to an inventor that he or she needs to hire a patent attorney to file the provisional patent application?
4. Spend some time studying the USPTO's website, or doing some Internet research on patents. Inventor's Digest (www.inventorsdigest.com) is another good resource for learning about patents. Discuss one fact about patents or the application process you find interesting and isn't included in the material in this chapter.

Sources: USPTO, www.uspto.gov (accessed February 27, 2017); J. H. Muskin, "Pitfalls of Provisional Patent Applications," *Inventors Digest*, www.inventorsdigest.com/archives/4111 (posted July 20, 2010, accessed August 6, 2014).

instances they start a firm to bring their product to market. Or in some cases, inventors choose to sell or license their product to a larger firm. The nearby "Partnering for Success" feature deals with the latter option—selling or licensing an invention to a larger firm. As illustrated in the feature, an increasing number of companies now have formal programs that allow inventors to submit their inventions for consideration.

Patent Infringement

Patent infringement takes place when one party engages in the unauthorized use of another party's patent. There were 5,600 patent infringement cases filed in 2015. The top five industries in which infringement cases were filed were consumer products, biotech/pharma, computer hardware/electronics, industrial/construction, and software.[16] A typical example of an infringement claim, filed several years ago, was that initiated by Alacritech, a start-up firm, which claimed that Microsoft violated two of its patents on technology used to speed the performance of computers connected to networks. According to court documents, Alacritech showed its technology to Microsoft, hoping that Microsoft would license it. But Microsoft passed on the offer and later announced a surprisingly similar technology, called Chimney. Alacritech again offered to license the technology to Microsoft but was rebuffed. In response, Alacritech filed suit against Microsoft. Microsoft claimed that its technology was developed independently.[17] After hearing the case, the U.S. District Court in San Francisco sided with Alacritech and filed a preliminary injunction against Microsoft, preventing it from shipping products that contained the contested technology. Later, the suit was settled out of court, with Microsoft agreeing to license Alacritech's technology.[18]

The tough part about patent infringement cases is that they are costly to litigate, which puts start-up firms and their entrepreneurs at quite a disadvantage. While there is no way of knowing how much it cost Alacritech to sue Microsoft, a typical patent-infringement suit, according to *Fortune Small Business*, costs each side at least $500,000 to litigate.[19]

Trademarks

LEARNING OBJECTIVE

3. Describe a trademark and explain the process entrepreneurs use to obtain one.

A **trademark** is any word, name, symbol, or device used to identify the source or origin of products or services and to distinguish those products or services from others. All businesses want to be recognized by their potential clientele and use their names, logos, and other distinguishing features to enhance their visibility. Trademarks also provide consumers with useful information. For example, consumers know what to expect when they see a Macy's store in a mall. Think of how confusing it would be if any retail store could use the name Macy's. The U.S. trademark system is based on first use; that is, whoever uses a trademark in commerce first generally has the best claim to it.

As is the case with patents, trademarks have a rich history. Archaeologists have found evidence that as far back as 3,500 years ago, potters made

PARTNERING FOR SUCCESS

How the Maker Movement is Bringing Individual Inventors and Large Firms Together

As noted in the text, the Maker Movement refers to the renewed interest in the United States and elsewhere for people to invent, design, and make things in their homes or in collaborative work spaces. It is an umbrella term that covers artisans that make things such as crafts, jewelry, and clothing to engineering-oriented people who focus on electronics, robotics, 3-D printing and more advanced projects. There are a growing number of makerspaces, FabLabs, and TechShops popping up across the country that accommodate both groups. Some of the products made in these places are inventions that are eligible for intellectual property protection.

A makerspace is a collaborative workspace that is typically inside a school, library, or a separate public or private facility. In these workspaces, people have access to the types of equipment needed to experiment with ideas and/or make physical prototypes. These spaces typically include 3D printers, laser cutters, soldering irons, wood lathes, craft-making tools, and sewing machines. For a few dollars an hour, participants can gain access to machines that cost thousands of dollars. FabLabs and TechShops are similar to makerspaces except they are trademarked names for specific types of makerspaces. One is governed by a foundation (Fab Foundation) and the other by a corporation (TechShop). FabLabs and TechShops are typically frequented by more experienced makers or inventors who are working on more advanced projects.

Some people become makers simply for the joy of inventing. Groups such as Make: magazine hold Maker Faires across the country where tech enthusiasts and others showcase their experiments, projects, and the things they've made. Some of the inventions that tech enthusiasts, hobbyists, engineers, and others develop outside their jobs have commercial potential. In these cases, to bring an invention to market, the inventor can either start a business or try to sell or license the invention to an existing company.

An increasing number of companies now have formal processes in place for inventors to submit invention ideas. Companies know there are independent makers out there, so why not tap into their creative potential? If a company buys an invention from someone, that's a one-time transaction. If a company licenses a product, then the inventor usually gets an up-front payment and an ongoing royalty payment of 5 percent to 15 percent of the gross sales.

The following are three examples of companies that have formal invention idea submission programs, along with a brief description of each program. There are a couple of caveats. First, nearly all invention submission programs expect submitters to have done their due diligence that is are there similar products already on the market, have you approached manufacturing or design firms to obtain cost estimates, and do you have a physical prototype of the device? Addressing these issues bolsters your case. Second, it also bolsters your case to have a patent or have already applied for one. Not only does the larger firm want you to be protected, but if you have a patent or patent pending, you will be able to communicate more freely about the details of your idea.

DeWALT. DeWALT is a tool maker. It has an online brochure that describes its invention submission process. An invention is judged on three criteria: uniqueness of the idea, commercial viability, and fit with DeWALT. In regard to fit, DeWALT has three criteria: is the problem solved by your idea experienced by a large number of consumers, does the idea logically complement any of the products shown on the DeWALT website, and does the idea improve upon an existing DeWALT product?

General Mills. General Mills' program is called the General Mills Worldwide Innovation Network (G-WIN). G-WIN is looking for ideas in seven areas—health, ingredients, packaging, processing, products, sustainability, and technologies. G-WIN also periodically posts specific needs or problems through targeted "Innovation Challenges." While patented technologies are preferred, a patent is not required to submit your idea to General Mills. The G-WIN site walks the inventor through the proposal submission process. Since G-WIN was initiated in 2007, a number of new products have emerged from the program, including Fiber One 90-Calorie Brownies and Nature Valley Protein bars. The G-WIN portal is available at https://gwin.secure.force.com/.

Rubbermaid. Rubbermaid makes a wide variety of consumer products. Its "Invention Center" has a five step process: submit your solution, team review (the Rubbermaid team reviews your solution for fit with Rubbermaid), in-depth evaluation, start the conversation (if the solution shows promise and is a fit, it is now time to talk about how to work together), and reaching an agreement. Rubbermaid only accepts patented ideas for which a patent application has been filed in the United States and that application has been published. Rubbermaid is currently looking for product ideas in 13 categories, including closet organization, food storage, laundry, outdoor storage, and recycling. You can submit ideas to Rubbermaid at www.rubbermaidinventorcenter.com.

Other companies that have active product submission programs include Procter & Gamble, General Electric, Johnson & Johnson, StanleyBlack&Decker, and Coleman.

Questions for Critical Thinking

1. Identify the makerspace, FabLab, or TechShop that is located nearest you. Describe the equipment that is available and the program the facility offers.

2. Why do you think companies are increasingly open to ideas from independent inventors?
3. Find an idea submission site for a company not mentioned in the feature. Describe how to submit an invention to the company. What appear to be the keys to getting an idea accepted by the company?
4. In most cases, do you think inventors and entrepreneurs get a fair shake when they sell or license a product to a large company? What steps should entrepreneurs take to make sure they are getting a fair deal?

distinctive marks on their articles of pottery to distinguish their work from others. But consider a more modern example. The original name that Jerry Yang and David Filo, the cofounders of Yahoo, selected for their Internet directory service was "Jerry's Guide to the World Wide Web." Not too catchy, is it? The name was later changed to Yahoo, which caught on with early adopters of the Internet.

The Four Types of Trademarks

There are four types of trademarks: trademarks, service marks, collective marks, and certification marks (see Table 12.5). Trademarks and service marks are of the greatest interest to entrepreneurs.

As described earlier, a trademark includes any word, name, symbol, or device used to identify and distinguish one company's products from another's. Trademarks are used to promote and advertise tangible products. Examples here include Apple for smartphones, New Balance for athletic shoes, Ann Taylor for women's clothing, and Zynga for online games.

Service marks are similar to ordinary trademarks, but they are used to identify the services or intangible activities of a business rather than a business' physical product. Service marks include *The Princeton Review* for test prep services, eBay for online auctions, and Verizon for smartphone service.

TABLE 12.5 Summary of the Four Forms of Trademark Protection, the Type of Marks the Trademarks Cover, and the Duration of the Trademarks

Type of Trademark	Type of Marks Covered	Duration
Trademark	Any word, name, symbol, or device used to identify and distinguish one company's goods from another's Examples: *Apple, d.light, Wiivv, Athletic Propulsion Lab, 3Derm*	Renewable every 10 years, as long as the mark remains in use
Service mark	Similar to trademarks; are used to identify the services or intangible activities of a business, rather than a business' physical products Examples: *1-800-FLOWERS*, Amazon.com, *IndieU, Real Time Cases, CoachUp, Dropbox*	Renewable every 10 years, as long as the mark remains in use
Collective mark	Trademarks or service marks used by the members of a cooperative, association, or other collective group Examples: *Information Technology Industry Council, International Franchise Association, Rotary International*	Renewable every 10 years, as long as the mark remains in use
Certification mark	Marks, words, names, symbols, or devices used by a person other than its owner to certify a particular quality about a good or service Examples: *100% Napa Valley, Florida Oranges, National Organic Program, Underwriters Laboratories*	Renewable every 10 years, as long as the mark remains in use

Collective marks are trademarks or service marks used by the members of a cooperative, association, or other collective group, including marks indicating membership in a union or a similar organization. The marks belonging to the American Bar Association, The International Franchise Association, and the Collegiate Entrepreneurs' Organization are examples of collective marks.

Finally, **certification marks** are marks, words, names, symbols, or devices used by a person other than its owner to certify a particular quality about a product or service. The most familiar certification mark is the UL mark, which certifies that a product meets the safety standards established by Underwriters Laboratories. Other examples are the Good Housekeeping Seal of Approval, Stilton Cheese (a product from the Stilton region in England), and 100 percent Napa Valley (from grapes grown in the Napa Valley of northern California).

What Is Protected Under Trademark Law?

Trademark law, which falls under the **Lanham Act**, passed in 1946, protects the following items:

- **Words:** All combinations of words are eligible for trademark registration, including single words, short phrases, and slogans. Birchbox, Rent the Runway, and the National Football League are examples of words and phrases that have been registered as trademarks.
- **Numbers and letters:** Numbers and letters are eligible for registration. Examples include 3M, Boeing 787, and AT&T. Alphanumeric marks are also registerable, such as 1-800-CONTACTS.
- **Designs or logos:** A mark consisting solely of a design, such as the Golden Gate Bridge for Cisco Systems or the Nike swoosh logo, may be eligible for registration. The mark must be distinctive rather than generic. As a result, no one can claim exclusive rights to the image of the Golden Gate Bridge, but Cisco Systems can trademark its unique depiction of the bridge. Composite marks consist of a word or words in conjunction with a design. An example is the trademark for Zephyrhill's bottled water, which includes Zephyrhill's name below a picture of mountain scenery and water.
- **Sounds:** Distinctive sounds can be trademarked, although this form of trademark protection is rare. Recognizable examples of such sounds include MGM's lion's roar, the familiar four-tone sound that accompanies "Intel Inside" commercials, and the Yahoo yodel.
- **Fragrances:** The fragrance of a product may be registerable as long as the product is not known for the fragrance or the fragrance does not enhance the use of the product. As a result, the fragrance of a perfume or room deodorizer is not eligible for trademark protection, whereas stationery treated with a special fragrance in most cases would be.
- **Shapes:** The shape of a product, as long as it has no impact on the product's function, can be trademarked. The unique shape of the Apple iPod has received trademark protection.[20] The Coca-Cola Company has trademarked its famous curved bottle. The shape of the bottle has no effect on the quality of the bottle or the beverage it holds; therefore, the shape is not functional.
- **Colors:** A trademark may be obtained for a color as long as the color is not functional. For example, Nexium, a medicine pill that treats acid reflux disease, is purple and is marketed as "the purple pill." The color of the pill has no bearing on its functionality; therefore, it can be protected by trademark protection.

- **Trade dress:** The manner in which a product is "dressed up" to appeal to customers is protectable. This category includes the overall packaging, design, and configuration of a product. As a result, the overall look of a business is protected as its trade dress. In a famous case in 1992, *Two Pesos, Inc., v. Taco Cabana International Inc.*, the U.S. Supreme Court protected the overall design, colors, and configuration of a chain of Mexican restaurants from a competitor using a similar decor.[21]

Trademark protection is very broad and provides many opportunities for businesses to differentiate themselves from one another. The key for young entrepreneurial firms is to trademark their products and services in ways that draw positive attention to them in a compelling manner.

Exclusions from Trademark Protection

There are notable exclusions from trademark protection that are set forth in the U.S. Trademark Act:

- **Immoral or scandalous matter:** A company cannot trademark immoral or scandalous matter, including profane words.
- **Deceptive matter:** Marks that are deceptive cannot be registered. For example, a food company couldn't register the name "Fresh Florida Oranges" if the oranges weren't from Florida.
- **Descriptive marks:** Marks that are merely descriptive of a product or service cannot be trademarked. For example, an entrepreneur couldn't design a new type of golf ball and try to obtain trademark protection on the words *golf ball*. The words describe a type of product rather than a brand of product, such as Titleist or Taylor Made, and are needed by all golf ball manufacturers to be competitive. This issue is a real concern for the manufacturers of very popular products. At one point, Xerox was in danger of losing trademark protection for the Xerox name because of the common use of the word *Xerox* as a verb (e.g., "I am going to Xerox this.").
- **Surnames:** A trademark consisting primarily of a surname, such as Anderson or Smith, is typically not protectable. An exception is a surname combined with other wording that is intended to trademark a distinct product, such as William's Fresh Fish or Smith's Computer Emporium.

The Process of Obtaining a Trademark

As illustrated in Figure 12.4, selecting and registering a trademark is a three-step process. Once a trademark has been used in interstate commerce, it can be registered with the USPTO. It can remain registered forever as long as the trademark remains in use. The first renewal is between the fifth and the sixth year following the year of initial registration. It can be renewed every 10 years thereafter, as long as the trademark remains in use.

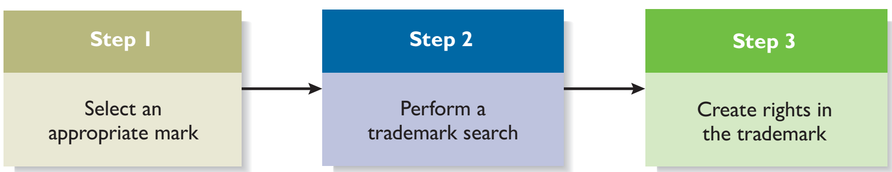


FIGURE 12.4
The Process of Obtaining a Trademark

Technically, a trademark does not need to be registered to receive protection and to prevent other companies from using confusingly similar marks. Once a mark is used in commerce, such as in an advertisement, it is protected. There are several distinct advantages, however, in registering a trademark with the USPTO: Registered marks are allowed nationwide priority for use of the mark, registered marks may use the federal trademark registration symbol (®), and registered marks carry with them the right to block the importation of infringing goods into the United States. The right to use the trademark registration symbol is particularly important. Attaching the trademark symbol to a product (e.g., Owlet Baby Monitor®) provides notice of a trademark owner's registration. This posting allows an owner to recover damages in an infringement action and helps reduce an offender's claim that it didn't know that a particular name or logo was trademarked.

There are three steps in selecting and registering a trademark:

Step 1 **Select an appropriate mark.** There are several rules of thumb to help business owners and entrepreneurs select appropriate trademarks. First, a mark, whether it is a name, logo, design, or fragrance, should display creativity and strength. Marks that are inherently distinctive, such as the McDonald's Golden Arches; made-up words, such as *Google*, *eBay*, and *Snapchat*; and words that evoke particular images, such as *Billy Goat Ice Cream*, are strong trademarks. Second, words that create a favorable impression about a product or service are helpful. A name such as *Safe and Secure Childcare* for a day care center positively resonates with parents.

Step 2 **Perform a trademark search.** Once a trademark has been selected, a trademark search should be conducted to determine if the trademark is available. If someone else has already established rights to the proposed mark, it cannot be used. There are several ways to conduct a trademark search, from self searches to hiring a firm specializing in trademark clearance checks. The search should include both federal and state searches in all states in which business will be conducted. If the trademark will be used overseas, the search should also include the countries where the trademark will be used.

Although it is not necessary to hire an attorney to conduct a trademark search, it is probably a good idea to do so. As noted above, self searches can also be conducted. The USPTO's website provides a powerful trademark search engine at www.uspto.gov/trademarks. There is a catch. The USPTO's search engine only searches trademarks that are registered. In the United States, you are not required to register a trademark to obtain protection. A trademark attorney can perform a more comprehensive search for you if you think it is necessary. Adopting a trademark without conducting a trademark search is risky. If a mark is challenged as an infringement, a company may have to destroy all its goods that bear the mark (including products, business cards, stationery, signs, and so on) and then select a new mark. The cost of refamiliarizing customers with an existing product under a new name or logo could be substantial.

Step 3 **Create rights in the trademark.** The final step in establishing a trademark is to create rights in the mark. In the United States, if the trademark is inherently distinctive (think of Starbucks, iTunes, or Facebook), the first person to use the mark becomes its owner. If the mark is descriptive, such as "Bufferin" for buffered aspirin, using the mark merely begins the process of developing a secondary meaning necessary to create full trademark protection. **Secondary meaning** arises when, over time, consumers start to identify a trademark with a specific product. For example, the name "chap stick" for lip balm was originally considered to be descriptive, and thus not afforded trademark protection. As people started to think of "chap stick" as lip balm, it met the threshold of secondary meaning, and the name "ChapStick" was able to be trademarked.

There are two ways that the USPTO can offer further protection for firms concerned about maintaining the exclusive rights to their trademarks. First, a person can file an **intent-to-use trademark application**. This is an application based on the applicant's intention to use a trademark. Once this application is filed, the owner obtains the benefits of registration. The benefits are lost, however, if the owner does not use the mark in business within six months of registration. Further protection can be obtained by filing a formal application for a trademark. The application must include a drawing of the trademark and a filing fee, ranging from $275 to $375, depending on how the application is filed. (It's cheaper to file electronically.) After a trademark application is filed, an examining attorney at the USPTO determines if the trademark can be registered. It currently takes about 10 months to get a trademark registered through the USPTO.

Trademark Infringement

Trademark infringement is the unauthorized use of a trademark or service mark in a manner that is likely to cause confusion.[22] The key is whether the infringement causes confusion. Think about Billy Goat Ice Cream, the company described in the "Opening Profile" of Chapter 7. No one company can trademark the words "Billy Goat" in that a Billy Goat is a male goat. So over time, a number of companies may have the words Billy Goat in their name and all trademark their respective names. A trademark dispute arises when a company that has already trademarked a name that includes the words Billy Goat thinks that another company's trademark that includes the words Billy Goat could be confused with its company. In this instance, the party that feels its trademark is being infringed on typically sends a cease-and-desist letter to the other party asking that they quit using the mark. So, if a year from now someone tried to trademark the name Billy Goat Yogurt, Billy Goat Ice Cream could object, claiming that a consumer could easily confuse Billy Goat Ice Cream and Billy Goat Yogurt. In contrast, if someone tried to trademark the name Billy Goat Blue Jeans, Billy Goat Ice Cream probably wouldn't object. It's unlikely a consumer would confuse Billy Goat Ice Cream with Billy Goat Blue Jeans.

Another scenario that can trigger a trademark dispute is if someone tries to trademark a name that is "confusingly similar" to a name that's already trademarked and in use. So if someone tried to trademark the name Acebook, for example, Facebook would probably object. It would argue that Acebook is confusingly similar to Facebook, so it shouldn't be allowed. If a company with an established trademark asks another company to quit using its mark and the other company refuses, then the company can file a civil action (i.e., lawsuit) in either state or federal court for trademark infringement, depending on the circumstances.[23]

There are occasions when a company's trademark is challenged, and the company thinks the objecting party has gone too far—in other words, there is no legitimate trademark infringement. In these cases, the start-up has a right to fight back, and force the complaining party to either back down or take them to court. Three scenarios in which this took place are provided in the nearby "What Went Wrong?" feature. In each case, you'll see a start-up resisting a name change trying to be forced by a larger company.

WHAT WENT WRONG?

David Conquers Goliath in Three Trademark Disputes

- Web: www.eatmorekale.com • Facebook: EatMoreKale.com • Twitter: @TeamKale
- Web: www.xoom.com • Facebook: Xoom • Twitter: @Xoom
- Web: https://snacks5thavenchew.com • Facebook: Snaks 5th Avenchew • Twitter: @Snaks5thAve

Trademark disputes often pit a large company against a start-up. It's a David vs. Goliath type of scenario, with a small entity on one side against a giant on the other. The dispute typically focuses on one party claiming that the other is using a name that is "confusingly similar" to a trademark they own. The large firm often prevails, but not always. The following are three examples of small firms that succeeded in trademark disputes with large companies. In these instances, the question of "What Went Wrong?" is left with the people representing the large firms.

Eat More Kale vs. Chick-fil-A In 2010, Bo Muller-Moore, who lived in Vermont, started selling T-shirts with the phrase "Eat More Kale" after a kale farmer asked him to make them. Kale is a healthy vegetable and is grown in Vermont. The phrase caught on, and Muller-Moore started placing it on clothing and bumper stickers. But when Muller-Moore went to trademark the phrase in 2011, Chick-fil-A sent him a letter requesting that he stop using the slogan because it was too similar to their "Eat Mor Chikin" advertising phrase. Chick-fil-A listed 30 other companies who had stopped using the "eat more" language in their marketing after it objected.

Muller-Moore fought back and a drawn-out battle with Chick-fil-A ensued. He used social media, pro-bono lawyers, and won the support of state officials, including then Vermont Governor Peter Shumlin. Eventually, Muller-Moore prevailed. The original trademark application for "Eat More Kale" was filed on August 31, 2011. The trademark was granted by the United States Trademark & Patent Office (USPTO) on August 18, 2015.

Xoom vs. Motorola In 2011, Motorola, which was then a subsidiary of Google, entered the tablet computer market. Its tablet was called the Xoom Tablet. The Xoom Tablet quickly caught the attention of Xoom Corp., a digital money transfer company. Xoom, which is now part of PayPal, allows a user to send money quickly and safely to 56 countries in the world. Founded in 2001, the company was awarded a service mark by the USPTO for Xoom on December 14, 2004.

Xoom objected to Motorola's use of word Xoom for its tablet computer. The two companies settled; the terms of the settlement weren't disclosed. Motorola agreed to phase out the Xoom branding for its tablets.

Snacks 5th Avenchew vs. Saks Fifth Avenue Carrie Sarabella of Hoboken, NJ started selling dog treats under the name "Snacks 5th Avenchew." Saks Fifth Avenue, the upscale retailer of women's apparel, got word of Sarabella's business and sent Sarabella a cease-and-desist letter, threatening legal action if she didn't drop the name. The letter claimed that Snacks 5th Avenchew infringed on Saks' well-known name.

Sarabella resisted, arguing through her lawyer that the name was acceptable under the fair use provision, which "recognizes that parody marks cause no harm to the established brand." Sarabella's attorney cited two cases similar to Saks' claim against Snacks 5th Avenchew. In 2002, Tommy Hilfiger brought suit against a novelty pet perfume called Timmy Holedigger. The suit was unsuccessful. Similarly, in 2007 Louis Vuitton objected to a fluffy toy maker using the name Chewy Vuiton. A federal U.S. appeals court unanimously rejected Louis Vuitton's claim. In both cases, the courts held that the complainants had failed to show any likelihood of confusion between the products in question and the larger company's registered trademarks because the former were obvious parodies.

Not long after these arguments were made, Saks Fifth Avenue notified Saraballa's lawyer that they would not pursue the matter further.

Questions for Critical Thinking

1. What is your reaction to each case? Were you surprised at how they turned out? Do you think each case turned out the way the trademark law intended it to?
2. Which of the three smaller companies profiled—Eat More Kale, Xoom, or Snacks 5th Avenchew—do you think had the strongest case in defending the name it was using? Which company do you think had the weakest case?
3. Why do you think Bo Muller-Moore was able to elicit such passion and support in his trademark dispute with Chick-fil-A?
4. To what degree do you think these cases should embolden small firms so they won't always have to give in to larger firms in intellectual property disputes if they think the law is on their side?

Sources: C. Alter, "Vermont Man Wins Right to Use 'Eat More Kale' Slogan, Despite Chick-fil-A Objections." *Fortune*, December 12, 2014; W. Ring. "Man Celebrates His New 'Eat More Kale' Trademark," *Burlington Free Press*, December 12, 2014; 4 Biggest Corporate Trademark Disputes in Recent History, SecureYourTrademark.com, available at https://secureyourtrademark.com/blog/4-biggest-corporate-trademark-disputes-recent-history/ (accessed February 25, 2017); O. Yaniv. "N.J. Entrepreneur Beats Saks Fifth Avenue in Trademark Dogfight," *New York Daily News*, October 29, 2014; T. Erdmann. "Snacks 5th Avenchew v. Saks Fifth Avenue. Lawinspiring.com, available at http://lawinspiring.com/2014/11/03/dog-snack-entrepreneur-wins-saks-5th-avenue-trademark-dispute/ (posted November 3, 2014, accessed February 25, 2017).

Copyrights

LEARNING OBJECTIVE

4. Define a copyright and identify what a copyright can protect.

A **copyright** is a form of intellectual property protection that grants to the owner of a work of authorship the legal right to determine how the work is used and to obtain the economic benefits from the work.[24] The work must be in a tangible form, such as a book, operating manual, magazine article, musical score, computer software program, or architectural drawing. If something is not in a tangible form, such as a speech that has never been recorded or saved on a computer disc, copyright law does not protect it.

Businesses typically possess a treasure trove of copyrightable material, as illustrated earlier in Table 12.1. A work does not have to have artistic merit to be eligible for copyright protection. As a result, things such as operating manuals, advertising brochures, and training videos qualify for protection. The Copyright Revision Act of 1976 governs copyright law in the United States. Under the law, an original work is protected automatically from the time it is created and put into a tangible form, whether it is published or not. The first copyright in the United States was granted on May 31, 1790, to a Philadelphia educator named John Barry for a spelling book.

What Is Protected by a Copyright?

Copyright laws protect "original works of authorship" that are fixed in a tangible form of expression. The primary categories of material that can be copyrighted follow:

- **Literary works:** Anything written down is a literary work, including books, poetry, reference works, speeches, advertising copy, employee manuals, games, and computer programs. Characters found in literary works are protectable if they possess a high degree of distinctiveness. A character that looks and acts like Garfield, the cartoon cat, would infringe on the copyright that protects Garfield.
- **Musical compositions:** A musical composition, including any accompanying words, that is in a fixed form (e.g., a musical score, CD, or an MP3 file) is protectable. The owner of the copyright is usually the composer and possibly a lyricist. **Derivative works**, which are works that are new renditions of something that is already copyrighted, are also copyrightable. As a result of this provision, a musician who performs a unique rendition of a song written and copyrighted by Miley Cyrus, Katy Perry, or Bruno Mars, for example, can obtain a copyright on his or her effort. Of course, each of these artists would have to consent to the infringement on its copyright of the original song before the new song could be used commercially, which is a common way that composers earn extra income.
- **Computer software:** In 1980, Congress passed the **Computer Software Copyright Act**, which amended previous copyright acts. Now, all forms of computer programs are protected.
- **Dramatic works:** A dramatic work is a theatrical performance, such as a play, comedy routine, newscast, movie, or television show. An entire dramatic work can be protected under a single copyright. As a result, a dramatic work such as a television show doesn't need a separate copyright for the video and audio portions of the show.
- **Pantomimes and choreographic works:** A pantomime is a performance that uses gestures and facial expressions rather than words to communicate a situation. Choreography is the arrangement of dance movements. Copyright laws in these areas protect ballets, dance movements, and mime works.

- **Pictorial, graphic, and sculptural works:** This is a broad category that includes photographs, prints, art reproductions, cartoons, maps, globes, jewelry, fabrics, games, technical drawings, diagrams, posters, toys, sculptures, and charts.

Other categories of items covered by copyright law include motion pictures and other audiovisual works, sound recordings, and architectural works.

Copyright law provides broad protection for authors and the creators of other types of copyrightable work. The most common mistake entrepreneurs make in this area is not thinking broadly enough about what they should copyright.

Exclusions from Copyright Protection

There are exclusions from copyright protection. The main exclusion is that copyright laws cannot protect ideas. For example, an entrepreneur may have the idea to open a soccer-themed restaurant. The idea itself is not eligible for copyright protection. However, if the entrepreneur writes down specifically what the soccer-themed restaurant will look like and how it would operate, that description is copyrightable. The legal principle describing this concept is called the **idea–expression dichotomy**. An idea is not copyrightable, but the specific expression of an idea is.

Other exclusions from copyright protection include facts (e.g., population statistics), titles (e.g., *Introduction to Entrepreneurship*), and lists of ingredients (e.g., recipes).

How to Obtain a Copyright

As mentioned, copyright law protects any work of authorship the moment it assumes a tangible form. Technically, it is not necessary to provide a copyright notice or register work with the U.S. Copyright Office to be protected by copyright legislation. The following steps can be taken, however, to enhance the protection offered by the copyright statutes.

First, copyright protection can be enhanced for anything written by attaching the copyright notice, or "**copyright bug**" as it is sometimes called. The bug—a "c" inside a circle—typically appears in the following form: © [first year of publication] [author or copyright owner]. Thus, the notice at the bottom of a magazine ad for Dell Inc.'s computers in 2018 would read, "© 2018 Dell Inc." By placing this notice at the bottom of a document, an author (or company) can prevent someone from copying the work without permission and claiming that they did not know that the work was copyrighted. Substitutes for the copyright bug include the word "Copyright" and the abbreviation "Copr."

Second, further protection can be obtained by registering a work with the U.S. Copyright Office. Filing a simple form and depositing one or two samples of the work with the U.S. Copyright Office completes the registration process. The need to supply a sample depends on the nature of the item involved. Obviously, one could not supply one or two samples of an original painting. The current cost of obtaining a copyright is $35 if filed electronically and $55 if filed on paper. Although the $35 fee seems modest, in many cases it is impractical for a prolific author to register everything he or she creates. In all cases, however, it is recommended that the copyright bug be attached to copyrightable work and that registration be contemplated on a case-by-case basis. A copyright can be registered at any time, but filing promptly is recommended and makes it easier to sue for copyright infringement.

Copyrights last a long time. According to current law, any work created on or after January 1, 1978, is protected for the life of the author plus 70 years. For works made for hire, the duration of the copyright is 95 years from publication or 120 years from creation, whichever is shorter. For works created before 1978, the duration times vary, depending on when the work was created. After a copyright expires, the work goes into the public domain, meaning it becomes available for anyone's use.

Copyright Infringement

Copyright infringement is a growing problem in the United States and in other countries, with estimates of the costs to owners at more than $25 billion per year. For example, less than a week after the film was released in the United States, bootleg video discs of the original Harry Potter movie were reported to be for sale in at least two Asian countries. Taking this a step further, we note that a recent study showed that as of 2013, Internet infringement in the entertainment industry "accounts for almost one-fourth of all bandwidth in North America, Europe and Asia."[25] **Copyright infringement** occurs when one work derives from another, is an exact copy, or shows substantial similarity to the original work. To prove infringement, a copyright owner is required to show that the alleged infringer had prior access to the copyrighted work and that the work is substantially similar to the owner's.

There are many ways to prevent infringement. For example, a technique frequently used to guard against the illegal copying of software code is to embed and hide in the code useless information, such as the birth dates and addresses of the authors. It's hard for infringers to spot useless information if they are simply cutting and pasting large amounts of code from one program to another. If software code is illegally copied and an infringement suit is filed, it is difficult for the accused party to explain why the (supposedly original) code included the birth dates and addresses of its accusers. Similarly, some publishers of maps, guides, and other reference works will deliberately include bits of phony information in their products, such as fake streets, nonexistent railroad crossings, and so on, to try to catch copiers. Again, it would be pretty hard for someone who copied someone else's copyrighted street guide to explain why the name of a fake street was included.[26]

Andrey Armyagov/123rf.com

The rampant illegal downloading and sharing of music—copyright infringement—is a major challenge the music industry continues to struggle with. Hackers are always looking for ways to skirt the law.

Current law permits limited infringement of copyrighted material. This limited infringement is considered to be **fair use**, which is the limited use of copyrighted material for purposes such as criticism, comment, news reporting, teaching, or scholarship. This provision is what allows textbook authors to repeat quotes from magazine articles (as long as the original source is cited), movie critics to show clips from movies, and teachers to distribute portions of newspaper articles or blog entries. The reasoning behind the law is that the benefit to the public from such uses outweighs any harm to the copyright owner. Other situations in which copyrighted material may be used to a limited degree without fear of infringement include parody, reproduction by libraries, and making a single backup copy of a computer program or a digital music file for personal use. Case 12.1, titled "GoldieBlox vs. Beastie Boys: The Type of Fight That No Start-up Wants to Be a Part Of," focuses on a copyright infringement case in which the courts ruled that fair use was not being employed appropriately. Along with providing clarity on the appropriate application of fair use, Case 12.1 vividly portrays the types of legal entanglements that start-ups can get into if they don't understand copyright law or intellectual property laws more broadly.

Copyright and the Internet

Every day, vast quantities of material are posted on the Internet and can be downloaded or copied by anyone with a computer and an Internet connection. Because the information is stored somewhere on a computer or Internet server, it is in a tangible form and probably qualifies for copyright protection. As a result, anyone who downloads material from the Internet and uses it for personal purposes should be cautious and realize that copyright laws are just as applicable for material on the Internet as they are for material purchased from a bookstore or borrowed from a library.

Copyright laws, particularly as they apply to the Internet, are sometimes difficult to follow, and it is easy for people to dismiss them as contrary to common sense. For example, say that a golf instructor in Phoenix posted a set of "golf tips" on his website for his students to use as they prepare for their lessons. Because the notes are on a website, anyone can download the notes and use them. As a result, suppose that another golf instructor in a different part of the United States or in a different country ran across the golf tips, downloaded them, and decided to distribute them to his students. Under existing law, the second golf instructor probably violated the intellectual property rights of the first. Arguably, he should have gotten permission from the first golf instructor before using the notes even if the website didn't include any information about how to contact the first instructor. To many people, this scenario doesn't make sense. The first golf instructor put his notes on a public website, didn't include any information about how to obtain permission to use them, and didn't even include information about how he could be contacted. In addition, he made no attempt to protect the notes, such as posting them on a password-protected web page. Still, intellectual property rights apply, and the second instructor runs the risk of a copyright infringement suit.

There are a number of techniques available for entrepreneurs and webmasters to prevent unauthorized material from being copied from a website. Password protecting the portion of a site containing sensitive or proprietary information is a common first step. In addition, there are a number of technical protection tools available on the market that limit access to, or the use of, online information, including selected use of encryption, digital watermarking (hidden copyright messages), and digital fingerprinting (hidden serial numbers or a set of characteristics that tend to distinguish an object from other similar objects).

Trade Secrets

LEARNING OBJECTIVE

5. Describe a trade secret and understand the common causes of trade secret disputes.

Most companies, including start-ups, have a wealth of information that is critical to their success but does not qualify for patent, trademark, or copyright protection. Some of this information is confidential and needs to be kept secret to help a firm maintain its competitive advantage. An example is a company's customer list. A company may have been extremely diligent over time tracking the preferences and buying habits of its customers, helping it fine-tune its marketing message and target past customers for future business. If this list fell into the hands of one or more of the company's competitors, its value would be largely lost, and it would no longer provide the firm a competitive advantage over its competitors.

A **trade secret** is any formula, pattern, physical device, idea, process, or other information that provides the owner of the information with a competitive advantage in the marketplace. Trade secrets include marketing plans, product formulas, financial forecasts, employee rosters, logs of sales calls, and laboratory notebooks. The medium in which information is stored typically has no impact on whether it can be protected as a trade secret. As a result, written documents, computer files, audiotapes, videotapes, financial statements, and even an employee's memory of various items can be protected from unauthorized disclosure.

Unlike patents, trademarks, and copyrights, there is no single government agency that regulates trade secret laws. Instead, trade secrets are governed by a patchwork of various state laws. The federal **Economic Espionage Act**, passed in 1996, does criminalize the theft of trade secrets (known as misappropriation) by third parties. The **Uniform Trade Secrets Act**, which a special commission drafted in 1979, attempted to set nationwide standards for trade secret legislation. Although the majority of states have adopted the act, most revised it, resulting in a wide disparity among states in regard to trade secret legislation and enforcement.

Iakov Filimonov/Shutterstock

Fitness centers like this one normally protect their membership lists as a trade secret. They worked hard to win their members and don't want to make it easy for a competitor to prospect them.

What Qualifies for Trade Secret Protection?

Not all information qualifies for trade secret protection. In general, information that is known to the public or that competitors can discover through legal means doesn't qualify for trade secret protection. If a company passes out brochures at a trade show that are available to anyone in attendance, nothing that is in the brochure can typically qualify as a trade secret. Similarly, if a secret is disclosed by mistake, it typically loses its trade secret status. For example, if an employee of a company is talking on a cell phone in a public place and is overheard by a competitor, anything the employee says is generally exempt from trade secret protection. Simply stated, the general philosophy of trade secret legislation is that the law will not protect a trade secret unless its owner protects it first.

Companies can maintain protection for their trade secrets if they take reasonable steps to keep the information confidential. In assessing whether reasonable steps have been taken, courts typically examine how broadly the information is known inside and outside the firm, the value of the information, the extent of measures taken to protect the secrecy of the information, the effort expended in developing the information, and the ease with which other companies could develop the information. On the basis of these criteria, the strongest case for trade secret protection is information that is characterized by the following:

- Is not known outside the company
- Is known only inside the company on a "need-to-know" basis
- Is safeguarded by stringent efforts to keep the information confidential
- Is valuable and provides the company a compelling competitive advantage
- Was developed at great cost, time, and effort
- Cannot be easily duplicated, reverse engineered, or discovered

Trade Secret Disputes

Trade secret disputes arise most frequently when an employee leaves a firm to join a competitor and is accused of taking confidential information along. For example, a marketing executive for one firm may take a job with a competitor and create a marketing plan for the new employer that is nearly identical to the plan being implemented at the previous job. The original employer could argue that the marketing plan on which the departed employee was working was a company trade secret and that the employee essentially stole the plan and took it to the new job. The key factor in winning a trade secret dispute is that some type of theft or misappropriation must have taken place. Trade secrets can be lawfully discovered. For example, it is not illegal for one company to buy another company's products and take them apart to see how they are assembled. In fact, this is a relatively common practice, which is another reason companies continuously attempt to innovate as a means of trying to stay at least one step ahead of competitors.

A company damaged by trade secret theft can initiate a civil action for damages in court. The action should be taken as soon after the discovery of the theft as possible. In denying the allegation, the defendant will typically argue that the information in question was independently developed (meaning no theft took place), was obtained by proper means (such as with the permission of the owner), is common knowledge (meaning it is not subject to trade secret protection), or was innocently received (such as through a casual conversation at a business meeting). Memorization is not a defense. As a result, an employee of one firm can't say that "all I took from my old job to my new one was what's in my head" and claim that just because the information conveyed wasn't in written form, it's not subject to trade secret protection. If the courts rule in favor of the firm that feels its trade secret has been stolen, the firm can stop the offender from using the trade secret and obtain financial damages.

Trade Secret Protection Methods

Aggressive protection of trade secrets is necessary to prevent intentional or unintentional disclosure. In addition, one of the key factors in determining whether something constitutes a trade secret is the extent of the efforts to keep it secret. Companies protect trade secrets through physical measures and written agreements.

Physical Measures There are a number of physical measures firms use to protect trade secrets, from security fences around buildings, to providing employees access to file cabinets that lock, to much more elaborate measures. The level of protection depends on the nature of the trade secret. For example, although a retail store may consider its inventory control procedures to be a trade secret, it may not consider this information vital and may take appropriate yet not extreme measures to protect the information. In contrast, a biotech firm may be on the cusp of discovering a cure for a disease and may take extreme measures to protect the confidentiality of the work being conducted in its laboratories.

The following are examples of commonly used physical measures for protecting trade secrets:

- **Restricting access:** Many companies restrict physical access to confidential material to only the employees who have a "need to know." For example, access to a company's customer list may be restricted to key personnel in the marketing department.
- **Labeling documents:** Sensitive documents should be stamped or labeled "confidential," "proprietary," "restricted," or "secret." If possible, these documents should be secured when not in use. Such labeling should be restricted to particularly sensitive documents. If everything is labeled "confidential," there is a risk that employees will soon lose their ability to distinguish between slightly and highly confidential material.
- **Password protecting confidential computer files:** Providing employees with clearance to view confidential information by using secure passwords can restrict information on a company's computer network, website, or intranet. Companies can also write-protect documents to ensure that employees can read but not modify certain documents.
- **Maintaining logbooks for visitors:** Visitors can be denied access to confidential information by asking them to sign in when they arrive at a company facility, having them wear name badges that identify them as visitors, and always making sure they are accompanied by a company employee.
- **Maintain logbooks for access to sensitive material:** Many companies maintain logbooks for sensitive material and make their employees "check out" and "check in" the material.
- **Maintaining adequate overall security measures:** Commonsense measures are also helpful. Shredders should be provided to destroy documents as appropriate. Employees who have access to confidential material should have desks and cabinets that can be locked and secured. Alarms, security systems, and security personnel should be used to protect a firm's premises.

Some of these measures may seem extreme. On the other hand, we live in an imperfect world and, because of this, companies need to safeguard their information against both inadvertent disclosure and outright theft. Steps such as shredding documents may seem like overkill at first glance but may be very important in ultimately protecting trade secrets. Believe it or not, there have been a number of cases in which companies have caught competitors literally going through the trash bins behind their buildings looking for confidential information.

Written Agreements It is important for a company's employees to know that it is their duty to keep trade secrets and other forms of confidential information secret. For the best protection, a firm should ask its employees to sign nondisclosure and noncompete agreements, as discussed in Chapter 7.

Intellectual property, and the problems that underlie the need for intellectual property to be created, are important enough that firms have been started strictly for the purpose of helping companies solve problems and obtain the intellectual property that they need.

Conducting an Intellectual Property Audit

LEARNING OBJECTIVE

6. Explain what an intellectual property audit is and identify the two primary reasons entrepreneurial firms should complete this type of audit.

The first step a firm should take to protect its intellectual property is to complete an intellectual property audit. This is recommended for all firms, regardless of size, from start-ups to mature companies. An **intellectual property audit** is conducted to determine the intellectual property a company owns.

The following sections describe the reasons for conducting an intellectual property audit and the basic steps in the audit process. Some firms hire attorneys to conduct the audit, whereas others conduct the audit on their own. Once an audit is completed, a company can determine the appropriate measures it needs to take to protect the intellectual property that it owns and that is worth the effort and expense of protecting.

Why Conduct an Intellectual Property Audit?

There are two primary reasons for conducting an intellectual property audit. First, it is prudent for a company to periodically determine if its intellectual property is being properly protected. As suggested by the contents of Table 12.6, intellectual property resides in every department in a firm, and it is common for firms to simply overlook intellectual property that is eligible for protection.

The second reason for a company to conduct an intellectual property audit is to remain prepared to justify its value in the event of a merger or acquisition. Larger companies purchase many small, entrepreneurial firms primarily because the larger company wants the small firm's intellectual property. When a larger company approaches, the smaller firm should be ready and able to justify its valuation.

The Process of Conducting an Intellectual Property Audit

The first step in conducting an intellectual property audit is to develop an inventory of a firm's existing intellectual property. The inventory should include the firm's present registrations of patents, trademarks, and copyrights. Also included should be any agreements or licenses allowing the company to use someone else's intellectual property rights or allowing someone else to use the focal company's intellectual property.

TABLE 12.6 Types of Questions to Ask When Conducting an Intellectual Property Audit

Patents	Copyrights
■ Are products under development that require patent protection? ■ Are current patent maintenance fees up to date? ■ Do we have any business methods that should be patented? ■ Do we own any patents that are no longer consistent with our business plan that could be sold or licensed? ■ Do our scientists properly document key discovery dates?	■ Is there a policy in place regarding what material needs the copyright bug and when the bug is to be put in place? ■ Is there a policy in place regarding when copyrightable material should be registered? ■ Is proper documentation in place to protect the company's rights to use the material it creates or pays to have created? ■ Are we in compliance with the copyright license agreements into which we have entered?
Trademarks	**Trade Secrets**
■ Are we using any names or slogans that require trademark protection? ■ Do we intend to expand the use of trademarks in other countries? ■ Do we need additional trademarks to cover new products and services? ■ Is anyone infringing on our trademarks?	■ Are internal security arrangements adequate to protect the firm's intellectual property? ■ Are employees who do not have a "need to know" routinely provided access to important trade secrets? ■ Is there a policy in place to govern the use of nondisclosure and noncompete agreements? ■ Are company trade secrets leaking out to competitors?

The second step is to identify works in progress to ensure that they are being documented in a systematic, orderly manner. This is particularly important for research and development work. As mentioned earlier, if two inventors independently develop essentially the same invention, the right to apply for the patent belongs to the person who invented the product first. Properly dated and witnessed invention logbooks and other documents help prove the date an invention was made.

The third step of the audit is to specify the firm's key trade secrets and describe how they are being protected. Putting this information in writing helps minimize the chance that if a trade secret is lost, someone can claim that it wasn't really a trade secret because the owner took no specific steps to protect it.

Chapter Summary

LO1. Intellectual property is any product of human intellect that is intangible but has value in the marketplace. It is called intellectual property because it is the product of human imagination, creativity, and inventiveness. Patents, trademarks, copyrights, and trade secrets are the major forms of intellectual property. A common mistake companies make is not thinking broadly enough when identifying their intellectual property assets. Almost all companies, regardless of size or age, have intellectual property worth protecting. But to protect this property, firms must first identify it. There are two rules of thumb for determining whether intellectual property is worth the time and expense of protecting. First, a firm should determine whether the intellectual property in question is directly related to its current competitive advantage or could facilitate developing future competitive advantages. Second, it's important to know whether the intellectual property has independent value in the marketplace.

LO2. A patent is a grant from the federal government conferring the right to exclude others from making, selling, or using an invention for the term of the patent. There are three types of patents—utility patents, design patents, and plant patents. The most common of these is the utility patent, which covers what we generally think of as new inventions. Design patents are concerned with the invention of new, original, and ornamental designs for manufactured products. The least common of the three patents—the plant patent—protects new plant varieties that can reproduce asexually. Obtaining a patent is a painstaking, six-step process that usually requires the help of a patent attorney. A patent can be sold or licensed, which is a common strategy for entrepreneurial firms.

LO3. A trademark is any word, name, symbol, or device that is used to identify the source or origin of products or services and to distinguish those items from others. Trademarks, service marks, collective marks, and certification marks are the four types of trademarks. Trademark law is far-reaching, helping businesses be creative in drawing attention to their products and services. Examples of marks that can be protected include words, numbers and letters, designs and logos, sounds, fragrances, shapes, and colors. Immoral or scandalous matter, deceptive matter, descriptive marks, and surnames are ineligible for trademark protection. Entrepreneurs follow three steps to select and register a trademark: (1) select an appropriate trademark, (2) perform a trademark search, and (3) create rights in the trademark.

LO4. A copyright is a form of intellectual property protection that grants to the owner of a work of authorship the legal right to determine how the work is used and to obtain the economic benefits associated with using the work. Thus, copyright law protects original works of authorship that are fixed in a tangible form of expression. This is a broad definition and means that almost anything a company produces that can be written down, recorded, or videotaped or that takes a tangible form itself (such as a sculpture) is eligible for copyright protection. Examples of copyrightable material include literary works, musical compositions, dramatic works, and pictorial, graphic, and sculptural works.

LO5. Unlike for patents, trademarks, and copyrights, there is not a single government agency that regulates trade secret laws. Instead, a trade secret (which is any formula, pattern, physical device, idea, process, or other information that provides the owner with a competitive advantage in the marketplace) is governed by a patchwork of various state laws. The federal Economic Espionage Act does criminalize the theft of trade secrets. Trade secret disputes arise most frequently when an employee leaves a firm to join a competitor and is accused of taking confidential information along. Firms protect their trade secrets through both physical measures and written agreements. Firms use a number of physical measures to protect their trade secrets. These include restricting access, labeling documents, password protecting computer files, maintaining logbooks for visitors, and maintaining adequate overall security measures.

LO6. There are two primary reasons for conducting an intellectual property audit. First, it is prudent for a company to periodically assess the intellectual property it owns to determine whether it is being properly protected. Second, a firm should conduct a periodic intellectual property audit to remain prepared to justify its value in the event of a merger or acquisition.

Key Terms

assignment of invention agreement, **459**
business method patent, **458**
certification marks, **466**
collective marks, **466**
Computer Software Copyright Act, **471**
copyright, **471**
copyright bug, **472**
copyright infringement, **473**
derivative works, **471**
design patents, **458**
Economic Espionage Act, **475**
fair use, **474**
idea–expression dichotomy, **472**
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intent-to-use trademark application, **469**
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patent infringement, **463**
plant patents, **459**
provisional patent application, **461**
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service marks, **465**
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Uniform Trade Secrets Act, **475**
utility patents, **457**

MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

✪ 12-1. What distinguishes intellectual property from other types of property, such as land, buildings, and inventory?

12-2. What are the two primary rules for determining whether intellectual property protection should be pursued for a particular intellectual asset?

12-3. What are the four key forms of intellectual property? What are the common mistakes that firms make with regard to intellectual property?

12-4. What are the major differences between utility patents and design patents? Provide an example of each.

12-5. What is a business method patent? Provide an example of a business method patent. How can having such a patent provide a firm a competitive advantage in the marketplace?

12-6. Give an example of a design patent. How can having a design patent provide a firm a competitive advantage in the marketplace?

12-7. What is a patent infringement? When does this take place? Identify a few exclusions from trademark protection.

12-8. What are the six steps in applying for a patent?

12-9. What is a trademark? How can trademarks help a firm establish a competitive advantage in the marketplace?

12-10. What are the three steps involved in selecting and registering a trademark?

12-11. What are the four types of trademarks available to an entrepreneur? What are the items that can be trademarked by firms?

12-12. What is a copyright?

12-13. In the context of copyright law, what is meant by the term *derivative work*?

✪ 12-14. What are the categories protected under copyright laws?

12-15. What is a copyright bug? Where would one expect to find the bug, and how is it used?

12-16. What is meant by the phrase *copyright infringement*? Would you characterize copyright infringement as a minor or as a major problem in the United States and in other countries? Explain.

12-17. What is a trade secret? Provide an example of a trade secret. How might the trade secret you identified help a firm establish a competitive advantage in the marketplace?

12-18. When do trade secret disputes normally take place in an organization?

12-19. What types of physical measures do firms take to protect their trade secrets?

12-20. What are the two primary purposes of conducting an intellectual property audit? What risks does a company run if it doesn't periodically conduct an intellectual property audit?

Application Questions

12-21. Imagine you're about to attend a one-day seminar dealing with intellectual property law, and you contact a friend of yours who is in the process of starting a business to urge her to attend the seminar with you. She says to you, "I'm really busy because I'm just about to launch my start-up, so I'll have to pass. If they offer the same seminar next year, I'll go with you then." How would you respond to your friend?

12-22. With a partner, list 30 products and services in your university that should be protected under intellectual property law. Categorize the list under the three forms (patent, copyright, and trademark). Present your list in class.

12-23. Tyler Simms just invented a new product that he is convinced is unique and will make him wealthy. The product is a toothbrush with a tube of toothpaste attached to the handle. Tyler is anxious to file a patent application on the product, but when he tells you about the idea, you say—"Whoa, let's do a preliminary patent application search first to see if someone else has already patented this idea." What do you find when you help Tyler with the preliminary search?

12-24. You have been appointed as an IP consultant for a shoe-manufacturing firm. The managing director, Elton Grey, recently emailed you, inquiring about the patent application process. One of the employees in the company has invented a new product for the firm, and Elton is not sure how to apply for the patent. Reply to his email.

12-25. Pam Tarver just opened an information technology consulting company and has thought for a long time about what to name it. She finally settled on the fictitious name Infoxx. Search the USPTO database to determine if the name Infoxx is available. Is it? If it is available, how should Pam go about obtaining a trademark on Infoxx, or any other name?

12-26. Ken and Jackie Smith just purchased a small winery in the Napa Valley of northern California. One thing they noticed when they were investigating the winery is that the owners never placed the "100% Napa Valley" certification mark on their bottles. Now that they own the winery Ken and Jackie are looking into using the mark. Investigate what is required to place the "100% Napa Valley" certification mark on a bottle of wine. If Ken and Jackie's winery qualifies, should they use the mark?

YOU BE THE VC 12.1 COMPANY: Flatiron School

• **Web: www.flatironschool.com** • **Facebook: https://www.facebook.com/flatiron** • **Twitter: @flatiron-school**

Business Idea: Launch an elite programming school that teaches people to code in an accelerated period of time and helps them find good-paying jobs as developers.

Pitch: There are many people in the 25- to 45-year-old age range who want to change their career. They're in the midst of their first career, and are either unhappy with it or have discovered that they have an interest in coding and want to build software. They may also want to avoid pursuing a two-year or a four-year college degree. Many may already have college degrees in another field, or may be facing circumstances that make pursuing a four-year degree in computer science impractical. There are also high school students who have a high aptitude for coding who would like to get a head start on a college computer science program before entering the job market.

Flatiron School (which is named after the iconic Flatiron Building in Midtown Manhattan) was started to serve these markets. It is an elite programming school headquartered in New York City, which teaches people to code and helps them find jobs as developers. The school places 98 percent of its graduates into jobs as developers where they make an average annual salary of $75,000. Flatiron School, which was launched in 2012, initially offered only full-time web and iOS development courses for adults. Its on-campus program, which had a 6 percent acceptance rate, was offered in New York City. Since then, the firm has expanded its New York City program by launching three new initiatives: (1) a Fellowship program, in partnership with the City of New York, to offer free tuition to a select number of people from low income backgrounds, (2) an online learning platform, named Learn.com, which not only services its online immersive students, but external partners, ranging from universities to corporations like Google; and (3) a high school program, which teaches high school students how to code in summer and after school programs.

The Flatiron School's programs provide its students the skills they need for an entry-level software engineering job in 12 weeks. This approach to education is intensive in nature. The program requires 150 hours of pre-work before classes start. During a 12-week semester, students are on campus from 9:00 am to 6:00 pm daily, and many stay during the evenings and come in on weekends to work in groups on projects. An advantage of the accelerated nature of the program is that students can quit their current job, spend 12 weeks at Flatiron School, and then get back in the job market quickly. A game-changing differentiator between Flatiron School and other coding programs and bootcamps is that its jobs report (i.e., the claim that 98 percent of its graduates get programming jobs) is verified by a third party auditor. Flatiron School believes that it is the only coding program or bootcamp in the country that does this.

12-27. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

12-28. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 12.2 COMPANY: Wakoopa

• **Web: www.wakoopa.com** • **Facebook: wakoopa** • **Twitter: @wakoopa**

Business Idea: To establish a social network for software users to make it easier to track, share, and find software.

Pitch: Buying software online or from a store is often a tricky task, and staying up-to-date with the latest releases can be confusing. There are thousands of new software releases every year and dozens of different operating systems. Although there are many online websites and magazines offering software reviews, there is no way of knowing how long the reviewer has used the program and what their own preference is. Wakoopa was founded by two Dutch bloggers, Robert Gaal and Wouter Broekhof, to solve these problems and create a social network for software users.

Wakoopa's sign-up process is very simple: Users provide a user name and password and are then sent to a page with the download links for the Wakoopa tracking software. They then install a small application on their PC or Mac that works by performing a check every 15 minutes to track what software is used. It tracks a range of applications such as music players, office software, and photo editing, and records how long they use it. The information gathered can then be shared with friends, and personal profiles are automatically updated with news, updates, and reviews on each specific application. Users can check out the usage statistics before they decide whether or not to spend money on a program. Wakoopa lets them check whether the program is a one-hit wonder or has proven its value to many users in the long term.

Wakoopa started in 2006 as a social network and acquired around 200,000 registered users who called themselves

"Wakoopians." In 2010, Wakoopa began selling their tracking software as a market research tool and closed down the social network in 2012. In the first six months following its launch in April 2007, 17,000 people downloaded the Wakoopa tracking program. In the following year, the 17,000 doubled again, helping to generate some 250 million hours of unique and useful data about software, including lists of the most popular and most used software applications on a year-by-year basis.

Early adopters of the site were primarily tech-savvy software developers and gamers, although there is evidence that the service is being used more widely by consumers who are happy to see their own desktop behavior become public. The payback is a lively social network for software and the opportunity to test the pulse of the most popular and unpopular new web applications.

In 2014, Wakoopa joined Netquest, an online fieldwork provider for the market research industry that operates in Spain, Latin America, and Portugal. The goal is to integrate the tracking program with other applications. In 2016, GfK acquired both Netquest and Wakoopa.

12-29. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

12-30. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this firm? Why or why not?

CASE 12.1

GoldieBlox vs. Beastie Boys: The Type of Fight That No Start-up Wants to Be a Part Of

GoldieBlox: • Web: www.goldieblox.com • Facebook: GoldieBlox • Twitter: @goldieblox
Beastie Boys: • Web: www.beastieboys.com • Facebook: Beastie Boys • Twitter: @beastieboys

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Launched in 2012, GoldieBlox is a toy company that introduces girls to the field of engineering. It was started by Debbie Sterling, an engineering student at Stanford, who was troubled by the lack of women in engineering and the lack of encouragement girls receive to go into math and science fields. "Goldie" is a smart young girl that Sterling made up. Each toy in the GoldieBlox series consists of a book, featuring Goldie, and a set of age-appropriate construction items, such as spools and ribbons. Girls play with the toy by helping Goldie solve problems by building things. For example, in GoldieBlox and the Spinning Machine, a toy in the series, players must help Goldie build a belt drive machine to help her dog, Nacho, chase his tail. The idea is to introduce girls to the fundamentals of engineering. GoldieBlox's toys have been picked up by independent toy stores and several big-box stores, including Toys "R" Us and Target.

Beastie Boys Song "Girls"

In fall 2013, GoldieBlox ran an online advertisement for its game "Princess Machine," featuring three young girls singing an altered version of the Beastie Boys 1987 song "Girls," without the Beastie Boys' permission. The advertisement quickly went viral, attracting over eight million views on YouTube. The ad changed the song's lyrics to promote the notion that girls are capable of ambitious tasks. Some of the original lyrics, "Girls do the dishes," "Girls to clean up my room," "Girls to do the laundry," were replaced with "Girls to build a spaceship," "Girls to code the new app," "Girls to grow up knowing." If you'd like to see the ad, go to YouTube and type in GoldieBlox and Beastie Boys, and you can pick from one of many videos that replay and comment on the ad.

Copyright Infringement or Fair Use?

The Beastie Boys, who did not know about the ad until it came out, were not happy. When they objected to GoldieBlox's use of their song, claiming copyright infringement, GoldieBlox filed a preemptive lawsuit against the Beastie Boys, saying that the company had created a parody of the song, which constituted fair use. Fair use allows for the limited use of copyrighted material for purposes such as parody, criticism, comment, news reporting, and teaching. Consistent with the nature of parody, GoldieBlox said that it was trying to make fun of the Beastie Boys song for the purpose of breaking down stereotypes and encouraging young girls to engage in activities that challenge their intellect, particularly in the fields of science, technology, engineering, and math (commonly called STEM in today's colleges and universities).

The Beastie Boys responded by voicing their support for GoldieBlox's overall message and efforts, but outlined, in an open letter, their objections to the video. Their objections were twofold. First, they argued that as creative as the video is, it was made to sell a product. Years ago, according to the letter, the group made a conscious decision not to permit its music or name to be used in product sales. Second, the letter referred to the fact that when they simply asked GoldieBlox how and why their song "Girls" had been used in an ad without their permission, they were sued. GoldieBlox responded to the letter by pulling the video and issuing an open letter of their own. The letter said that the video was made with the best of intentions, with the goal of transforming the song "Girls" into a powerful anthem for young women. They went on to say that although they believe the video falls under fair use, they would honor the Beastie Boys wishes and no longer use the video.

Despite the letter from GoldieBlox, in December 2013, the Beastie Boys filed a countersuit against the company, arguing that the video's use of the song didn't constitute fair use as the ad used "the Beastie Boys" musical composition "Girls" with lyrics modified to become a "jingle" to sell GoldieBlox products.

Settlement

In March 2014, GoldieBlox and the Beastie Boys reached a settlement, in favor of the Beastie Boys. The settlement included the issuance of an apology by GoldieBlox and a stipulation that GoldieBlox would make payments, based on a percentage of its revenue, to one or more charities selected by the Beastie Boys that support science, technology, engineering, and mathematics education for girls. Along with an apology, the company went on to say that in hindsight, they should have reached out to the Beastie Boys to secure the proper rights to the song before using it in their ad. A follow-up article published by *The Guardian* reported details of GoldieBlox's settlement with the Beastie Boys. Along with the apology, the settlement requires GoldieBlox to pay $1 million to one or more charities of the Beastie Boys' choice, based on a percentage of yearly earnings, until the $1 million is paid.

Discussion Questions

12-31. If the case hadn't been settled by GoldieBlox and the Beastie Boys and you had been asked to render a judgment on the case, would you have rendered a judgment in favor of GoldieBlox or the Beastie Boys? Explain your decision.

12-32. Briefly comment on how both sides handled the dispute.

12-33. What do we learn about fair use from the GoldieBlox–Beastie Boys dispute?

12-34. What do we learn about the process of launching and growing a firm, in general, from the GoldieBlox–Beastie Boys dispute?

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CASE 12.2

You Make the Call: Can a Company Patent How It Makes a Peanut Butter and Jelly Sandwich?

Smucker's • Web: www.smuckers.com • Facebook: Smuckers • Twitter: @smuckers
Albie's • Web: www.albies.com • Facebook: albies-foods-inc

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

Here's a question that a panel of judges decided: Can a company patent how it makes a peanut butter and jelly sandwich? More specifically, in this instance, judges considered whether J. M. Smucker's method of making Uncrustables—which is a crustless peanut butter and jelly sandwich sealed inside soft bread—is worthy of legal protection against imitators. While the nature of this case is interesting, the legal rulings resulting from the case have broader implications. At stake is how generous the patent office should be in awarding patents—an issue with solid arguments on both sides.

There were actually two cases leading up to the one that resulted in the final verdict. The three cases are designated Round 1, Round 2, and Round 3 of Smucker's battle to patent the peanut butter and jelly sandwich.

The case involves the Smucker's Uncrustables sandwich. Uncrustables are found in the frozen food section of most grocery stores. They are 2-ounce peanut butter and jelly pockets that are sealed inside soft bread. They come in boxes of 4, 10, or 18 sandwiches. To make an Uncrustables ready to eat, the customer simply needs to let it thaw for 30–60 minutes.

Uncrustables were developed in 1995 by David Geske, of Fargo, ND, and Len Kretchman, of Fergus Falls, MN. The two started mass-producing them for Midwestern schools. Smucker's took note of their success and bought Geske and Kretchman's company in 1999. The purchase of the company included a general patent on crustless peanut butter and jelly sandwiches (Patent No. 6,004,596) that Geske and Kretchman had obtained.

Round 1: Smucker's versus Albie's Foods

It wasn't long before Smucker's was defending its turf. In 2001, Smucker's ordered a much smaller firm, Albie's Foods, to stop selling its own crustless peanut butter and jelly sandwich. Albie's was selling the sandwich to a local school district. Albie's fought back, and the case was eventually dismissed. In its arguments, Albie's contended that the "pasty"—a meat pie with crimped edges, which the company saw its crustless peanut butter and jelly sandwich as a variation of—had been a popular food in northern Michigan since the immigration of copper and iron miners from England in the 1800s.

Round 2: Smucker's and the Patent Office

Stung by its experience with the case it brought against Albie's, Smucker's returned to the USPTO to try to get its general patent on crustless peanut butter and jelly sandwiches broadened as a means of being able to better defend the Uncrustables. The patent office rejected the application. The gist of the Smucker's argument was that its sandwich's sealed edge is unique, and its layering approach, which keeps the jelly in the middle of the sandwich, is one-of-a-kind and, as such, should be protected by law. The patent office disagreed with this view. It said that the crimped edge, which was one of the things Smucker's argued was unique about its sandwich, is similar to the crimped edges in ravioli and pie crusts. In addition, the patent office determined that putting jelly in the middle of a peanut butter and jelly sandwich is hardly unique, and as evidence cited a 1994 *Wichita* (Kansas) *Eagle* newspaper article on back-to-school tips that suggested just this approach.

Round 3: Smucker's Appeals

Smucker's appealed the patent office's decision to the U.S. Court of Appeals. During the court hearings the attorney representing Smucker's argued that the method for making the Uncrustables is unique because the two slices of bread are sealed by compression but are not "smashed" as they are in tarts or ravioli. (Recall that the patent office's original decision compared the process of making Uncrustables to that of making ravioli.) Smucker's further argued that it wouldn't be fair to let other companies simply copy the Uncrustables and benefit from the hard work of Smucker's scientists and the money that the company had invested to produce what it believed was a unique product. The Uncrustables is also a big seller for Smucker's.

Broader Issues Involved

The Smucker's case was watched closely because of the broader issues involved. Critics of the U.S. patent process contend that the USPTO is too generous when awarding patents—a generosity that they say stifles innovation and drives up the cost for consumers. In the Smucker's case, the critics would argue that Smucker's shouldn't get the patent, because it will deter other food companies from making their own versions of peanut butter and jelly sandwiches, which will keep the price of the Uncrustables high. Advocates of the U.S. patent process argue the opposite—that patents motivate a company like Smucker's to invest in new-product innovation, and that absent patent protection, a company like Smucker's would have no incentive to develop a product like the Uncrustables.

The Court's Ruling

In mid-April 2005, after listening to all the arguments, the U.S. Court of Appeals ruled on whether Smucker's should get the patent it was requesting. Which way do you think the court ruled and why? Use a search engine to find the answer to this interesting question!

Discussion Questions

12-35. Go to the USPTO's website (www.uspto.gov) to look up Patent No. 6,004,596. Read the patent. After reading the patent, are you more inclined or less inclined to side with the Smucker's point of view?

12-36. Type "Uncrustables" into the Google search engine and look at the Uncrustables sandwich. Spend a little time reading about the Uncrustables on the Smucker's website. Again, after looking over the website, are you more inclined or less inclined to side with the Smucker's point of view?

12-37. In regard to the arguments espoused by the "critics" of the U.S. patent system and the "advocates" of the U.S. patent system, with which of the points of view do you agree? Thinking as an entrepreneur, use your own words to state why you think the critics or the advocates have a stronger point of view.

12-38. After using a search engine to discover how the court ruled, why do you think the court ruled as it did? Use materials in the chapter to explain and justify your thinking.

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ESSAY QUESTIONS

1. Maggie Simpson has always admired her Grandmother Thompson's cooking and has considered putting together a cookbook titled *Grandma Thompson's Favorite Recipes*. Some of Grandma's recipes are truly original, and before she writes the book, Maggie would like to copyright several of the most original ones. Can she do this? Write a paragraph or two to fully explain the reasons supporting your answer.
2. Two years ago, Mike Carini opened a restaurant called Mike's Italian. To his horror, Mike just found out that several disgruntled customers have launched a website with the Internet address www.avoidmikesitalian.com. The site contains testimonials by people who have eaten at Mike's and have not been satisfied. Is there anything that Mike can do to shut down the website? If so, what actions can he take and why? Write a paragraph or two to describe the actions Mike can take and the reasons he can take those actions.

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Getting Personal with MATI ENERGY

MATI Energy/Photo Credit: Tatiana Birgisson

Founder

TATIANA BIRGISSON

BS Economics, Duke University, 2010

Dialogue with Tatiana Birgisson

BEST PART OF BEING A STUDENT
Traveling the world on the cheap & loving it. Best part about being a student entrepreneur? EVERYBODY wants to help you

BEST ADVICE I'VE RECEIVED
Imagine a college student were trying to steal your dream—work so hard that they never can

FAVORITE BAND ON MY SMARTPHONE MUSIC LIST
Of Monsters and Men

WHAT I DO WHEN I'M NOT WORKING
Rock climb, ski, work out, spend time with family, enjoy the outdoors

MY BIGGEST WORRY AS AN ENTREPRENEUR
Time. You don't have enough

FAVORITE PERSON I FOLLOW ON INSTRAGRAM
My sister

CHAPTER 13

Preparing for and *Evaluating* the Challenges of Growth

OPENING PROFILE

MATI ENERGY

Growing in a Fast-Paced, Yet Conscientious Manner

• *Web: https://matienergy.com* • *Facebook: MATI Energy* • *Twitter/Instagram: @drinkmati*

Tatiana Birgisson enrolled at Duke University in 2008. She has an interesting background. Her father is from Iceland and her mother is native to Venezuela. Her family moved every few years in pursuit of various academic degrees. Birgisson's summers were split between families in Iceland and Venezuela. It was in the Caribbean that she got her first taste of entrepreneurship in an uncle's tourism business. At Duke, Birgisson studied mechanical engineering until her junior year when she changed her major to Economics in pursuit of greater understanding of the financial world instead of the physical world around her. In her spare time, she enjoys rock climbing, both indoor and outdoor.

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Describe how firms can properly prepare for growth.
2. Discuss the six most common reasons firms pursue growth.
3. Explain the importance of being able to manage the stages of growth.
4. Describe the challenges of firm growth, particularly those of adverse selection and moral hazard.

In 2012 Birgisson started making tea in her dorm room, partly to fight depression. She started with black tea and wondered if other students might buy it, but market research told her that her early customers were looking for something with a little more punch. She remembered yerba mate, a plant with as much caffeine as coffee, which people use for tea in Latin America. She quickly found that yerba mate wasn't the answer, and eventually settled on guayusa, yerba mate's "cousin." Guayusa is an Amazonian superleaf naturally packed with caffeine and polyphenols, so it provides a clean, focused energy. Amazonian hunters call guayusa the "night watchman" because it helps sharpen their awareness and gives them energy when heading into the jungle at night to hunt.

To determine if entrepreneurship was her passion, Birgisson entered InCube (since renamed to The Cube), a university-sponsored residential entrepreneurship program at Duke. InCube (or The Cube) provides students with space, access to mentors, and support in launching businesses. Birgisson's drink was no longer tea—it had morphed into more of an energy drink consisting of carbonated fruit juice and guayusa. The idea was to produce a healthier alternative to traditional energy drinks like Red Bull and Monster. Birgisson's product and prospective business were well received. In the summer of 2012, she received $5,000 from a summer innovation program at Duke, and in early 2013 won the Duke Start-up Challenge for the best undergraduate startup, which included an $11,500 cash prize. In the fall of 2014 she received a $50,000 NC IDEA grant. NC IDEA is an organization that normally provides grants to high-potential North Carolina tech firms. Birgisson's business, which she named MATI Energy, was the first beverage business to win a NC IDEA grant. MATI is a play on her nickname, Tati.

In April 2015, Birgisson was invited to pitch MATI Energy at Google Demo Day. She pitched to a three-judge panel which included AOL cofounder Steve Case. She won the award for the best start-up in North America. She also impressed Mr. Case who invested $100,000 in MATI on the spot. Case's interest, along with the momentum that MATI was already showing, allowed Birgisson to raise a $1.3 million round of funding.

With respect to growth, Birgisson has tenaciously built MATI. She literally went door-to-door to convince her first group of retailers to carry her product. MATI Energy was soon selling thousands of cans per month. Her tenacity paid off in winning shelf space at Whole Foods Markets. She had a tough time getting Whole Foods' attention via e-mail and phone calls, so she drove from Durham to Atlanta, walked into Whole Foods' regional office and requested a meeting. After waiting most of the day she finally was able to pitch her product. Armed with sales numbers and a cooler full of chilled MATI, she won Whole Foods over and has been in Whole Foods Market stores ever since . . . and it happened in under 5 minutes. Along with Birgisson's stick-to-itiveness, MATI has benefited from changing environmental trends. Consumers are increasingly in-tune with the ingredients in their food and beverages. This trend favors MATI, which provides a healthy alternative to the leading brands of energy drinks and other beverage alternatives.

In regard to growing MATI Energy, Birgisson has encountered a number of challenges. Prior to early 2016, MATI's drinks were made by a co-packer. Birgisson experienced problems with production capacity and quality control. To remedy this situation, Birgisson raised capital to build her own production facility, which is located in Clayton, NC. The facility ensures quality control and provides the production capacity that Birgisson anticipates MATI will require going forward. It also includes an R&D laboratory, where she and her staff create and test new formulations. It's unusual for a company MATI's size to have its own lab. New Product Development labs are found in the facilities of major brands—like Monster and Red Bull—but not normally in smaller companies. Birgisson carefully manages MATI's cash flow. It takes money to fuel growth. The amount of operating capital that MATI has and needs to maintain its operations is carefully monitored.

MATI Energy is now hitting on all cylinders. Six flavors are now available—citrus, cherry, tropical, peach mango, passion fruit, and blueberry pomegranate. The ingredients include carbonated water, brewed guayusa (leaves), apple juice concentrate, lime juice concentrate, natural flavors, and other juices depending on the flavor. Each 12-ounce can provides the nutritional equivalents of $1\frac{1}{2}$ cups of coffee, 3 cups of green tea's worth of antioxidants, and one-half banana's worth of potassium. A 12 pack of MATI Energy drinks cost about $26.50 online and $2.69/can at retail.

MATI's growth continues to accelerate, which will require careful attention to manage properly. Birgisson is up to the challenge. At the time this feature was written, MATI's drinks were available at grocery stores across the Southeast and Texas, and will soon be in Florida and the Midwest and nationwide online on Amazon Prime and that firm's website. The next channels to crack will be wholesale stores, such as Costco, and convenience stores across the country.

As an entrepreneurial venture, the experiences of MATI Energy are encouraging in that the company has gotten off to a good start and has achieved growth in a well-executed manner. Its true test will be whether it is able to achieve **sustained growth**, which is growth in both revenues and profits over a sustained period of time. Evidence shows that relatively few firms generate sustained and outstanding, profitable growth.[1] For example, consider. *Inc* magazine's Build 100 project. The study entailed collecting data on more than

100,000 U.S. midmarket companies (those with 85 to 999 employees) to study firm growth. Incredibly, the project found that less than 1.5 percent of the companies in the study achieve sustained growth, which was measured by increasing their number of employees every year from 2007 to 2012. The study found that a company's growth typically follows one of several patterns: (1) it might burst on the scene with years of expansion and then decelerate and decline, (2) it might grow in fits and starts, possibly in sync with the overall economy, (3) it might enjoy a brief boom and then plateau, or (4) it might achieve steady incremental growth repeated over time. The fourth option is the healthiest and the pattern that leads to sustained growth. "It's akin to Aesop's tortoise and hare story," Gary Kunkle, the chief researcher on the project, remarked. "Slow and steady wins the race."[2]

Although challenging, most entrepreneurial ventures try to grow and see it as an important part of their ability to remain successful.[3] This sentiment was expressed by Hewlett-Packard (HP) cofounder David Packard, who wrote that while HP was being built, he and cofounder Bill Hewlett had "speculated many times about the optimum size of a company." The pair "did not believe that growth was important for its own sake" but eventually concluded that "continuous growth was essential" for the company to remain competitive.[4] When HP published a formal list of its objectives in 1996, growth was one of the seven objectives.[5]

The first part of the chapter focuses on preparing for growth, including a discussion of three specific areas on which a firm can focus to equip itself for growth. The second part of the chapter focuses on reasons for growth. Although sustained growth is almost always the result of deliberate intentions, a firm can't always choose its pace of growth. This section lists the seven primary reasons that motivate and stimulate business growth. The chapter's third section focuses on managing growth, which centers on knowing and managing the stages of growth. In the final section, we examine the challenges of growth, including the managerial capacity problem and the day-to-day challenges associated with growing a firm.

Preparing for Growth

LEARNING OBJECTIVE

1. Describe how firms can properly prepare for growth.

Most entrepreneurial firms want to grow. Especially in the short term, growth in sales revenue is an important indicator of an entrepreneurial venture's potential to survive today and be successful tomorrow. Growth is exciting and, for most businesses, is an indication of success. Many entrepreneurial firms have grown quickly, producing impressive results for their employees and owners as a result of doing so; consider firms examined in this book such as SoulCycle, Rent the Runway, and Casper, among others, as examples of this.

Although there is some trial and error involved in starting and growing any business, the degree to which a firm prepares for its future growth has a direct bearing on its level of success.[6] This section focuses on three important things a business can do to prepare for growth.

Appreciating the Nature of Business Growth

The first thing that a business can do to prepare for growth is to appreciate the nature of business growth. Growing a business successfully requires preparation, good management, and an appreciation of the issues involved. The following are issues about business growth that entrepreneurs should appreciate.

Not All Businesses Have the Potential to Be Aggressive Growth Firms. The businesses that have the potential to grow the fastest over a sustained period of time are ones that solve a significant problem or have a major impact on their customers' productivity or lives. This is why the lists of fast-growing firms are often dominated by health care, technology, social media, and entertainment companies. These companies can potentially have the most significant impact on their customers' businesses or lives. This point is affirmed by contrasting the women's clothing store industry with the biotechnology industry. From 2012 to 2017, the average growth rate for women's clothing stores in the United States was negative (−1.3 percent) while the average growth rate for medical supplies' companies was 2.8 percent.[7] While there is nothing wrong with starting and owning a women's clothing store, it is important to have a realistic outlook of how fast the business will likely grow. Even though an individual women's clothing store might get off to a fast start, as it gets larger, its annual growth will normally start to reflect its industry norm.[8]

A Business Can Grow Too Fast. Many businesses start fast and never let up, which stresses a business financially and can leave its owners emotionally drained. Sometimes businesses grow at a measured pace and then experience a sudden upswing in orders and have difficulty keeping up. This scenario can transform a business with satisfied customers and employees into a chaotic workplace with people scrambling to push the business' products out the door as quickly as possible. The way to prevent this from happening is to recognize when to put the brakes on and have the courage to do it. This set of circumstances played out early in the life of The Pampered Chef, a company, which sells kitchen utensils through home parties. Just about the time the company was gaining serious momentum, it realized that it didn't have a sufficient quantity of products in its inventory to serve the busy Christmas season. This reality posed a serious dilemma. The Pampered Chef couldn't instantly increase its inventory (its vendors were all low in their own inventories and the company was small, so it couldn't make extraordinary demands on its vendors), yet it didn't want to discourage its home consultants from making sales or signing up new consultants. One option was to institute a recruiting freeze (on new home consultants), which would slow the rate of sales. Doris Christopher, the company's founder, remembers asking others for advice. Most advised against instituting a recruiting freeze, arguing that the lifeblood of any direct sales organization is to sign up new recruits. In the end, the company decided to institute the freeze and slowed its sales enough to fill all orders on time during the holiday season. The freeze was lifted the following January, and the number of The Pampered Chef recruits soared. Reflecting on the decision, Doris Christopher later wrote:

> Looking back, the recruiting freeze augmented our reputation with our sales force, customers, and vendors. People saw us as an honest company that was trying to do the right thing and not overestimating our capabilities.[9]

Other businesses have faced similar dilemmas and have sometimes made the right call, and other times haven't. The overarching point is that growth must be handled carefully. As we emphasize throughout this chapter, a business can only grow as fast as its infrastructure allows. Table 13.1 provides a list of 10 warning signs that a business is growing too fast.

Business Success Doesn't Always Scale. Unfortunately, the very thing that makes a business successful might suffer as the result of growth. This is what business experts often mean when they say growth is a "two-edged sword." Businesses that are based on providing high levels of individualized service often do not grow or scale well. For example, an investment brokerage service that initially provided high levels of personalized attention can quickly evolve into providing standard or even substandard service as it adds customers and starts automating its services. Its initial customers might find it harder to get individualized service than it once was and start viewing the company as just another ordinary business.

TABLE 13.1 10 Warning Signs That a Business Is Growing Too Fast

- Borrowing money to pay for routine operating expenses
- Extremely tight profit margins
- Over-stretched staff
- Declining product quality
- E-mail and text messages start going unanswered
- Customer complaints are up
- Employees dread coming to work
- Productivity is falling
- Operating in a “crisis” mode becomes the norm rather than the exception
- Those working with the business’ financial structure are starting to worry

There is also a category of businesses that sell high-end or specialty products that earn high margins. These businesses typically sell their products through venues where customers prioritize quality over price. These businesses can grow, but only at a measured pace. If they grow too quickly, they can lose the “exclusivity” they are trying to project, or can damage their special appeal. Fashion clothing boutiques often limit the number of garments they sell in a certain size or color for a similar reason. Even though they know they could sell more of a particular blouse or dress, they deliberately limit their sales so their customers don’t see each other wearing identical items.

Staying Committed to a Core Strategy

The second thing that a business can do to prepare for growth is to stay committed to a core strategy. As discussed in Chapter 4, an important part of a firm’s business model is its core strategy, which defines how it competes relative to its rivals. A firm’s core strategy is largely determined by its **core competencies**, or what it does particularly well.[10] While this insight might seem self-evident, it’s important that a business not lose sight of its core strategy as it prepares for growth. If a business becomes distracted or starts pursuing every opportunity for growth that presents itself, the business can easily stray into areas where it finds itself at a competitive disadvantage. For example, eBags, an online merchant that specializes in selling handbags, luggage, and backpacks, at one point acquired a website that sells shoes. After three years, it sold the site (Shoedini.com) to Zappos after concluding that the shoe business was too far of a stretch from the company’s core strategy and its core competencies.

The way most businesses typically evolve is to start by selling a product or service that is consistent with their core strategy and then increase sales by incrementally moving into areas that are different from, but related to, their strengths and core capabilities. This is how Zappos operates. The company started by selling shoes and has gradually expanded into clothing, bags, housewares, and many other products. The success of its new product lines will be determined largely by whether the company’s existing core competencies are sufficient to profitably sell these items. If they aren’t, then Zappos will have to develop or acquire additional core competencies, or it is likely to struggle to effectively manage its growth.

A parable that helps affirm why sticking to a core strategy is so important is provided by Jim Collins in his book *Good to Great*. In the book, Collins retells the fable of the fox and the hedgehog, which was originally told by Isaiah Berlin. According to the fable, because he is sly, cunning, and strong, everyone thinks the fox is better than the hedgehog. All the lowly hedgehog knows how to do is one thing—curl up in a ball, with its spikes out, to deter intruders. The ironic thing is that whatever the fox does, and no matter how many of its 100 tricks it tries to use, the hedgehog always wins, because it knows how to do one thing well—roll up and stick its spikes out. In *Good to Great*, Collins says businesses that are successful over the long haul are more like hedgehogs than foxes. Rather than moving swiftly in all directions, like foxes, successful businesses keep their heads down and do one thing particularly well. Like the hedgehog, they see what is essential and ignore the rest.[11]

Planning for Growth

The third thing that a firm can do to prepare for growth is to establish growth-related plans.[12] This task involves a firm thinking ahead and anticipating the type and amount of growth it wants to achieve.

The process of writing a business plan, covered in Chapter 6, greatly assists in developing growth-related plans. A business plan normally includes a detailed forecast of a firm's first three to five years of sales, along with an operations plan that describes the resources the business will need to meet its projections. Even though a business will undoubtedly change during its first three to five years, it's still good to have a plan. Many businesses periodically revise their business plans as a foundation for helping them guide their growth-related decisions.

It is also important for a business to determine, as early as possible, the strategies it will choose to employ as a means of pursuing growth. For example, Proactiv, the acne medicine company, is a single-product company and has grown by steadily increasing its domestic sales, introducing its products into foreign countries, and by encouraging nontraditional users of acne medicine, like adult males, to use its product. Proactiv's decision to stick with one product and to avoid growing through initiatives such as acquisitions and licensing has allowed the company to focus on marketing and building its brand. In contrast, Sir Kensington, the subject of Case 13.1, has expanded into a number of new product lines since it launched in 2010. It started by selling ketchup, and now sells mayonnaise, mustard, and fabanaise. Fabanaise is a vegan mayo made with aquafaba. Aquafaba is a natural egg substitute made from chickpeas and water.[13]

Fuse/Getty Images

It is important that a business establish growth-related plans and objectives. Here, the two founders of a young entrepreneurial firm are charting their growth plans for several years in the future.

On a more personal level, a business owner should step back and measure the company's growth plans against his or her personal goals and aspirations. The old adage, "Be careful what you wish for," is as true in business as it is in other areas of life. For example, if a business has the potential to grow rapidly, the owner should know what to expect if the fast-growth route is chosen. Fast growth normally implies a quick pace of activity, a rapidly rising overhead, and a total commitment in terms of time and attention on the part of the business owners. The upside is that if the business is successful, the owner will normally do very well financially. The downside is long hours and time away from family. Commenting on the balancing act that many fast-growth entrepreneurs experience, Felix Lluberes, Executive Vice President and founder of Position Logic, a GPS tracking software Company, said:

> The biggest challenge (in growing a company) is keeping your family happy and constantly deciding when to miss important family events because work demands it. Working hard is not a sacrifice as long as you achieve your ultimate objective.[14]

The trade-offs implied by this scenario are acceptable to some business owners and not to others.

Even if they make a conscientious effort to plan for growth, some firms fail because they simply cannot generate enough growth to reach breakeven and make their ventures worthwhile. This was the case for Dishero, the subject of the nearby "What Went Wrong?" feature. Dishero's primary business was photographing food. It had revenue and happy customers from day one; but, it just couldn't grow fast enough to reach breakeven and forecast a profitable future.

Reasons for Growth

LEARNING OBJECTIVE

2. Discuss the six most common reasons firms pursue growth.

Although sustained, profitable growth is almost always the result of deliberate intentions and careful planning, firms cannot always choose their pace of growth. A firm's **pace of growth** is the rate at which it is growing on an annual basis. Sometimes firms are forced into a high-growth mode sooner than they would like. For example, when a firm develops a product or service that satisfies a need for many customers and orders roll in very quickly, it must adjust quickly or risk faltering. In other instances, a firm experiences unexpected competition and must grow to maintain its market share.

This section examines six primary reasons firms try to grow to increase their profitability and valuation, as depicted in Figure 13.1.

Capturing Economies of Scale

Economies of scale are generated when increasing production lowers the average cost of each unit produced. Economies of scale can be created in service firms as well as traditional manufacturing companies.[15] This phenomenon occurs for two reasons. First, if a company can get a discount by buying component parts in bulk, it can lower its variable costs per unit as it grows larger. **Variable costs** are the costs a company incurs as it generates

- Economies of scale
- Economies of scope
- Market leadership
- Influence, power, and survivability
- Need to accommodate the growth of key customers
- Ability to attract and retain talented employees

FIGURE 13.1
Primary Reasons for Firm Growth

WHAT WENT WRONG?

Dishero: How Mediocre Success Can Lead to Difficult Decisions

Dishero was started in 2013 by Alex Fishman, Ilya Ginzburg, and Dmitry Fink. It operated in the restaurant space. Its primary service was photographing food. Many restaurants have photos of their dishes. The photos appear on their menus, on their smartphone apps, on their social media pages, and on in-store video monitors. Dishero raised $2.8 million in funding. It put together a strong engineering and business team, topping out at 17 people in six cities and three countries. The company had revenue and happy customers almost from day one. It scored a major hire about two-thirds of the way through its existence. Dishero hired a VP of Sales, who was the first VP of Sales at OpenTable. At OpenTable, he hired the company's first 45 salespeople and acquired their first 1,000 restaurants. Sadly, in 2016 Dishero ceased operations. What went wrong?

Dishero's expertise was photographing food, and by all objective measures it was very good at it. If you'd like to see a sample of Dishero's photos, go to Google Images and type Dishero into the search bar. Most restaurants take photos of their dishes, and use them in various ways. For example, Spreadz Deli & Café, located in Santa Clara, CA, was a Dishero customer. The deli has side-by-side video monitors that customers see as they stand in line. When Dishero first approached Spreadz, both monitors displayed menu items—one for sandwiches and the other for salads and coffees. Dishero helped Spreadz transition to using one monitor for the menu and the other to display high-quality photos of their menu items. This allowed the deli staff to recommend items that were shown on the monitor. It also sped up their lines. The 30 or so photos that rotated on the screen showed the menu items along with their names. So someone would see the BBQ Salmon Sandwich on the display and if they liked what they saw, when they got to the counter would say, "I'll take the BBQ Salmon Sandwich."

Dishero provided similar services for other restaurants. For instance, Dragon Rouge restaurant in Alameda, CA was another Dishero customer. Dishero photographed its food for video monitors scattered throughout the restaurant. The monitor at the bar created a lot of conversation. People would see dishes they hadn't tried before, and would order something they wouldn't normally have ordered.

In an Internet post titled "My Cofounder Said 'I love what we're doing' And We Shut Down Our Startup," Dishero cofounder Alex Fishman wrote about the reasons Dishero failed. In short, Dishero just couldn't grow fast enough. When the firm closed, it was bringing in about $9,000 a month and its expenses were $100,000 a month. That's not unheard of for start-ups. Many start-ups take time to reach breakeven and then start making money. But in Dishero's case, revenue growth was painfully slow and unpredictable. Fishman said that Dishero was in the worst possible place. When things work out, it's obvious what to do. When things don't work out, it's hard, but again it's clear what do. Dishero found itself right in the middle. It wasn't failing and it wasn't succeeding. It was a judgment call regarding what to do.

In his post, Fishman elaborated on some of the challenges Dishero encountered. First, selling to restaurants is hard. Restaurant owners are busy, they run low margin businesses, and they experience high employee turnover. They've also been prospected many times by start-ups trying to sell something, whether it's a reservation app, a meal delivery service, an electronic menu tablet, or a new social media strategy. Many of the start-ups promise the moon, and then either under-deliver or fail. As a result, it was hard to get restaurant managers' or owners' attention and even harder to get them to refer Dishero to another restaurant if they became a satisfied customer. Second, Dishero had to employ a sales force to approach restaurant owners to try to sell their service. That strategy resulted in a high cost of customer acquisition. Before deciding to close Dishero, the cofounders sat down and identified three options. They still had investor money in the bank so the situation was not dire. Option A was to continue to iterate. Option B was to pivot with the restaurant industry. Option C was to shut down. They didn't seriously consider an Option D, which would have been pivoting outside the restaurant industry. They had cherry-picked their team for the restaurant space.

They made the difficult decision to pick Option C. In Fishman's Internet post (URL is provided below), he includes transcripts of e-mail exchanges between himself and Dishero's investors about the decision to close the company. The exchanges are interesting and civil. At the time Dishero closed, the company had $1.8 million in the bank. The investors told them to keep the funds, which eventually led to the creation of Bugsee, a company started by two of Dishero's three cofounders, Alex Fishman and Dmitry Fink. Bugsee (www.bugsee.com) creates tools for app developers.

Questions for Critical Thinking

1. If you were the owner or manager of a restaurant, would you have used Dishero's service? Why or why not?
2. What, if anything, could Dishero's cofounders have done in advance of launching the company to discern the level of sales to expect? Do you think Dishero had achieved product-market fit prior to trying to grow the firm?
3. Do you think Dishero's cofounders made the right decision in picking Option C—which was to shut down the firm? Explain your answer.
4. What can entrepreneurial firms learn about the dynamics of growing a firm via Dishero's experience?

Sources: My Cofounder Said "I love what we're doing" And We Shut Down Our Startup, available at https://entrepreneurs.maqtoob.com/my-cofounder-said-i-love-what-were-doing-and-we-shut-down-our-startup-80d5e710c2b2#.f9l2d77vc (posted June 17, 2016, accessed March 17, 2017); Dishero Testimonial—Spreadz Deli & Café, available at https://www.youtube.com/watch?v=Sy61jyXxKao (posted May 5, 2015, accessed March 18, 2017); Dishero Testimonial—Dragon Rouge, available at https://www.youtube.com/watch?v=-1xG_TT_Cel (posted May 15, 2015, accessed March 18, 2017).

sales. Second, by increasing production, a company can spread its fixed costs over a larger number of units. **Fixed costs** are costs that a company incurs whether it sells something or not. For example, in a manufacturing setting, it may cost a company $10,000 per month to air-condition its factory. The air-conditioning cost is fixed; cooling the factory will cost the same whether the company produces 10 or 10,000 units per month. In a service setting, a hotel's registration areas, restaurants, and other areas must be air-conditioned regardless of the number of rooms that have been filled for a particular evening.

A related reason firms grow is to make use of unused resources such as labor capacity and a host of others. For example, a firm may need exactly 2.5 full-time salespeople to fully cover its trade area. Because a firm obviously can't hire 2.5 full-time salespeople, it may hire 3 salespeople and expand its trade area.[16]

Capturing Economies of Scope

Economies of scope are similar to economies of scale. With **economies of scope**, the advantage a firm accrues comes through the scope (or range) of a firm's operations rather than from its scale of production.[17] For example, a company's sales force may be able to sell 10 items more efficiently than 5 because the cost of travel and the salesperson's salary is spread out over 10 products rather than 5. Similarly, a company such as TOMS, the focus of Case 4.2, captures economies of scope in its advertising when the same feature is used to advertise TOMS' shoes along with TOMS' eyewear and TOMS' coffee.

Market Leadership

Market leadership occurs when a firm holds the number one or the number two position in an industry or niche market in terms of sales volume. Many firms work hard to achieve market leadership, to realize economies of scale and economies of scope, and to be recognized as the brand leader. Being the market leader also permits a firm to use slogans such as "Number 1 App in the Apple App Store" in its promotions, helping it win customers and attract talented employees as well as business partners.

Influence, Power, and Survivability

Larger businesses usually have more influence and power than smaller firms in regard to setting standards for an industry, getting a "foot in the door" with major customers and suppliers, and garnering prestige. In addition, larger businesses can typically make a mistake yet survive more easily than entrepreneurial ventures. Commenting on this issue, Jack Welch, GE's former CEO, once said, "Size gives us another big advantage; our reach and resources enable us to go to bat more frequently, to take more swings, to experiment more, and unlike a small company, we can miss on occasion and get to swing again."[18]

A firm's capacity for growth affects its survival in additional ways. For example, a firm that stays small and relies on the efforts and motivation of its founder or a small group of people is vulnerable if those people leave the firm or lose their passion for the business. This reason was partly to blame for the failure of Prim, as explained in Chapter 1's "What Went Wrong?" feature. Prim failed in part because its founders lost interest in the business and decided to move on to other things. As a firm grows and adds employees, it's normally not as vulnerable to the loss of a single person or a small group of people's participation or passion for the business.

Need to Accommodate the Growth of Key Customers

Sometimes firms are compelled to grow to accommodate the growth of a key customer. For example, if Intel has a major account with an electronics firm buying a large number of its semiconductor chips, and the electronics firm is growing at a rate of 20 percent per year, Intel may have to add capacity each year to accommodate the growth of its customer or else risk losing some or all of its business.

Ability to Attract and Retain Talented Employees

The final reason that firms grow is to attract and retain high-quality personnel. It is natural for talented employees to want to work for a firm that can offer opportunities for promotion, higher salaries, and increased levels of responsibility. Growth is a firm's primary mechanism to generate promotional opportunities for employees, while failing to retain key employees can be very damaging to a firm's growth efforts. High turnover is expensive, and in knowledge-based industries in particular, such as biotechnology and software development, a company's number one asset is the combined talent, training, and experience of its employees.[19] In less knowledge-intensive settings, turnover may not be as critical, but it is still costly. Entrepreneurial ventures rarely have the excess financial capital needed to support the unfavorable relationship between employee hiring and turnover. However, when talented individuals leave a large company either voluntarily or through layoffs, entrepreneurial ventures have opportunities to hire people with skills the venture did not pay for them to develop.

Managing Growth

LEARNING OBJECTIVE

3. Explain the importance of being able to manage the stages of growth.

Many businesses are caught off guard by the challenges involved with growing their companies. One would think that if a business got off to a good start, steadily increased its sales, and started making money, it would get progressively easier to manage the growth of a firm. In many instances, just the opposite happens. As a business increases its sales, its pace of activity quickens, its resource needs increase, and the founders often find that they're busier than ever. Major challenges can also occur.[20] For example, a business might project its next year's sales and realize it will need more people and additional equipment to handle the increased workload. The new equipment might need to be purchased and the new people hired and trained before the increased business generates additional income. It's easy to imagine serious discussions among the members of a new venture's management team trying to figure out how that will all work out.

The reality is that a company must actively and carefully manage its growth for it to expand in a healthy and profitable manner. As a business grows and becomes better known, there are normally more opportunities that present themselves, but there are more things that can go wrong, too. Many potential problems and heartaches can be avoided by prudently managing the growth process. This section focuses on knowing and managing the stages of growth. The final section in this chapter focuses on a related topic—the challenges of growth.

Knowing and Managing the Stages of Growth

The majority of businesses go through a discernable set of stages referred to as the organizational life cycle.[21] The stages, pictured in Figure 13.2, include introduction, early growth, continuous growth, maturity, and decline. Each

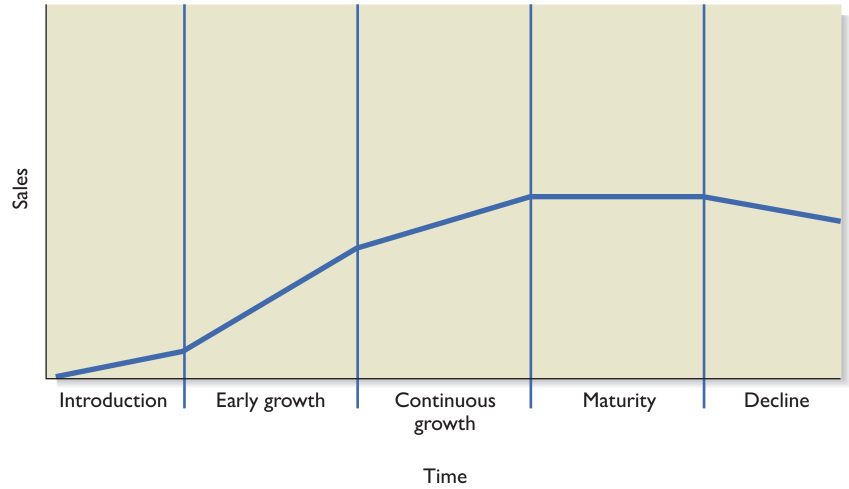


FIGURE 13.2
Organizational Life Cycle

stage must be managed differently. It's important for an entrepreneur to be familiar with these stages, along with the unique opportunities and challenges that each stage entails.

Introduction Stage. This is the start-up phase where a business determines what its strengths and core capabilities are and starts selling its initial product or service. It's a very "hands-on" phase for the founder or founders, who are normally involved in every aspect of the day-to-day life of the business. The business is typically very nonbureaucratic with no (or few) written rules or procedures. The main goal of the business is to get off to a good start and to try to gain momentum in the marketplace.

The main challenges for a business in the introduction stage are to make sure the initial product or service is right and to start laying the groundwork for building a larger organization. It is important to not rush things. This sentiment is affirmed by the growth pattern of Nest Labs, the subject of Case 11.1. Nest sold a single product, the Nest Learning Thermostat, for two years before its second product, the Nest Protect, which is a smoke and carbon monoxide

Africa Studio/Shutterstock

This young entrepreneur sells women's clothing online. She started by hand-tailoring many of the garments she sold. Her ability to grow her business will depend in part on her willingness to step back from hand-tailoring clothes and move into a more managerial role.

detector, was introduced. The company needed two years to scale its operations and management team before it was ready to add a second product and accelerate its growth. In regard to laying the groundwork to build a larger organization, many businesses use the introduction stage to try different concepts to see what works and what doesn't, recognizing that trial and error gets harder as a business grows. It's important to document what works and start thinking about how the company's success can be replicated when the owner isn't present or when the business expands beyond its original location.

Early Growth Stage. A business's early growth stage is generally characterized by increasing sales and heightened complexity. The business is normally still focused on its initial product or service but is trying to increase its market share and might have related products in the works. The initial formation of policies and procedures takes place, and the process of running the business will start to consume more of the founder's or founders' time and attention.

For a business to be successful in this stage, two important things must take place. First, the founder or owner of the business must start transitioning from his or her role as the hands-on supervisor of every aspect of the business to a more managerial role. As articulated by Michael E. Gerber in his excellent book *The E-Myth Revisited*, the owner must start working "on the business" rather than "in the business."[22] The basic idea is that early in the life of a business, the owner typically is directly involved in building the product or delivering the service that the business provides. As the business moves into the early growth stage, the owner must let go of that role and spend more time learning how to manage and build the business. If the owner isn't willing to make this transition or doesn't know it needs to be made, the business will never grow beyond the owner's ability to directly supervise everything that takes place, and the business' growth will eventually stall.

The second thing that must take place for a business to be successful in the early growth stage is that increased formalization must take place. The business has to start developing policies and procedures that tell employees how to run it when the founders or other top managers aren't present. This is how franchise restaurants run so well when they're staffed by what appears to be a group of teenagers. The employees are simply following well-documented policies and procedures. This task was clearly on the mind of Emily Levy, the founder of EBL Coaching, a tutoring service for children who are struggling in school or trying to overcome disabilities, when she was asked by Ladies Who Launch (a support network for female entrepreneurs) early in the life of her business about her growth plans:

> My future goals include continuing to spread EBL Coaching's programs nationally, using our proprietary materials and self-contained multisensory methods. I have already developed a series of workbooks, called "Strategies for Success," addressing specific study skills strategies, that are being used in a number of schools across the country. The real challenge will be figuring out how to replicate our programs while maintaining our high quality of teaching and personalized approach.[23]

Continuous Growth Stage. The need for structure and more formal relationships increases as a business moves beyond its early growth stage and its pace of growth accelerates. The resource requirements of the business are usually a major concern, along with the ability of the owner and manager to take the firm to the next level. Often the business will start developing new products and services and will expand to new markets. Smaller firms may be acquired, and the business might start more aggressively partnering with other firms. When handled correctly, the business's expansion will be in areas that are related to its strengths and core capabilities, or it will develop new strengths and capabilities to complement its activities.

The toughest decisions are typically made in the continuous growth stage. One tough decision is whether the owner of the business and the current management team have the experience and ability to take the firm any further. This scenario played out for Rachel Ashwell, the founder of Shabby Chic, a home furnishing business. Ashwell expanded her company to five separate locations, inked a licensing deal with Target, wrote five how-to books related to her business, and hosted her own television show on the Style Network before concluding that her business had stalled. Her choice was to continue running the business or find more experienced management to grow it further. She opted for the latter, which reignited the company's growth.[24]

The importance of developing policies and procedures increases during the continuous growth stage. It's also important for a business to develop a formal organizational structure and determine clear lines of delegation throughout the business. Well-developed policies and procedures lead to order, which typically makes the process of growing a business more organized and successful.

Maturity Stage. A business enters the maturity stage when its growth slows. At this point, the firm typically focuses more intently on efficiently managing the products and services it has rather than expanding in new areas. Innovation slows. Formal policies and procedures, although important, can become an impediment if they are too rigid and strict.[25] It's important that the firm continues to adapt and that the founders, managers, and employees remain passionate about the products and services that are being sold. If this doesn't happen, a firm can easily slip into a no-growth situation.

A well-managed firm that finds its products and services are mature often looks for partnering or acquisition opportunities to breathe new life into the firm. For example, Coca-Cola, a firm in the maturity stage of its life cycle, has a long history of acquisitions. Among other purchases, it acquired Minute Maid in 1960, the Indian cola brand Thums Up in 1993, the Odwalla brand of fruit juices, smoothies, and bars in 2001, Fuze Beverages and Glaceau in 2007, Honest Tea in 2008 and 2011, a minority interest in Monster Beverage in 2014, and Unilever's Soy Beverage Brand in 2016.

If a company does grow organically while in the maturity stage, it normally focuses on the "next generation" of products it already sells rather than investing in new or related products or services.

Decline Stage. It is not inevitable that a business enter the decline stage and either deteriorate or die. Many American businesses have long histories and have thrived by adapting to environmental change and by selling products that remain important to customers. Eventually all businesses' products or services will be threatened by more relevant and innovative products. When this happens, a business' ability to avoid decline depends on the strength of its leadership and its ability to appropriately respond.

A firm can also enter the decline stage if it loses its sense of purpose or spreads itself so thin that it no longer has a competitive advantage in any of its markets. A firm's management team should be aware of these potential pitfalls and guard against allowing them to happen.

A framework that is similar to the organizational life cycle is the technology adoption life cycle, which is suited primarily for technology firms that are introducing disruptive innovations to the market. The technology life cycle is associated with the concept of "crossing the chasm," which explains why some technology products reach mainstream markets while others don't. An explanation of the technology life cycle, the concept of "crossing the chasm," and an example of a start-up that successfully crossed the chasm and reached mainstream markets is provided in the nearby "Savvy Entrepreneurial Firm" feature.

SAVVY ENTREPRENEURIAL FIRM

Salesforce.com Crosses the Chasm

• **Web: www.salesforce4.com** • **Facebook: Salesforce** • **Twitter: @salesforce**

In 1991, Geoffrey A. Moore, a lecturer and management consultant, wrote an influential book titled *Crossing the Chasm*. The book became an instant must-read for managers, entrepreneurs, and investors. The book was updated in 2009 and again in 2014. It has been described as the bible for understanding why some technology-oriented start-ups grow into large firms while others stall or languish in terms of adoption and firm growth.

The book's premise is that there is a chasm between the early adopters of a product (the technology enthusiasts and visionaries) and the early majority (the pragmatists). The key insight is that to cross the chasm, firms must first dominate a niche of early adopters and expand from a position of strength. The concept is related to the technology adoption life cycle. The stages in the technology adoption life cycle are innovators, early adopters, early majority, late majority, and laggards. Start-up products initially appeal to "innovators," who are people who like to try new things but are seldom willing to spend much. Then come the early adopters, or visionaries, who are willing to take a chance on a new product if it solves a burning problem. After the early adopters come the early majority, which is the largest segment. The early majority will only buy if a product is complete and is heavily recommended by others. If it's not recommended, they won't buy, regardless of how well a product suits their needs. Next is the late majority, which buys only after a product has become the standard. The laggards, who bring up the rear, rarely buy.

The chasm is hard to cross. Ironically, it is not the early adopters who convince the early majority to buy. In fact, the early majority typically mistrusts the enthusiasm of visionaries. They start buying when credibility is established and momentum within their own group starts to build. In his book, Moore suggests techniques to successfully appeal to the early majority, and cross the chasm, including issues pertaining to a firm's target market, its positioning strategy, its marketing strategy, and a number of other important factors. It's well worth the time to read the book to learn the techniques and capture the subtleties.

Salesforce.com is an example of a company that has crossed the chasm. Prior to Salesforce.com, software was a product that was sold on discs that clients would install on their computers. The software would then need to be integrated into the clients' system, which typically cost more than the software itself. By the time the software was installed, there were often updates available. Many clients would forgo installing the updates, at least for a period of time, to simply avoid the additional hassle and expense of installing them.

Salesforce.com introduced a better way. Its better way was software-as-a-service, later abbreviated as SaaS. The idea was that instead of selling software on discs to be installed on a client's computers, there would be only one copy of the software, running on Salesforce.com computers, which multiple users could access simultaneously via the Internet. The sales pitch was compelling. By adopting Salesforce.com's solution, a client would no longer incur the costs and headaches involved with installing, updating, and maintaining software.

What's interesting is the way Salesforce.com managed the rollout of the product and how the firm eventually crossed the chasm. In regard to the rollout, the company picked a single market to go after, salespeople, and no one else. There was nothing in the product for marketing, customer service, or any other division in a company. Salesforce.com focused exclusively on the United States as its target market, partly to stay close to its customer. The firm also chose to initially target tech-savvy industries. The result was a product designed to achieve a singular objective—helping salespeople make their quota. As a result, salespeople loved it. And because they loved it, they told other salespeople about it, and adoption grew virally. The number of early adopters grew. Credibility was built as the product was displayed at tradeshows and was talked about in mainstream media. Eventually, companies such as Merrill Lynch saw the merits of the service and signed on. Salesforce.com crossed the chasm and started appealing to the early majority and a wider number of users.

The irony of the Salesforce.com story, which is the essence of Moore's insight, is that by picking a single niche market, and establishing sufficient credibility that the early majority noticed, Salesforce.com was able to cross the chasm faster than it would have if it had created a much more robust product initially and tried to appeal to a broader cross-section of markets.

Questions for Critical Thinking

1. Select at least two other firms that you believe have crossed the chasm. Briefly summarize how the firms rolled out their products (or services) and what you believe their key steps were in successfully crossing the chasm.
2. In contrast to question #1, list at least two start-ups with which you are familiar that produced products or services that you believe never crossed the chasm. Briefly describe why you believe they never crossed the chasm.
3. Do you believe consumer products cross the chasm (or fail to cross the chasm) much like technology products?
4. In regard to adopting technology products, do you see yourself as an early adopter or as part of the early majority? How does your answer affect the manner in which you buy technology products?

Sources: Salesforce.com Homepage, www.salescorce.com (accessed July 3, 2014 and May 4, 2017); G. A. Moore, *Crossing the Chasm*, 3rd edition (New York: HarperCollins, 2014).

Challenges of Growth

LEARNING OBJECTIVE

4. Discuss the challenges of firm growth, particularly those of adverse selection and moral hazard.

There is a consistent set of challenges that affect all stages of a firm's growth. The challenges typically become more acute as a business grows, but a business' founder or founders and managers also become more savvy and experienced with the passage of time. The challenges illustrate that no firm grows in a competitive vacuum.[26] As a business grows and takes market share from rival firms, there will be a certain amount of retaliation that takes place. This is an aspect of competition that a business owner needs to be aware of and plan for. Competitive retaliation normally increases as a business grows and becomes a larger threat to its rivals.

This section is divided into two parts. The first part focuses on the managerial capacity problem, which is a framework for thinking about the overall challenge of growing a firm. The second part focuses on the four most common day-to-day challenges of growing a business.

Managerial Capacity

In her thoughtful and seminal book *The Theory of the Growth of the Firm*, Edith T. Penrose argues that firms are collections of productive resources that are organized in an administrative framework.[27] As an administrative framework, the primary purpose of a firm is to package its resources together with resources acquired outside the firm as a foundation for being able to produce products and services at a profit. As a firm goes about its routine activities, the management team becomes better acquainted with the firm's resources and its markets. This knowledge leads to the expansion of a firm's **productive opportunity set**, which is the set of opportunities the firm feels it is capable of pursuing. The opportunities might include the introduction of new products, geographic expansion, licensing products to other firms, exporting, and so on. The pursuit of these new opportunities causes a firm to grow.

Penrose points out, however, that there is a problem with the execution of this simple logic. The firm's administrative framework consists of two kinds of services that are important to a firm's growth—entrepreneurial services and managerial services. **Entrepreneurial services** generate new market, product, and service ideas, while **managerial services** administer the routine functions of the firm and facilitate the profitable execution of new opportunities. However, the introduction of new product and service ideas requires substantial managerial services (or managerial "capacity") to be properly implemented and supervised. This is a complex problem because if a firm has insufficient managerial services to properly implement its entrepreneurial ideas, it can't quickly hire new managers to remedy the shortfall. It is expensive to hire new employees, and it takes time for new managers to be socialized into the firm's culture, acquire firm-specific skills and knowledge, and establish trusting relationships with other members of their firms.[28] When a firm's managerial resources are insufficient to take advantage of its new product and services opportunities, the subsequent bottleneck is referred to as the **managerial capacity problem**.

As the entrepreneurial venture grows, it encounters the dual challenges of adverse selection and moral hazard. **Adverse selection** means that as the number of employees a firm needs increases, it becomes increasingly difficult for it to find the right employees, place them in appropriate positions, and provide adequate supervision.[29] The faster a firm grows, the less time managers have to evaluate the suitability of job candidates and the higher the chances are that an unsuitable candidate will be chosen. Selecting "ineffective" or "unsuitable" employees increases the venture's costs. **Moral hazard** means that as a firm grows and adds personnel, the new hires typically do not have the same ownership incentives as the original founders, so the new hires may not be as motivated as the founders to put in long hours or may even try to avoid hard work.[30] To make sure the new hires are doing what they are employed to do, the firm will typically hire monitors (i.e., managers) to supervise the employees. This practice creates a hierarchy that is costly and isolates the top management team from its rank-and-file employees.

The basic model of firm growth articulated by Penrose is shown in Figure 13.3 while Figure 13.4 shows the essence of the growth-limiting managerial capacity problem.[31] Figure 13.4 indicates that the ability to increase managerial services is not friction free. It is constrained or limited by (1) the time required to socialize new managers, (2) how motivated entrepreneurs and/or managers are to grow their firms, (3) adverse selection, and (4) moral hazard.

The reality of the managerial capacity problem is one of the main reasons that entrepreneurs and managers worry so much about growth. Growth is a generally positive thing, but it is easy for a firm to overshoot its capacity to manage growth in ways that will diminish the venture's sales revenues and profits.

For firms that sell products online, one decision they'll need to make, which has a bearing on the amount of managerial capacity they need to maintain in-house, is the manner in which they'll fulfill their orders. This topic is covered in the nearby "Partnering for Success" feature.

Day-to-Day Challenges of Growing a Firm

Along with the overarching challenges imposed by the managerial capacity problem, there are a number of day-to-day challenges involved with growing a firm. The following is a discussion of the four most common challenges.

Cash Flow Management. As discussed in Chapters 8 and 10, as a firm grows, it requires an increasing amount of cash to service its customers. In addition, a firm must carefully manage its cash on hand to make sure it maintains sufficient liquidity to meet its payroll and cover its other short-term obligations. There are many colorful anecdotes about business founders who have had to rush to a bank and get a second mortgage on their houses to cover their business' payroll. This usually occurs when a business takes on too much work, and its customers are slow to pay. A business can literally have $1 million in

FIGURE 13.3
Basic Model of Firm Growth

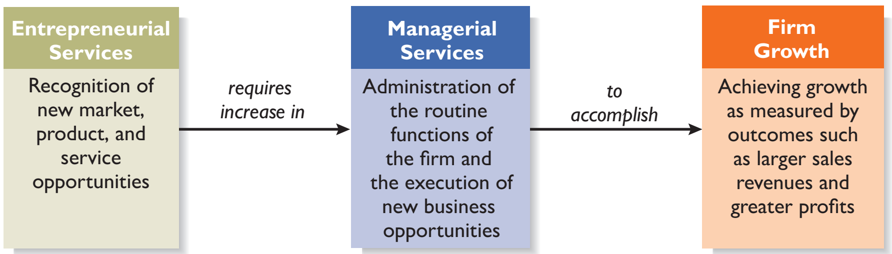
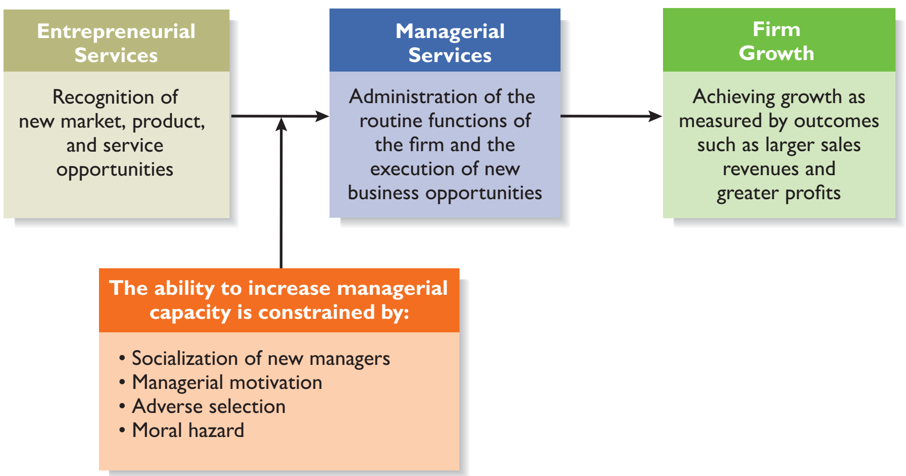


FIGURE 13.4
The Impact of Managerial Capacity

Source: Based on material in E. T. Penrose, *The Theory of the Growth of the Firm* (New York: Oxford University Press, 1959).



PARTNERING FOR SUCCESS

Three Choices for Fulfilling Orders for an Online Company

Imagine the following. You go to an e-commerce site and buy a pair of running shoes. You're anxious to get the shoes because the shoes you have are worn out. The shoes arrive in three days. You take the shoes out of the box, which has the name of the online company from which you bought the shoes on it. You quickly glance at the order form in the box, which also has the name and logo of the website you bought the shoes from. If someone asked you where you thought the shoes were shipped from, you'd probably say a warehouse owned by the online company you bought the shoes from.

Actually, you'd have no way of knowing where the shoes were shipped from. As shown below, there are three ways that online businesses fulfill orders and ship products. Each choice has pluses and minuses. Two of the three choices involve partnering with other companies.

Option #1: Partner with dropshippers. Dropshipping is a distribution strategy in which online retailers do not maintain inventory, but instead when they get an order, they pass the order on to a manufacturer, wholesaler, or other retailer who fulfills the order. Here's how it works. An online site that sells running shoes, for example, takes an order. It then electronically transmits the order to the appropriate shipper, such as New Balance. New Balance then packages and ships the item, usually in a day or so. The product is shipped in a box with the online retailer's name and logo, and the buyer never knows the difference. The advantage of dropshipping, from the online retailer's point of view, is that it doesn't need to maintain warehouses or employ packaging and shipping personnel. It also doesn't need to anticipate demand or get stuck with outdated merchandise. The disadvantage is that profit margins are reduced. The online retailer must share the profits from each order with one or more dropshippers.

Option #2. Partner with a logistics company. Many online companies partner with fulfillment companies that handle their warehousing, packaging, and shipping for them. Amazon Fulfillment, Shipwire, and Rakuten Super Logistics are examples of fulfillment services. Here's how they work. An online company offers a certain number of products for sale. Those products are shipped by the manufacturer or manufacturers to the fulfillment company. The fulfillment company then receives, tags, and stores the online company's inventory. When the online company receives an order, the order is electronically transferred to the fulfillment company. The fulfillment company then pulls the items from the online company's inventory, places them in a box, and ships them to the customer. The box will look like it came directly from the online company. The fulfillment company will also handle returns. Similar to dropshipping, the advantage of this approach is that the online company doesn't need to maintain warehouses or employ packaging and shipping personnel. The disadvantage is that there is a cost for the service the fulfillment company provides.

Option #3: Fulfill your own orders. Some companies fulfill their own orders. For example, Riffraff, a women's clothing company, has a brick-and-mortar store in Fayetteville, Arkansas. Adjacent to the store is a warehouse, where the company stores its inventory and fulfills all of its online orders. The manufacturers of the products Riffraff sells deliver Riffraff's inventory directly to its warehouse. When an order is placed online, Riffraff employees pull the merchandise from shelves in the warehouse, place it in a box, and ship it to the customer. The advantage of this approach is tighter quality control in that Riffraff controls the process. Its employees, rather than a dropshipper's employees or the employees of a fulfillment company, handle its merchandise, package it, and ship it to the customer. Its employees also handle customer returns. The disadvantage is that the firm must maintain a warehouse and employee packaging and shipping personnel.

Each of the three approaches has pluses and minuses, so there is no one best choice. Many companies fulfill their own orders when they're first starting out, because the founders may have more time than money. Also, companies that want their products packaged or shipped in a unique way may find that it works best for them to do it themselves. Conversely, if a company has a broad inventory, dropshipping may be the best choice. eBags, for example, is an online seller of luggage, backpacks, and travel accessories. It has literally thousands of products listed. eBags uses a dropshipper, largely because it would be cost prohibitive for eBags to warehouse all the products it sells. Finally, for a company that's in a rapid-growth mode, using a fulfillment company may be the best choice. Using a fulfillment company frees the management of the firm to focus on product development, customer acquisition, and scaling the company rather than fulfillment and shipping.

Questions for Critical Thinking

1. If a company sold a product that was trendy, such as teenage fashions, which of the fulfillment approaches would be the best choice? Explain your answer.
2. If a company wanted to focus all of its energy on its core business, such as product sales and R&D, which of the approaches to order fulfillment would be appropriate?
3. RedStag Fulfillment (www.redstagfulfillment.com) is a start-up fulfillment service that maintains fulfillment locations in several U.S. cities. Spend some time studying RedStag's website. Describe the fulfillment services that RedStag could offer an online company that sells running shoes and apparel.
4. Skip ahead to Chapter 14 and read the "Opening Profile" feature, which focuses on FilterEasy. According to the feature, is FilterEasy a dropshipper, does it use a fulfillment service, or does it maintain warehouses and fulfill its own orders? Explain why you think FilterEasy made the choice it did regarding fulfillment and shipping.

Sources: Shopify Blogs, "Everything You Ever Wanted to Know About Third-Party Warehousing and Fulfillment," available at https://www.shopify.com/blog/60645957-everything-you-ever-wanted-to-know-about-third-party-warehousing-and-fulfillment (posted October 26, 2015, accessed April 13, 2017).

accounts receivable but not be able to meet a $25,000 payroll. This is why almost any book you pick up about growing a business stresses the importance of properly managing a firm's cash flow.

Growth usually increases rather than decreases the challenges involved with cash flow management because an increase in sales means that more cash will be flowing into and out of the firm. Growth is also expensive, in that it often involves investing more money in operations, marketing, administrative processes (to better track accounts payable and receivable), and personnel. This point is made by Vinny Antonio, president of Victory Marketing Agency:

> Cash flow management for a rapidly growing, bootstrapped company can be harder than the world's most difficult Sudoku puzzle. It's almost a full-time job staying on top of who owes you what and who you owe, and then priortizing those payments. All the while, you're pushing for more growth, but with that comes additional expenses—most notably, your executive team. Good talent doesn't come cheap, and you often have to find creative ways to lure the right personnel to your team.[32]

Some firms raise the cash needed to fund growth via investors or a line of credit at a bank. Other firms deliberately restrict the pace of their growth to avoid cash flow challenges.

Price Stability. If firm growth comes at the expense of a competitor's market share, price competition can set in. For example, if an entrepreneur opened a fast-casual restaurant near a Panera Bread that started eroding Panera Bread's market share, Panera Bread would probably fight back by running promotions or lowering prices. This type of scenario places a new firm in a difficult predicament and illustrates why it is important to start a business by selling a differentiated product to a clearly defined target market. There is no good way for a small firm to compete head-to-head against a much larger rival on price. The best thing for a small firm to do is to avoid price competition by serving a different market and by serving that market particularly well.

Quality Control. One of the most difficult challenges that businesses encounter as they grow is maintaining high levels of quality and customer service. As a firm grows, it handles more service requests and paperwork and contends with an increasing number of prospects, customers, vendors, and other stakeholders. If a business can't build its infrastructure fast enough to handle the increased activity, quality and customer service will usually suffer. What happens to many businesses is that they run into the classic chicken-or-egg quandary. It is hard to justify hiring additional employees or leasing more office space until the need is present, but if the business waits until the need is present, it usually won't have enough employees or office space to properly service new customers.

There is no easy way to resolve this type of quandary other than to recognize that it may take place and to plan for it in the best way possible. Many businesses find innovative ways to expand their capacity to try to avoid shortfalls in quality control or customer service.

Capital Constraints. Although many businesses are started fairly inexpensively, the need for capital is typically the most prevalent in the early growth and continuous growth stages of the organizational life cycle. The amount of capital required varies widely among businesses. Some businesses, like restaurant chains, might need considerable capital to hire employees, construct buildings, and purchase equipment. If they can't raise the capital they need, their growth will be stymied.

Most businesses, regardless of their industry, need capital from time to time to invest in growth-enabling projects. Their ability to raise capital, whether it's through internally generated funds, through a bank, or from investors, will determine in part whether their growth plans proceed.

Chapter Summary

LO1. Sustained growth is defined as growth in both revenues and profits over an extended period of time. Successfully growing a business is a function of preparation, good management, and an appreciation of the issues involved. The three primary things that a business can do to prepare for growth are appreciating the nature of business growth, staying committed to a core strategy, and planning for growth. In this sense, firm growth is not a random or chance event. It is something firms pursue deliberately.

LO2. The six most common reasons that firms grow in an effort to increase their profitability and valuation are to: (1) capture economies of scale (which are generated when increasing production lowers the average cost of each unit produced); (2) capture economies of scope (similar to economies of scale, scope economies are advantages a firm generates through the range of its operations); (3) achieve market leadership (which happens when a firm holds the top or second position in its industry or the segment of an industry in which it competes); (4) maintain influence, power, and survivability (conditions through which a firm is able to affect the setting of an industry's standards as well as having the scale and scope that will allow it to make a mistake and continue operating); (5) accommodate the growth of key customers (which is the ability to serve an important customer's expanding demand for the firm's product or service); and (6) maintain an ability to attract and retain talented employees (the most desirable employees want to work for a firm in which learning and growth opportunities will be readily available to them).

LO3. Many businesses are caught off guard by the challenges involved with growing and managing their companies. As a business increases its sales, its pace of activity quickens, its resource needs increase, and the founders often find that they're busier than ever. Evidence indicates that the majority of businesses go through a discernable set of stages referred to as the organizational life cycle. The stages include introduction, early growth, continuous growth, maturity, and decline. The introduction phase occurs when a business determines what its strengths and core capabilities are and starts selling its initial product or service. The business is typically very nonbureaucratic with no (or few) written rules or procedures. The main goal of the business is to get off to a good start and try to gain momentum in the marketplace. A business's early growth stage is characterized by increasing sales and heightened complexity. For a business to succeed in this stage (1) the founder or owner of the business must start transforming from his or her role as the hands-on supervisor of every aspect of the business to a more managerial role, and (2) increased formalization must take place. The toughest decisions are typically made in the continuous growth stage. One tough decision is whether the owner of the business and the current management team have the experience and ability to take the firm any further. In the maturity stage, the firm's growth slows and eventually comes to a halt, as does its ability to generate product or service innovations. In the decline stage, the firm's sales begin falling rather dramatically. In addition, the quality of the firm's relationships with stakeholders such as customers, suppliers, employees, and financial institutions begin to suffer.

LO4. There is a consistent set of challenges that affect each and every stage of a firm's growth. The first of these challenges is known as the managerial capacity problem. This particular problem suggests that firm growth is limited by the managerial capacity (i.e., personnel, expertise, and intellectual resources) that firms have available to implement new business ideas. The basic idea is that it does a firm little good to have exciting ideas about growth when it lacks the managerial capacity to implement its ideas. The second core challenge has four parts; collectively, these are categorized as the day-to-day growth-related challenges that firms encounter. The day-to-day challenges of managing growth include cash flow management (the challenge of continuously verifying that the firm has sufficient cash on hand to meet its needs), price stability (this challenge surfaces when a firm competes successfully against larger competitors who respond by making the new venture compete on the basis of price, a competitive dimension on which it is at a disadvantage compared to large, established competitors), quality control (with growth, the entrepreneurial venture may find it increasingly difficult to maintain the quality of its product or service as demanded by customers), and capital constraints (here the challenge is to find the financial capital needed to support early and hopefully continuous firm growth).

Key Terms

adverse selection, **503**
core competencies, **493**
economies of scale, **495**
economies of scope, **497**
entrepreneurial services, **503**
fixed costs, **497**
managerial capacity problem, **503**
managerial services, **503**
market leadership, **497**
moral hazard, **503**
pace of growth, **495**
productive opportunity set, **503**
sustained growth, **490**
variable costs, **495**

MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

13-1. What is sustained growth? Why is it important?
13-2. Can most firms be classified as rapid-growth firms? Explain your answer.
13-3. What are the potential downsides to firm growth?
13-4. Do all firms have the potential to be aggressive-growth firms? Why or why not?
13-5. Is it possible for a firm to grow too fast? If so, what are the potential downsides?
13-6. Why is it difficult for some firms to grow or scale their operations?
13-7. What are the benefits of planning for growth?
✪ 13-8. What are the factors that a business needs to keep in mind when preparing for growth? What are the indicators that a business is growing too fast?
13-9. Why do firms pursue growth? How can a firm achieve economies of scale?
13-10. How does a firm's growth rate affect its ability to attract and retain talented employees?
✪ 13-11. What are the repercussions faced by a firm when it fails to manage growth?
13-12. What is the managerial capacity problem?
13-13. What is adverse selection and how might it affect entrepreneurial firms?
13-14. What is moral hazard and how might it affect entrepreneurial firms?
13-15. Why is cash flow management such an important issue for a firm entering a period of rapid growth?
13-16. How do rapid growth firms deal with potential cash flow shortfalls?
13-17. Why is price stability such an important issue for a firm entering a period of rapid growth?
13-18. According to the chapter, one of the most difficult challenges involved with rapid growth is quality control. Why is this so?
13-19. Explain the dual challenges of adverse selection and moral hazard.
13-20. Why is it expensive for a firm to grow?

Application Questions

13-21. Sean Damsey has been running a budget hotel for the past six months and has been doing quite well. He did a quick survey and found that his town still does not have enough hotels to accommodate the number of tourists that visit, especially during weekends and holidays. At the moment, there are only three hotels, including Sean's. Sean is planning to expand and start another hotel in the same area, but he is afraid that his business might grow too fast and he would not be able to manage the growth. How would you advise him?

13-22. Joanna Collins and Pete Stash recently opened a fine dining restaurant in the suburbs. They have been very enthusiastic about it and have been looking forward to growing their business successfully. Neither Joanna or Pete is an experienced restaurateur; they are new entrepreneurs, and this is their first time doing business. As their friend Stanley Black has been operating an Italian restaurant for five years, Joanna has approached him for advice. She knows that there will be many challenges to face while experience growth. What should Stanley tell them to expect about the day-to-day challenges of a growing firm?

13-23. Patty Stone owns an industrial equipment company named Get Smart Industrial that sells three products in the oil services industry. Get Smart's products are sold via a direct sales force. Patty wants to grow the firm by adding new products but has run into resistance from her chief financial officer (CFO), who argues that adding new products will increase inventory costs and place a strain on the company's cash flow. While Patty is sensitive to her CFO's concerns, what arguments can she make in favor of adding new products as a way of effectively growing her firm?

13-24. Three years ago, Chris Dees launched a medical products company that specializes in providing products for people with diabetes. His company is number one in its industry. Recently, a couple of competitors have entered the picture, and Chris is wondering if it is worth the fight to remain number one. In terms of firm growth, what advantages are there to being the market leader?

13-25. Kyle Simms just succeeded his father as the CEO of a consumer products firm in Mission Viejo, CA. Prior to returning to the family business, Kyle spent 11 years at Procter & Gamble in Cincinnati. Kyle's dad built a solid company, but over the past five years, its growth was flat. Kyle wants to grow the company, but at the same time doesn't want to disturb its healthy culture or overshoot its ability to manage its growth. Kyle's question to you is, "How do I manage this careful balance?" What would you tell him?

13-26. Yolande runs a successful small computer and electronics repair business. Recently, she has seen a shift in the demand for repairs. Laptop repairs have dropped from 70 percent of the work to under 10 percent. Tablets have increased to nearly 20 percent; smart phones are now 70 percent. Desktop computer repairs are rare. What do these figures tell you, and how should she prepare for the future?

13-27. Meredith Colella is a food products engineer who has developed an innovative approach for the packaging of meat. Her approach will extend the shelf life of most meat products by about 30 percent. Meredith is getting ready to try to sell the idea to investors. What could Meredith tell the investors that would give them confidence that she is prepared to cope with the challenges of rapid growth?

13-28. As an experienced entrepreneur for the last 25 years, Martin Perry has been invited by the local council to give a speech to young entrepreneurs who are keen on starting their own business. As these young entrepreneurs have already attended entrepreneurship workshops before, what do you think Matthew's talk should cover?

13-29. Bruce Steven is a renowned entrepreneur in your neighborhood. He has been operating a fitness center for the past 10 years, and everyone in the neighborhood and surrounding areas are loyal members. One evening after your workout at his center, Bruce invited you for coffee. He explained that his center is experiencing slow growth and he was losing his enthusiasm for the business. Explain to him what his next course of action should be.

YOU BE THE VC 13.1 COMPANY: Eureka Robotics

• Web: eurekarobotics.com • Facebook: Eureka Robotics • Twitter: @eurekarobotics

Business Idea: Develop robots that can handle precise, intricate, and complicated tasks such as building computers and aircraft from stores of parts.

Pitch: As a statement of intent, the first offering from Singapore start-up Eureka Robotics could not have been more media-friendly. A team of graduates from Nanyang Technological University developed a robot that had mastered a task that has roundly defeated many humans—assemble a flat-pack IKEA chair. Two industrial robots fitted with grippers, force sensors, and a 3D camera completed the job of building the Stefan chair in 8 minutes and 55 seconds, creating headlines around the globe in the process.

The experiment did have a serious purpose, though: it was the first test of whether robotics equipment already available on the market could be used to perform more intricate tasks. Fine-grained object manipulation, such as hammering a peg into a hole, has traditionally been extremely challenging for robots. These are the skills where, so far, human dexterity has placed us above machines. The IKEA challenge required the robots to recognize chair parts, work out how to pick them up and move them without causing damage, and then, perform the required moves flawlessly. Early attempts were fraught with problems—the robots dropped wooden pins, or let go of parts too soon, or even dismantled what they had already done. A number of chair kits were broken. Eventually, though, Eureka Robots succeeded in programming the robots to assemble the chair frame.

Eureka Robotics' second launch took the proof of principle and turned it into a practical application. Archimedes is a six-axis robotic arm that picks up and manipulates optical lens mirrors that are used in products such as cameras, medical imaging, and eyewear. It's perhaps not as newsworthy as overcoming the challenge of assembling the Stefan chair, but it has far more commercial potential. The global market for optical instruments and lens manufacturing is expected to reach $27 billion by 2022, according to *Research and Markets*. Archimedes can handle multiple sizes of lenses and mirrors while loading the delicate objects onto a tray to be coated. The process eliminates the need for human interaction and, therefore, the potential for defects. Until now, robots used in industry either had high accuracy but low agility, where robots perform the same movements repeatedly, or low accuracy but high agility, such as when robots handle packages of different sizes in logistics. Archimedes is among the first robots to have both high accuracy and high agility (HAHA). Its accuracy in placing objects is within a tenth of a millimeter, and it does so with the gentleness of a human touch. It uses artificial intelligence to analyze how many lenses there are and their respective sizes, and an algorithm plans the most efficient way to slot them onto the tray.

The Eureka Robotics team has also experimented with a number of other robotics concepts, from autonomous planning and routing to advanced algorithms. In one example, it used two mobile robots to 3D-print a 1.8-meter concrete structure. The robot's ability to move around to print structures at virtually any scale means that, in the future, it may be possible to 3D-print entire buildings without any human intervention at all. There is still more potential for growth through a range applications that can improve productivity and efficiency in any type of manufacturing process that is currently done with manual labor, such as drilling and tapping of custom machinery.

13-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

13-31. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 13.2 COMPANY: Eliport

• Web: eliport.com • Facebook: eliportrobots • Twitter: @EliportRobots

Business Idea: Develop ground-based, entirely autonomous delivery robots that do not require people to be involved at any stage of the delivery. Robotic distribution will allow the distribution of packages cheaply and efficiently, with no need for customers to wait in.

Pitch: Interest in delivery drones, both airborne and ground-based, surged as the COVID-19 pandemic spread, fueling a market that is expected to grow from $11.9 billion in 2018 to $34 billion by 2024. All eyes are on startups with autonomous delivery robots to conquer the delivery industry in the post-coronavirus world. Spanish entrepreneurial venture Eliport is already making great progress in this space with its fleet of ground-based delivery machines that travel on pavements and in pedestrian zones at walking speed.

What makes Eliport robots a little different is that they can be loaded and unloaded without any human interaction. Eliport's four-wheeled robots begin by loading themselves up with 30–40 kilograms of cargo at a centrally located warehouse or logistics hub. Then, guided by GPS and a 3D map of the neighborhood in which they operate, they proceed to their destination. Once they arrive, they automatically transfer their cargo into secure, pre-installed "trunk" containers. Households can then retrieve their delivery at their convenience.

Eliport's robots avoid obstacles on sidewalks via a combination of 10 to 14 sensors, which include video cameras, LiDAR (light detection and ranging), and radar. Each battery pack enables the bots to travel 25 kilometers (16 miles), and additional top-ups can be done via chargers located at pick-up and drop-off points. If human access is required to manually add or remove goods, this can be facilitated, but only via facial recognition or a code-based security system.

While the legal frameworks of delivery robots are yet to be ironed out—what happens if the device causes damage, for example—customers do seem willing to use delivery bots and, it has been noted, change buying behavior if offered delivery within the hour. Traditionally, households tend to stick to one large weekly shop because it is a lot of trouble to drive to a grocery store, load food into a trolley, and queue to pay. Now, if they run out of, say, olive oil while cooking, they can simply order it and wait the half an hour it will take to arrive.

Eliport says that tapping into just 0.1 percent of the global delivery market will see its bots delivering 1.78 million parcels every day. Much of the demand will come from the burgeoning e-commerce sector, which is expecting further demand if customers can be guaranteed smooth delivery to their doorsteps. The legislative environment, which had previously barred delivery bots, is beginning to soften. The United States has been quicker to pass laws that allow robots on its sidewalks, and nine states, including Virginia, Washington DC, Florida, and Texas have already given the green light. In Europe, bots are being welcomed in Finland and Estonia as well as a handful of cities in the United Kingdom and Spain.

13-32. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

13-33. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 13.1

Sir Kensington's: Pursuing a Measured, Yet Promising Path to Growth

• Web: www.sirkensingston.com • Facebook: Sir Kensingston's • Twitter: @sirkensingstons

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

In early 2008, Scott Norton and Mark Ramadan, classmates at Brown University, were having lunch. They got to talking about food and stumbled on an interesting topic. For most types of food there are many choices. Just think of milk. Not only are there different brands of milk, but there is whole milk, 2 percent milk, and skim milk, along with soy milk, rice milk, almond milk, and coconut milk. The same is true for cereal, yogurt, mustard, and sauces. The only product they could think of where there is only one choice is ketchup. Heinz ketchup. They wondered why that was the case and if there was something they could do about it.

For some reason, the idea of creating a new brand of ketchup interested them. They started from the premise that they wanted to create something compelling, something that they could create a brand around. They also wanted something that reflected their values. Most ketchup, they learned, is made from tomato concentrate, corn syrup, vinegar, and onion powder. They quickly decided if they made ketchup, it would be made from natural ingredients, such as fresh tomatoes, cane sugar, and real diced onions instead of onion powder. They started tinkering with recipes, mostly in Norton's apartment. To test their early recipes, they invited their friends to a ketchup party. They had eight different ketchups and held a blind taste test. They asked their friends to rate each ketchup on several criteria, including taste, texture, similarity to Heinz, and so forth. There were two ketchups that came out on top—Classic and Spicy. They thought, "Why don't we make these two types of ketchups, put them in jars and see what happens?"

Before they went further, they thought a lot about branding. They instinctively knew that natural ingredients and taste alone wouldn't get the attention they needed. They needed their ketchup to stand out—to jump off the shelf at a grocery store. They imagined the name Sir Kensington, a fictional merchant who would be pictured on their bottles. They also decided to make their bottles and labels unique. Instead of plastic squeeze bottles, they elected to go with squat square bottles with a wide instead of a narrow top (so the ketchup could be spooned rather than squeezed from the bottle). They also designed and printed labels that looked as though they belonged on fine food rather than a ketchup bottle.

In 2009, Norton and Ramadan graduated and took jobs in the business world. They kept the idea of Sir Kensington alive and continued to work part time on the project. In 2010, they both left their traditional jobs to pursue Sir Kensington's full time.

Early Growth

In June 2010, Sir Kensington's debuted at New York's annual Fancy Foods Show. After the show, Norton and Ramadan hit the streets, trying to make sales. Their efforts weren't random. They were aware of the technology adoption life cycle and decided to apply it to their business. The stages in the technology adoption life cycle are innovators, early adopters, early majority, late majority, and laggards. As explained in this chapter, the life cycle is often associated with the concept of "Crossing the Chasm," first introduced in 1991 by Geoffrey A. Moore. In a nutshell, the life cycle concept argues that a firm should start with innovators, and firmly establish itself in each stage before it moves to the next stage. The hardest transition is from early adopters to the early majority. Innovators and early adopters are people who enjoy trying new things. The early majority are mainstream customers. A firm "crosses the chasm" when it moves from early adopters to the early majority. A diagram of the technology adoption life cycle is shown in Figure 13.5.

Consistent with the theories mentioned above, Norton and Ramadan targeted independent grocery stores as their first adopters of Sir Kensington's ketchup. Independent stores tend to appeal to "innovators," people who are looking for new choices. Norton and Ramadan put a lot of thought into how to appeal to innovators. One important piece was the package. They worked hard to create a bottle and label that looked different and conveyed Sir Kensington's values. They ended up with a bottle and label that looked like nothing else in the ketchup aisle—it was short, squat, had a wide opening at the top, and had Sir Kensington's image prominently displayed on the front. They figured that combination would incent an innovator to pick the bottle up. Once it was in the hands of the innovator, the label took over. The label drew a clear distinction between Sir Kensington's and other ketchups. The label reminded the shopper that Sir Kensington's was made strictly from natural ingredients, with half the sugar and half the salt of traditional ketchup. They figured the label would close the sale. The first store to say yes was Murray's Cheese, an independent grocer in Greenwich Village in New York City. Several other independents quickly followed. Based on this early traction, Norton and Ramadan were able to land Dean & DeLuca, Williams-Sonoma, and Whole Foods. It wasn't easy. Whole Foods, for example, has seasons where they try out different categories of products. Norton and Ramadan established a relationship with a food broker who knew Whole Foods' schedule and made the appropriate introductions. In its first year, 10,000 jars were sold.

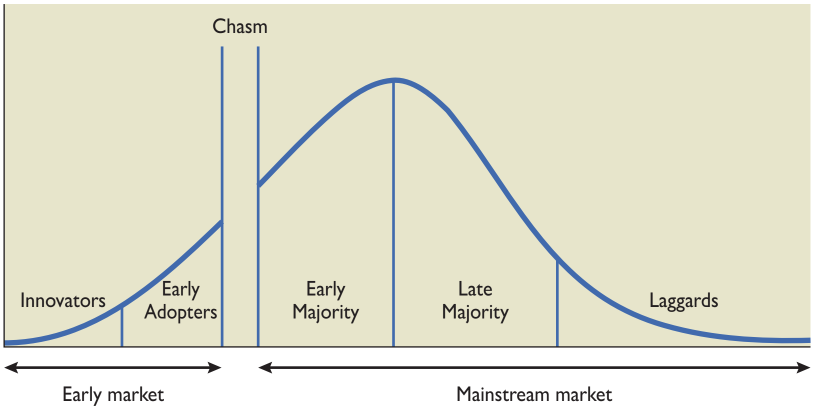
Restaurants came next, in the 2012 time frame, and are generally harder than retailers for new food companies to crack. This is particularly true for a product such as ketchup. Retailers sell ketchup—it's a product on which they earn money. Restaurants give ketchup away—it's something that costs them money. Sir Kensington's was a premium-priced product. As a result, it was a tough sell. Eventually, several high-end restaurants signed on, including the Four Seasons Hotels, mostly because they liked the Sir Kensington's product and brand. Once the Four Seasons signed on, it was easier to convince other high-end restaurants to follow suit.

Crossing the Chasm

In 2013, Norton and Ramadan decided it was time for Sir Kensington to cross the chasm. What that meant was finding a way to appeal to mainstream consumers rather than innovators and early adopters. The change was also precipitated by the opportunity to sell in more mainstream stores such as Safeway and Target, and through online outlets such as Amazon.com. As mentioned previously, crossing the chasm isn't easy. The same product and style that appeals to innovators and early adopters doesn't necessarily appeal to mainstream consumers. The challenge that Norton and Ramadan faced, which is typical for companies attempting to cross the chasm, was to maintain the integrity and quality of their product while softening it in ways that would incent mainstream consumers to buy.

Several things were changed in preparation for the move. Sir Kensington's image was changed. The original Sir Kensington had a rather stern look with a neatly trimmed fashionable mustache. The new Sir Kensington was happier, with a large bushy mustache. The thinking was that mainstream consumers would be more comfortable bringing the happy Sir Kensington into their homes. Additionally, the taste of the product was tweaked some to make it seem more mainstream. Norton and Ramadan didn't feel as though they were compromising their product or firm's integrity by

FIGURE 13.5
Technology Adoption Life Cycle



Original Sir Kensington's bottle (on the left) compared to new Sir Kensington's bottle (on the right). Note how the original Sir Kensington is rather stern while the new Sir Kensington is happier. The company believed that the happier Sir Kensington would better appeal to main-stream consumers.

Kensington + Sons, LLC.

making these changes. They were just shifting their product to appeal more to mainstream consumers. The nearby photo shows the two Sir Kensington ketchup bottles. Notice how the bottle changed to make it more appealing to mainstream customers.

The shift worked and Sir Kensington's crossed the chasm. By early 2014, it was available in over 3,000 stores in the United States and in many restaurants and restaurant chains.

Sir Kensington's Today

While adding new product lines is an obvious path to firm growth, Norton and Ramadan resisted the temptation for some time. They felt that Sir Kensington's Ketchup was successful in part because it offered an alternative to Heinz's near monopoly in the ketchup market. That wasn't true of many products, as Norton and Ramadan had observed that day in 2008 when they first started talking about how few choices consumers had when it came to ketchup. Many times, they later noted, restaurants told them if they only had a matching set of Sir Kensington's Ketchup and Mustard, they would adopt both. But oddly, consumers have many choices for mustard. Everything that Norton and Ramadan felt was to their advantage when it came to selling ketchup would be to their disadvantage in selling mustard.

In 2014, Sir Kensington did expand its product line to include two types of mayonnaise—classic and chipotle. Like ketchup, there aren't many brands of mayonnaise, so Norton and Ramadan are on familiar ground. In 2015, the company added three varieties of mustard, Spicy Brown Mustard, Dijon Mustard, and Yellow Mustard. In 2016, two varieties of Fabanaise, which is a mayonnaise substitute, were added. The varieties are classic, made from sunflower oil and aquafaba, and chipotle, made from chipotle peppers and aquafaba. Aquafaba is a natural egg substitute made from chickpeas and water. Fabanaise appeals to consumers for a variety of reasons. They may be vegan, may have allergies, or may simply prefer the taste of Fabanaise to regular mayo.

Sir Kensington has ambitious plans for further growth. In 2015, the company raised $8.5 million in funding. Interestingly, the company has found that the bigger they get, the easier it is to source higher-quality ingredients because they have more scale. Norton and Ramadan maintain that Sir Kensington is a character and brand that is not specific to condiments, and their ultimate goal is to leave a mark on the food world and to improve the lives of people through food.

Discussion Questions

13-34. There is a discussion early in this chapter about the need to prepare for growth. What actions did Scott Norton and Mark Ramadan take that demonstrate their commitment to trying to fully understand growth and its ramifications for their firm?

13-35. We noted in this chapter that core competencies are essentially what a firm does particularly well. What are the core competencies of the firm Sir Kensington's? How sustainable are these core competencies?

13-36. Look at Figure 13.2, which shows the organizational life cycle. In which of these stages is Sir Kensington's located? To what issues do Sir Kensington's founders need to be particularly sensitive in this stage?

13-37. What are four key lessons about growth potential entrepreneurs could learn by studying how Sir Kensington's has grown?

Sources: Sir Kensington's website, www.sirkensington.com (accessed April 13, 2017); M. Watrous. "Sir Kensington's Making Bold Moves in Condiment Category," *Food Business News*, December 2, 2015; Sir Kensington's Gourmet Ketchup LORE Workshop, available online at http://www.youtube.com/watch?v=21JjzvXgsD4 (posted October 5, 2012, accessed April 14, 2017).

CASE 13.2

Airbnb: Passing through the Stage of Growth in an Exemplary Manner

• *Web: www.airbnb.com* • *Facebook: Airbnb* • *Twitter: @Airbnb*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

It all started because two aspiring designers needed money to pay their rent. It was October 2007, and Brian Chesky and Joe Gebbia were sharing an apartment in San Francisco. There was an international design conference coming to town. The two noticed that on the conference's website, all the hotels that were listed were sold out. The thought occurred to them that they could make money by renting out space in their apartment to people attending the conference.

They proceeded to pull out a couple of air beds they had in a closet and said to each other, "This is it. We're going to be AirBed & Breakfast—at least for the weekend." They quickly designed a website (www.airbedandbreakfast.com), put it up, and filled the three spots they had available in their apartment. They figured they'd get a couple of guys in their twenties who decided to attend the conference at the last minute. They ended up with three people who broke all their assumptions—about the business, the market, everything. The first person was a guy from India, who just couldn't believe they put up a website offering space in their apartment. The second was a 35-year-old woman from Boston and the third was a 45-year-old father of five from Utah.

This initial experience got Chesky and Gebbia thinking there might be a bigger opportunity here. They made good money, about $1,000, renting their space for the conference. They also got to meet three amazing designers in the exact same field they aspired to enter. They also started thinking about the feedback their guests had provided regarding staying in their apartment. They had liked the social element of the experience. Instead of being in a sterile hotel, they got to stay with other designers who knew San Francisco and were eager to show them around. And they saved a little money to boot.

Pre-Launch and Launch

Rather than running with the AirBed & Breakfast concept, Chesky and Gebbia spent the next four months working on another idea—a roommate matching site. They eventually realized that others were already pursuing that idea, so they returned to the AirBed & Breakfast notion. They knew they'd need programming help, so they approached a good friend and expert programmer, Nate Blecharczyk, who agree to sign on. They targeted South by Southwest (SXSW) in Austin, slated for February 2008, for their launch date. SXSW is an annual film, music, and emerging technologies conference. At this point, the business, still called AirBed & Breakfast, was straightforward. It provided a way for people to find housing, at a private residence rather than a hotel, when attending a conference. AirBed & Breakfast didn't own any lodging. Instead, it acted as a broker and received a service fee from both the host and the guest for every booking. The cost of lodging was set by the host rather than AirBed & Breakfast.

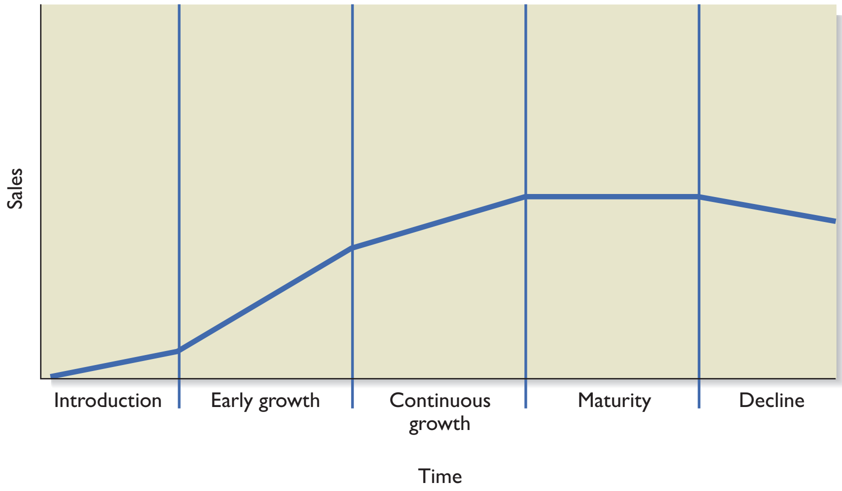
AirBed & Breakfast's reception at SXSW was encouraging enough to continue. Chesky, Gebbia, and now Blecharczyk decided to pursue their firm and see what they could make of it.

Stages of Growth

While growing, most businesses go through a discernable set of stages referred to as the organizational life cycle. The stages, pictured in the chart nearby, include introduction, early growth, continuous growth, maturity, and decline. Each stage has its own set of characteristics and must be managed differently. At the time this case was written—April 2017—AirBed & Breakfast, now called Airbnb, was in the continuous growth stage of the organizational life cycle. Although Airbnb is now a strong, successful firm, the path to get there wasn't an easy one. The following is a description of how Airbnb navigated the introduction, early growth, and early portion of the continuous growth stage of the organizational life cycle.

Introduction

After the SXSW conference in Austin, Chesky, Gebbia, and Blecharczyk picked another conference and advertised their service. At this conference, they started hearing something they hadn't heard before. People started saying things like they'd love to use the site next month when they visited London, but they weren't attending a conference or event. So Chesky and Gebbia started thinking that maybe their business was bigger than conferences or events. They also decided it was bigger than air beds. So the site's content expanded from air beds to apartments, private rooms, boats, and virtually anyplace someone could comfortably spend a night.



The next few months were slow. The business wasn't taking off the way the founding team had hoped it would. They were funding the business primarily via personal credit cards. In the summer of 2008, to raise money, Chesky, Gebbia, and Blecharczyk came up with a novel idea. The U.S. presidential election, between Barack Obama and John McCain, was in full swing. The two designed limited edition boxes of cereal, one called Obama O's and the other named Cap'n McCain's. The boxes were sold at election parties for $40 each. They sold about 800 boxes of the cereal, which helped them raise $30,000 for their business.

In early 2009, some friends encouraged Chesky, Gebbia, and Blecharczyk to apply for Y Combinator, a start-up accelerator in the Silicon Valley. Y Combinator provides its participants a small amount of funding in exchange for a modest amount of equity and three months of intense mentorship. They met with Paul Graham, the head of Y Combinator, who initially hated their idea. The meeting was almost over when the issue of the cereal boxes came up. Graham was impressed and said if they could convince people to pay $40 for $4 boxes of cereal, he'd give them a chance. Chesky later said that getting into Y Combinator was a turning point for the business in that it provided the founders a structure through which they could work on the company full time and had access to high-quality mentors and advice.

At this time, the majority of business AirBed & Breakfast was getting was from New York City. Graham told the AirBed & Breakfast team something that Chesky later said was the single best piece of advice they received. Graham told them that it was better to have 100 people who loved their service than 1 million people who sort of liked it. The idea was that people who love an idea tell others, and they then tell others, allowing the idea to spread organically. This knowledge resulted in Chesky and Gebbia deciding to shuffle back and forth from California, to attend Y Combinator events, to New York City, to meet their customers. They set out to meet every one of their customers in New York City. They took pictures of their customers' places. They hosted parties for their customers to talk about the service. Two things started to happen. First, bookings in New York City started increasing. Apparently, their customers appreciated being asked for their feedback and started talking up the service. Second, every time they went to New York they used their own service. They started realizing that there were things about their service that were not as good as they thought. They'd try to book a room on their website and think, "This is annoying." They also realized that the pictures of the rooms for rent needed to be bigger. They'd look at the small picture of an apartment listed on their site and then actually go to the place and think, "Wow, this place is beautiful—I would have never known from the small photos." As a result of their experiences as customers of their own business, they put a lot of effort into redesigning the site and the business. Looking back, Chesky and Gebbia now believe that meeting users in New York City in the spring of 2009 was the fundamental thing that changed the company for the better. Not only did they talk to their users, they booked rooms with them, slept in their homes, hung out with them, and picked their brains for hours on end for advice. It shaped their business, shaped the design of their website, and shaped the company's policies that were being developed. It goes back to a basic Paul Graham quote, "Make something people want."

By April 2009, business was picking up. AirBed & Breakfast, which had been renamed Airbnb, raised $585,000 from Sequoia Capital, which was a huge legitimization event. Based on what the company learned in New York City, the Sequoia investment, and the changes that were made, the Airbnb team felt that they had achieved product/market fit. According to investor Marc Andreessen, "Product/market fit means being in a good market with a product that can satisfy the market." Airbnb was ready to move to the early growth stage of the organizational life cycle.

Early Growth Stage

Airbnb's service started to spread. An advantage the company had was that its service benefited from a network effect. The majority of its initial hosts were in

Airbnb provides alternatives to staying in a hotel or hostel while traveling. If you're traveling to San Francisco, Airbnb lists rooms in homes like the ones shown here.

robert cicchetti/Shutterstock

New York City and San Francisco, but the people who booked the rooms came from everywhere. Those people would go back to their home cities and spread the word. Some would even become Airbnb hosts themselves. The Airbnb team did several things at this time to hasten growth. The company targeted events such as music festivals, major sporting events, and conventions to spread the word about their service. They worked hard to generate press and awareness at each event. They also engaged in a practice they called "Turning on Markets." They would travel from city to city, such as Paris and London, and meet with Airbnb hosts and do many of the same things they did with their initial hosts in New York City. After they left, they would see Airbnb bookings in the cities they visited pick up. They also came to realize that along with arranging for 1–3 night rentals, there was also a market for people who wanted to sublet a space for a month or even longer. This was a promising market because it was a market no one else was equipped to accommodate. If you need a place to stay in a city for a month, it's really too long of a period to rent a hotel room or stay in a hostel and too short of a period to rent an apartment. Airbnb, if it had enough hosts that were willing to provide this service, was the perfect solution.

At the same time these activities were taking place, Chesky and Gebbia shifted their priorities. They transitioned from building a product to building a company. Prior to entering the early growth stage, Chesky and Gebbia were involved in almost every decision that was made and every initiative that the firm pursued. Now their main function was setting the vision, hiring, maintaining and strengthening the culture of the company, and increasing formalization. A good example of increased formalization is how Airbnb evolved in regard to new employee orientation. Early on, Chesky personally conducted the new employee orientation for each of the firm's new hires. As the company grew, he started doing it once a week in groups. As it continued to grow, he taped it and as part of a formal onboarding process the new hires watched the tape. Another change that took place in the early growth phase is Airbnb started relying more on data than intuition for decision making.

The early growth stage also exposed Airbnb to new challenges. The company started attracting competitors as a result of its success. It also started experiencing government and regulatory challenges. Some cities have restrictions for subletting for a short period of time. In many cities, hosts must register with local authorities and obtain a license or permit. In addition, in some jurisdictions, collection of a transient occupancy tax by Airbnb is required. Airbnb's approach regarding legal challenges was to listen to all sides and try to reach an accommodation with which all parties were comfortable. The legal challenges the company would face only intensified when it reached the continuous growth stage.

Another challenge has been safety issues. In June of 2011, an Airbnb renter virtually destroyed the home of an Airbnb host. This was a wake-up call for the company. At that time, Airbnb didn't have a trust and safety team. It didn't remove many users. The incident changed the way the company thought about safety, and it has put safeguards in place and became much more hands-on in managing its marketplace.

Continuous Growth Stage

Airbnb is now in the continuous growth stage of the organizational life cycle. In the continuous growth stage, the need for structure and more formal relationships increases. In addition, businesses typically develop new products and enter new markets. This is what Airbnb is currently experiencing. Formalization has increased. The company now has a formal onboarding process with employees across the globe. It remains protective of its core values and culture. The company has a formal Core Values Council. If an employee or work group is unsure whether an idea or initiative fits or doesn't fit with Airbnb's core values, it can reach out to the committee for advice.

In terms of growth, the company remains on an aggressive growth path. It currently has four markets. First, people renting out a room in their home for a 1–3 night stay. This is the market Airbnb started with and still represents more than 50 percent of its rentals. The second is people renting out their entire home or apartment for a short-term stay. Most of Airbnb's bookings occur in these two markets. The third market, which Airbnb didn't pursue but happened organically, is the vacation rental market. This market involves "second homes" that people own in vacation destinations, like Lake Tahoe, Orlando, or Cape Cod, and are willing to rent when they're not present. The fourth market, which Airbnb broke into in the early growth stage, is the sublet market. This is the market for rentals that people need for a month or more.

Airbnb Moving Forward

Airbnb is now a large company. Its growth and size have surprised many, including its founders. The company currently has 3-plus million listings worldwide, is present in 65,000 cities and towns, and is in 191 countries. In a 2017 interview with *Fortune*, Chesky was asked, "Did you ever think (Airbnb) would be this big?" He responded by saying, "I remember when Joe (Gebbia) and I were having conversations, we'd said, 'This thing is going to be huge. One day hundreds of people will stay on airbeds across the world.'" On New Year's Eve 2016, two million people from 191 countries stayed in Airbnb properties. The company is now valued at $31 billion.

Airbnb continues to grow. Its total number of rentals increases every year. The company's listed nights booked hit 52 million in 2016 versus 25 million in 2015. In terms of market penetration, according to a Morgan Stanley study, in 2015, 15 percent of leisure travelers surveyed had used Airbnb in the past 12 months. In 2016, that number rose to 19 percent and Morgan Stanley predicts the number will reach 25 percent in 2017.

The biggest threat to Airbnb's growth remains government regulation. Many cities around the world have enacted laws to regulate shared accommodation. For example, in Barcelona, Spain, a special license is required to offer short-term rentals. The city stopped issuing licenses in 2014, so the only way to start a new Airbnb would be to buy an existing property with a license. Similarly, in early 2017, New York City introduced legislation allowing the state to fine Airbnb for listing properties for terms less than 30 days if a permanent resident will not be present.

Despite these challenges, Airbnb remains in the continuous growth stage of the organizational life cycle. The next stage is the maturity stage, which a business enters when its growth slows.

Perhaps to hedge against regulation slowing its growth, in late 2016 Airbnb announced a new service offering, its first departure from rentals. The new product is Experiences, which offers travelers excursions and experiences hosted by local residents. The service launched in 12 cities, including London, San Francisco, Paris, and Tokyo, and will offer experiences such as stargazing, surfing, mountain biking, food tasting, and murder-mystery tours. So far, thousands of people have submitted experiences to be considered. Airbnb will charge Experiences hosts a 20 percent commission for bookings. There is also speculation that Airbnb is working on a concept called "end-to-end" which will involve services that accommodate all of a traveler's needs. The services may involve airport transfers, air travel, restaurant bookings, city guides, and more.

Discussion Questions

13-38. Make a list of the things that you think Airbnb did "right" in growing its business.

13-39. Comment on the propensity of Airbnb's founders to solicit customer feedback. Based on the information in the case, do you think they did it too often, not often enough, or just right? Is there anything in their approach to obtaining feedback that you think you'll emulate if you start a business?

13-40. To what degree did Airbnb pass through the introduction stage and the early growth stage of the organizational life cycle in a manner consistent with the recommended handling of each stage provided in the chapter?

13-41. To what degree do you think government regulations threaten Airbnb's continual growth? Do you think the company will be able to generate sufficient profits from new initiatives, like Experiences, to offset profits lost to stricter regulations?

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ESSAY QUESTIONS

1. Imagine you have a friend who has created a new board game. A prototyping lab in the College of Engineering where your friend goes to college made a prototype of the game for him, which he took to a trade show; it received an enthusiastic response. He even obtained orders for 2,000 copies of the game. When you asked your friend how he plans to pay for the initial production run of the game, he said that he plans to bootstrap his company and will pay for everything from his profits. Does your friend have a good sense of the financial implications of launching a new product into the marketplace? Write a few paragraphs to describe the scenario that you believe is more likely to play out for your friend.
2. Look at the website of Lush Cosmetics (www.lush.com). As you'll see, the firm makes a wide range of fresh and natural beauty and cosmetic products. Lush is continually expanding into new markets and is aggressively competing against more traditional brands. Write a one-page set of recommendations for Lush that outlines some of the issues it should be aware of as it continues its expansion program.

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Getting Personal with FILTEREASY

Filter Easy, Inc./Photo Credit: Kevin Barry

Cofounders

KEVIN BARRY

BS, Poole College of Management, North Carolina State University, undecided

THAT TARKINGTON

BS, Poole College of Management, North Carolina State University, undecided

Dialogue with Kevin Barry

FAVORITE BAND ON MY SMARTPHONE MUSIC LIST
Simon and Garfunkel

MY ADVICE FOR NEW ENTREPRENEURS
Define your vision and see it through

WHAT I DO WHEN I'M NOT WORKING
Downhill ski, exercise, and cook

MY FAVORITE SMARTPHONE APP
Nest

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
Learning how much I do not know

BEST ADVICE I'VE RECEIVED
Failure is not an option

CHAPTER 14

Strategies for *Firm Growth*

OPENING PROFILE

FILTEREASY

Employing Both Internal and External Strategies for Growth

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If you've ever been responsible for a house or apartment, you can relate to Kevin Barry's story. He needed to replace the air filter on his apartment's heating/air conditioning system. He drove to the store, bought the filter, and brought it home, only to find out it was the wrong size. He returned to the store and found the filter that fit. After he installed it, the thought occurred to him that he had just spent two hours replacing a simple air filter.

Barry shared his experience with Thad Tarkington, a classmate at North Carolina State University. Tarkington had a story of his own to tell. Tarkington's mom had to replace her entire HVAC (heating, ventilation, and air conditioning) system after she forgot to change the filters for two years. Air filters play two important roles in a home: (1) they remove particles from the air, such as dust, pollen, bacteria and other contaminants and (2) they protect the home's HVAC system. The catch is that the filters get dirty and have to be replaced, normally every two to three months.

This set of circumstances got Barry and Tarkington thinking. Buying air filters is a hassle. It usually requires a trip to a hardware store and it's hard to remember the right size. In addition, it is a home maintenance item that many people simply forget. Failure to replace an HVAC system's air filters on a timely basis has several negative effects. It can affect the health of the people living in the house, increase a home's energy bill, and shorten the life of the system.

Barry and Tarkington settled on a business idea to address this situation. Inspired by monthly subscription services such as Netflix, Birchbox, and Dollar Shave Club, the idea was to create a monthly subscription service for air filters. The two were passionate enough about the idea that they decided to leave college in late 2012 to work on it full time. They started FilterEasy, the name they picked for their company, in November 2012.

In spring 2013, Barry and Tarkington were accepted into an accelerator program at The Iron Yard in Greenville, SC. They received a small amount of funding and access to mentors to build a beta website and flesh out FilterEasy's approach. From the customer's perspective, the approach that was decided on is very easy. To subscribe to FilterEasy's service, all you have to do is access the company's website, enter information about the number of filters you need and the dimensions of the filters, and choose how often you want them delivered. FilterEasy then ships the filters, you swap out the old filters for the new ones, and you're set until a new batch of filters arrives.

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Identify and discuss the core internal growth strategy for entrepreneurial firms.
2. Describe additional internal product-growth strategies entrepreneurial firms can use.
3. Examine international expansion as a growth strategy.
4. Discuss different types of external growth strategies.

Fresh out of The Iron Yard accelerator program, Barry and Tarkington bootstrapped their initial sales. They reached out to friends and family who became their first customers and fulfilled orders out of a garage. They also made a goal of winning one new customer a day, which they were able to meet in that during the first couple of months, they acquired several hundred customers for their subscription service.

In the winter of 2013, things started coming together. They entered into a partnership with AAF Flanders, the country's largest filter manufacturer, to make their filters. This move allowed Barry and Tarkington to accelerate the growth of the business. Based on the momentum they were generating, in December 2013 they raised a $310,000 seed round of funding. The seed round provided them the ability to improve their website, ramp up their marketing, and add people to their team. It also provided them access to mentors who had a track record of building successful online businesses.

FilterEasy launched an updated website in March 2014. They continued to gain momentum and by early 2015 had over 10,000 subscribers. The subscriber count enabled the company to raise another round of funding, which led to additional hires in marketing, customer support, and engineering. They also revamped their branding which included a new logo and mascot. The mascot, who is named Effie and can be seen on FilterEasy's website, is an elephant with a string around its trunk. Elephants have good memories and so does FilterEasy's reliable subscription service.

As FilterEasy acquired additional funding and gained access to more experienced mentors, its growth strategy evolved. FilterEasy is now both a B2C and a B2B company. Its B2C operation continues to build its subscriber base of individual consumers. Its B2B operations, which are newer, involve initiatives in several channels. One is apartment complexes and corporations, which require hundreds or thousands of air filters during each replacement cycle rather than just a few. Recently, FilterEasy partnered with several energy companies that provide electricity and natural gas to customers in the United States and parts of Canada. In an effort to help their customers conserve energy and live in healthier surroundings, the statements that these energy companies sends their customers every month now includes an option to opt-in to FilterEasy's subscription service. FilterEasy is looking to secure more partnerships of this nature, given their tremendous upside potential. FilterEasy has also grown via acquisition. It has purchased two smaller filter delivery services.

FilterEasy has hit its stride and is now growing via both internal and external growth strategies. Its future is not without challenges given that managing rapid growth is taxing for all companies. However, Barry and Tarkington remain committed to growing their firm profitably.

In this chapter, we discuss the most common strategies firms use to grow. The growth strategies are divided into internal strategies for growth and external strategies for growth, as shown in Figure 14.1.

Internal Growth Strategies

LEARNING OBJECTIVE

1. Identify and discuss the core internal growth strategy for entrepreneurial firms.

Internal growth strategies involve efforts taken within the firm itself, such as new product development, other product-related strategies, and international expansion, for the purpose of increasing sales revenue and profitability. Many businesses, such as Nest Labs, Sir Kensington's, and Zappos, are growing through internal growth strategies. The distinctive attribute of internally generated growth is that a business relies on its own competencies, expertise,

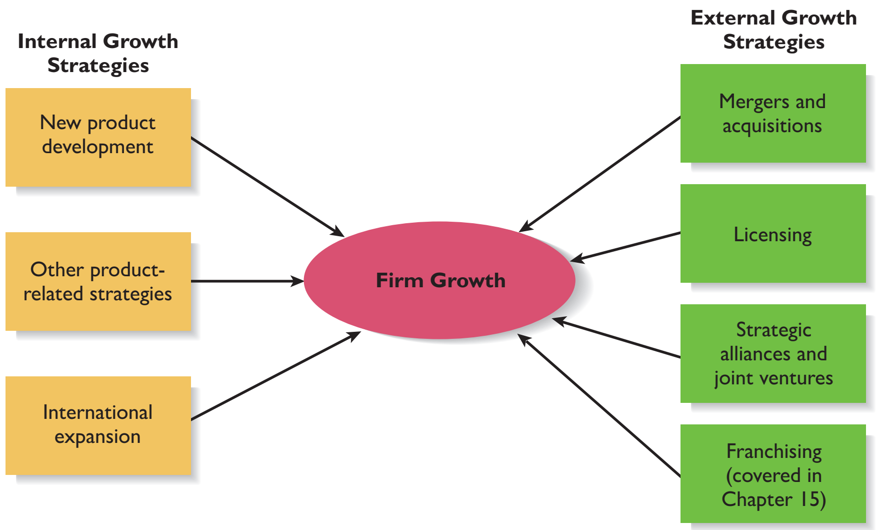

FIGURE 14.1
Internal and External Growth Strategies

business practices, and employees. Internally generated growth is often called **organic growth** because it does not rely on outside intervention. Almost all companies grow organically during the early stages of their organizational life cycles.

Effective though it can be, there are limits to internal growth. As a company enters the middle and later stages of its life cycle, sustaining growth strictly through internal means becomes more challenging. Because of this, the concern is that a company will "hit the wall" in terms of growth and will experience flat or even declining sales. This can happen when a company has the same product or service that it tries to sell to the same list of potential buyers. Companies in this predicament need to either expand their client list, add new products or services to complement their existing ones, or find new avenues to growth. Sometimes companies face this challenge through no fault of their own.

We list the distinct advantages and disadvantages of internal growth strategies in Table 14.1.

New Product Development

New product development involves designing, producing, and selling new products (or services) as a means of increasing firm revenues and profitability. In many fast-paced industries, new product development is a competitive necessity. For example, the average product life cycle in the computer software industry is 14 to 16 months, at the most. Just thinking of how quickly we are introduced to new computers, new smartphones, and related products highlights for us how rapidly products change in this industry. Because of these rapid changes, to remain competitive, software companies must always have new products in their pipelines. For some companies, continually developing new products is the essence of their existence.

Although developing new products can result in substantial rewards, it is a high-risk strategy. The key is developing innovative new products that aren't simply "me-too" products that are entering already crowded markets. When properly executed though, there is tremendous upside potential to developing new products and/or services. Many biotech and pharmaceutical companies, for example, have developed products that not only improve the quality of life for their customers but also provide reliable revenue streams. In many cases, the products are patented, meaning that no one else can make them, at least until the patents expire. Successful new products can also provide sufficient cash flow to fund a company's operations and provide resources to support developing additional new products.

TABLE 14.1 Advantages and Disadvantages of Internal Growth Strategies

Advantages	Disadvantages
Incremental, even-paced growth. A firm that grows at an even pace can continually adjust to changing environmental conditions to fine-tune its strategies over time. In contrast, a firm that doubles its size overnight through a merger or acquisition is making a much larger commitment at a single point in time.	**Slow form of growth**. In some industries, an incremental, even-paced approach toward growth does not permit a firm to develop competitive economies of scale fast enough. In addition, in some industries it may not be possible for a firm to develop sufficient resources to remain competitive. A high level of merger and acquisition activity typically characterizes these industries.
Provides maximum control. Internal growth strategies allow a firm to maintain control over the quality of its products and services during the growth process. In contrast, firms that grow through collaborative forms of growth, such as alliances or joint ventures, must share the oversight function with their business partners.	**Need to develop new resources**. Some internal growth strategies, such as new product development, require a firm to be innovative and develop new resources. While internal innovation has many positive attributes, it is typically slow, expensive, and risky.
Preserves organizational culture. Firms emphasizing internal growth are not required to blend their organizational culture with another organization. As a result, the venture can grow under the auspices of a clearly understood, unified corporate culture.	**Investment in a failed internal effort can be difficult to recoup**. Internal growth strategies, such as new product development, run the risk that a new product or service idea may not sell, making it difficult to recoup the development cost the firm incurred.
Encourages internal entrepreneurship. Firms that grow via internal growth strategies are looking for new ideas from within the business rather than from outsiders. This approach encourages a climate of internal entrepreneurship and innovation.	**Adds to industry capacity**. Some internal growth strategies add to industry capacity, and this can ultimately help force industry profitability down. For example, a restaurant chain that grows through geographic expansion may ultimately force industry profitability down by continuing to open new restaurants in an already crowded market.
Allows firms to promote from within. Firms emphasizing internal growth strategies have the advantage of being able to promote within their own organizations. The availability of promotional opportunities within a firm is a powerful tool for employee motivation.	

Pablo Calvog/Shutterstock

These young entrepreneurs are hoping to grow their organic food start-up via a smartphone app for their store. Here, they are reading some reviews about their app that customers posted.

For example, Amgen, a large and historically profitable biotech company, has several stellar pharmaceutical products, including Enbrel and Neupogen. Enbrel is a tumor necrosis factor (TNF) blocker that is used to treat rheumatoid arthritis as well as some related conditions; Neupogen helps prevent infection in cancer patients undergoing certain types of chemotherapy. These products have provided the company sufficient revenue to cover its overhead, fund new product development, and generate profits for an extended period of time.[1]

The keys to effective new product and service development, which are consistent with the material on opportunity recognition (Chapter 2) and feasibility analysis (Chapter 3), follow:

- **Find a need and fill it:** Most successful new products fill a need that is presently unfilled. "Saturated" markets should be avoided. For example, in the United States as well as in most developed countries, consumers have a more-than-adequate selection of appliances, tires, credit cards, and cell phone plans. These are crowded markets with low profit margins. The challenge for entrepreneurs is to find unfilled needs in attractive markets and then find a way to satisfy those unfilled needs.
- **Develop products that add value:** In addition to finding a need and satisfying it, the most successful products are those that "add value" for customers in some meaningful way.
- **Get quality and pricing right:** Every product represents a balance between quality and pricing. If the quality of a product and its price are not compatible, the product may fail and have little chance for recovery. To put this in slightly different terms, customers are willing to pay higher prices for higher-quality products and are willing to accept lower quality when they pay lower prices.
- **Focus on a specific target market:** Every new product and service should have a specific target market in mind, as we have highlighted throughout this book. This degree of specificity gives the innovating entrepreneurial venture the opportunity to conduct a focused promotional campaign and select the appropriate distributors. The notion that "it's a good product, so somebody will buy it" is a naïve way to do business and often contributes to failure.
- **Conduct ongoing feasibility analysis:** Once a product or service is launched, the feasibility analysis and marketing research should not end. The initial market response should be tested in customer interviews, focus groups, and surveys, and incremental adjustments should be made when appropriate.

There is also a common set of reasons that new products fail, as articulated by eSeller Media and shown in Table 14.2.[2] It behooves entrepreneurs to be aware of these reasons and to work hard to prevent new product failures as a result of poor execution in these areas.

TABLE 14.2 The Top 5 Reasons New Products Fail

1. The potential market was overestimated.
2. Customers saw the product as too expensive.
3. The product was poorly designed.
4. The product was no different than the competition's ("me too" products).
5. The costs of developing the product line were too high.

This discussion is a reminder that to achieve healthy growth, whether via the development of new products or another means, a firm must sell a product or service that legitimately creates value and has the potential to generate profits along with sales.

Additional Internal Product-Growth Strategies

LEARNING OBJECTIVE

2. Describe additional internal product-growth strategies entrepreneurial firms can use.

Along with developing new products, firms grow by improving existing products or services, increasing the market penetration of an existing product or service, or pursuing a product extension strategy.

Improving an Existing Product or Service

A business can often increase its revenue by **improving an existing product or service**—enhancing quality, making it larger or smaller, making it more convenient to use, improving its durability, or making it more up-to-date. Improving an item means increasing its value and price potential from the customer's perspective. For example, smartphone companies routinely increase revenues by coming out with "new" versions of their existing phones.

A mistake many businesses make is not remaining vigilant enough regarding opportunities to improve existing products and services. It is typically much less expensive for a firm to modify an existing product or service and extend its life than to develop a new product or service from scratch. For example, many women have set aside the flat irons that they've used for years to do their hair and have bought a ceramic flat iron because they're safer and do a better job. Selling "improved" flat irons is a much less expensive way for curling iron manufacturers to grow sales than to develop a completely new product.

Increasing the Market Penetration of an Existing Product or Service

A **market penetration strategy** involves actions taken to increase the sales of a product or service through greater marketing efforts or through increased production capacity and efficiency.[3] An increase in a product's market share is typically accomplished by increasing advertising expenditures, offering sales promotions, lowering the price, increasing the size of the sales force, or increasing a company's social media efforts. Consider Proactiv, the skin-care company. Since its inception in 1994, Proactiv has relied on celebrity endorsers to demonstrate and promote its product. Actress Judith Light and actress/singer Vanessa Williams were the firm's first celebrity endorsers. Over the years, the company has added additional celebrity endorsers to appeal to a broader and more diverse clientele. The additions include actress Jane Seymour, musical artists Katy Perry, Maite Perroni, and Justin Bieber, and tennis player Caroline Wozniacki.[4] Dr. Katie Rodan, a cofounder of Proactiv, points to the celebrity endorser program as one of the savviest actions the company has taken to build market share.[5]

Another example is the prepaid card, like the Starbucks Card, that almost all restaurants and retailers now offer. By making it more convenient for customers to purchase its products, restaurants and retailers boost their revenues. Prepaid cards also make it easier to give a restaurant's or retailer's offering as a gift. Think of how many people buy Target, Macy's, or Pottery Barn prepaid (gift) cards as birthday or holiday gifts. A benefit to those receiving these cards is the opportunity to use them to buy a product that fulfills a true need.

Increased market penetration can also occur through increased capacity or efficiency, which permits a firm to have a greater volume of product or service to sell. In a manufacturing context, an increase in product capacity can occur by expanding plant and equipment or by outsourcing a portion of the production process to another company. **Outsourcing** is work that is done for a company by people other than the company's full-time employees.[6] For example, a firm that previously manufactured and packaged its product may outsource the packaging function to another company and as a result free up factory space to increase production of the basic product. Additionally, a firm might outsource its information technology function to free up resources that could be invested in product development efforts.

Extending Product Lines

A **product line extension strategy** involves making additional versions of a product so that it will appeal to different clientele or making related products to sell to the same clientele.[7] For example, a company may make another version of a low-end product that is a little better and then make another version of it that represents the top of the line to appeal to different clientele. This is a strategy that allows a firm to take one product and extend it into several products without incurring significant additional development expense. Computer manufacturers provide a good example of how to execute a product line extension strategy. Each manufacturer sells several versions of its desktop and laptop computers. The different versions of the same computer typically represent good, better, and best alternatives based on processor speed, memory capacity, monitor size, graphic capabilities, and other features. In regard to making related products to sell to the same clientele, many firms start by offering one product or service and then expand into related areas.

Firms also pursue product extension strategies as a way of leveraging their core competencies into related areas. For example, Zipcar, the popular car sharing service, has applied the expertise it developed through its consumer car sharing service to launch Zipcar for business, an initiative that allows businesses to use Zipcar's services in the same way that individuals do. Similarly, it recently launched FastFleet, a service to help cities more efficiently use cars in their fleet. An account of the history of Oracle, a computer database software company, provides a particularly interesting example of the potential payoff of a product extension strategy. The example demonstrates that product extension strategies can take time and patience to pay off but can lead to breakthrough growth strategies:

> As Ellison [Oracle's CEO] recognized that he had sold a database to almost every one of the biggest companies in the world, he knew he would need new products to sell. That is how he came up with the idea of applications. Oracle applications would sit on top of and use Oracle databases to perform functions such as inventory management, personnel record keeping, and sales tracking. The proof of his thinking took almost seven years, but by 1995, the company generated nearly $300 million in license revenues from application products and an additional $400 million in applications-related services.[8]

Geographic Expansion

Geographic expansion is another internal growth strategy. Many entrepreneurial businesses grow by simply expanding from their original location to additional geographic sites. This type of expansion is most common in retail settings. For example, a small business that has a successful retail store in one location may expand by opening a second location in a nearby community. Gap Inc., Walgreens, and Panera Bread are examples of firms that have grown through geographic expansion. Of course, McDonald's, which now has almost 37,000 worldwide locations, is the classic example of incredibly successful growth through geographic expansion. Subway is another firm achieving a significant level of success through geographic expansion, with nearly 34,000 units across the globe. The keys to successful geographic expansion follow:

- **Perform successfully in the initial location:** Additional locations can learn from the initial location's success.
- **Establish the legitimacy of the business concept in the expansion locations:** For example, a particular type of fitness center may be well accepted in its original location because it has been there a long time and has a loyal clientele. However, potential clientele in a neighboring community may be completely unfamiliar with its unique products and services. A common mistake an entrepreneurial venture makes when it expands from one community to another is to assume that if something works in one community, it will automatically work in another.
- **Don't isolate the expansion location:** Sometimes the employees in an expansion location feel isolated and that they are not receiving adequate training and oversight from the headquarters location. It is a mistake to believe that an expansion location can excel without the same amount of attention and nurturing that it took to build the business in the original location.

Product-related strategies, regardless of the form they take, work best when a company remains vigilant about making sure the product remains in demand and consumer trends aren't turning against it. A lack of vigilance in this area contributed to the failure of Crumbs Bake Shop, a company that at one time was the most popular cupcake-focused bake shop in the United States. A description of why Crumbs failed, which is an example all entrepreneurial firms can learn from, is provided in the nearby "What Went Wrong?" feature.

International Expansion

LEARNING OBJECTIVE

3. Examine international expansion as a growth strategy.

International expansion is another common form of growth for entrepreneurial firms.[9] According to the SBA Office of Advocacy, U.S. companies exported goods and services worth a record $2.3 trillion in 2014. In terms of individual businesses, 97 percent of all U.S. exports are accounted for by small businesses.[10] A look at the world's population and purchasing power statistics affirms the importance of international markets for growth-oriented firms. Approximately 95.6 percent of the world's population and 70 percent of its total purchasing power are located outside the United States. Influenced by these data, an increasing number of the new firms launched in the United States today are international new ventures.

International new ventures are businesses that, from inception, seek to derive competitive advantage by using their resources to sell products or services in multiple countries.[11] From the time they are started, these firms, which are sometimes called "global start-ups" or "born globals," view the world as their marketplace rather than confining themselves to a single country. Becoming an international new venture can be intentional or can result from unsolicited orders from foreign buyers. For example, uShip is an Austin, TX, company that operates an online marketplace for shipping services. Shortly after it launched in 2003, overseas customers started arranging shipments via uShip's website. uShip is now in approximately 20 countries and has an office in Amsterdam.[12]

WHAT WENT WRONG?

Lessons for Growth-Minded Start-Ups from Crumbs Bake Shop's Failure

Crumbs Bake Shop was founded in 2003 by Jason and Mia Bauer, a husband-and-wife team. The idea was to sell gourmet cupcakes. The cupcakes came in an assortment of sizes and fillings. Most of the cupcakes were familiar flavors, such as cookie dough, tiramisu, and caramel apple. There were also cupcakes named after celebrities like Elvis Presley and Artie Lange. The cupcakes came in three main sizes: the mini "taste" size, the "classic" size, and the "signature" size. The signature size cupcakes, which were nearly double the size of standard cupcakes, cost anywhere from $3.50 to $4.50. Crumbs placed small signs in front of each cupcake or baked good reporting the price and calorie count. The blackbottom cheesecake brownie cupcake was reported to have 1,090 calories. In its latter years, Crumbs made a $42 "Colossal" cupcake that served as many as eight people.

Crumbs expanded quickly and soon became the largest cupcake chain in the United States. At its peak it had expanded to 79 locations with plans for many more. It broadened its approach some but primarily stuck to selling cupcakes. In early 2011, Crumbs was sold to a shell company, which took it public that June. For the first time, its same-store sales started to decline. The company's new CEO, Edward Slezak, tried a new approach to growth—striking licensing deals to sell Crumbs-branded products in other stores. He also started closing unprofitable locations. In mid-2013, Crumbs announced a partnership with David Burke, a well-known chef and restaurateur, to begin marketing a new line of gourmet sandwiches and salads at select Crumbs locations. The partnership ended roughly a month later due to poor sales. In late 2013, Crumbs opened a gluten-free store in downtown Manhattan in New York City.

On July 8, 2014, Crumbs announced that it planned to close all of its stores. The company's stock had been delisted several days earlier by the NASDAQ Stock Exchange. The company warned that the delisting would cause it to default on up to $14 million in debt. A sad ending. At one time Crumbs was proud and growing. Now it was closing. What went wrong? Several things—all of which provide valuable lessons for growing entrepreneurial firms.

First, an increasingly crowded market. When Crumbs opened in 2003, it was unique. There were only a handful of bakeries devoted to cupcakes nationwide. By 2011, the year Crumbs' same-day sales started to decline, there were many. Some were bakeries and some were simple kiosks. In addition, almost any bakery could add gourmet cupcakes to its product offerings if it wanted to do so.

Second, consumers started losing interest in cupcakes. When Crumbs opened, cupcakes were hot. Consumers eventually moved on. To illustrate this point, *The Wall Street Journal* ran an article in early 2013 titled "Forget Gold, the Gourmet-Cupcake Market is Crashing," in which it reported Crumbs' declining sales. While its drop in sales was attributed in part to Hurricane Sandy (many of Crumbs' restaurants were in the New York City area), *The Wall Street Journal* article said that Crumbs was suffering from a larger problem: "gourmet-cupcake burnout."

Third, high real estate costs. Crumbs had nice stores. Many were large for a single-product company. Its shops averaged about 1,000 square feet. One Crumbs Bake Shop near Chicago, according to a 2014 *Business Insider* article, measured 3,300 square feet. That's about the same size as a generous four-bedroom home.

Fourth, no pivot or change in strategy. Despite falling same-store sales, Crumbs kept opening new locations. It added 35 locations from mid-2011 to 2013 alone. This was during a period in which it knew its same-store sales were declining. It also maintained its focus on cupcakes, with no serious attempt to diversify. A challenge with selling a product like cupcakes is that it's an occasional rather than a regular purchase. While people might eat at the same restaurant every day or buy bread from the same bakery several times a week, very few people buy items like gourmet cupcakes more than occasionally.

Questions for Critical Thinking

1. What are three lessons that other start-ups can learn from Crumbs' failure?
2. To what degree do you think Crumbs should have been able to anticipate a decline in interest in gourmet cupcakes?
3. Why do you think Crumbs doggedly stuck to its singular focus on selling cupcakes, in light of declining same-store sales?
4. Was Crumbs' failure preventable? What, if anything, could have been done to save Crumbs? Based on the material in the chapter, what types of growth could Crumbs have pursued that it failed to pursue?

Sources: H. Peterson, "4 Reasons Why Crumbs Bake Shop Massively Failed," *Business Insider*, available at https://www.businessinsider.com/4-reasons-why-crumbs-bake-shop-closed-2014-7 (posted July 8, 2014, accessed July 8, 2014); Wikipedia, Crumbs Bake Shop, www.wikipedia.com (accessed April 9, 2017); E. Maltby and S. Needleman, "Forget Gold, the Gourmet-Cupcake Market is Crashing," *The Wall Street Journal,* April 17, 2013.

Although there is vast potential associated with selling overseas, it is a fairly complex form of firm growth. Of course, alert entrepreneurs should carefully observe any changes in purchasing power among the world's societies that may result from a financial crisis like the one the world experienced in 2008 and 2009. Let's look at the most important issues that entrepreneurial firms should consider in pursuing growth via international expansion.

Assessing a Firm's Suitability for Growth through International Markets

Table 14.3 provides a review of the issues that should be considered, including management/organizational issues, product and distribution issues, and financial and risk management issues, when a venture considers expanding into international markets. If these issues can be addressed successfully, growth through

TABLE 14.3 Evaluating a Firm's Overall Suitability for Growth through International Markets

Management/Organizational Issues

Depth of management commitment. A firm's first consideration is to test the depth of its management commitment to entering international markets. Although a firm can "test the waters" by exporting with minimal risk, other forms of internationalization involve a far more significant commitment. A properly funded and executed international strategy requires top management support.

Depth of international experience. A firm should also assess its depth of experience in international markets. Many entrepreneurial firms have no experience in this area. As a result, to be successful, an inexperienced entrepreneurial firm may have to hire an export management company to familiarize itself with export documentation and other subtleties of the export process. Many entrepreneurial firms err by believing that selling and servicing a product or service overseas is not that much different than doing so at home. It is.

Interference with other firm initiatives. Learning how to sell in foreign markets can consume a great deal of entrepreneurs' or managers' time. Overseas travel is often required, and selling to buyers who speak a different language and live in a different time zone can be a painstaking process. Overall, efforts must be devoted to understanding the culture of the international markets the venture is considering. Thus, a firm should weigh the advantages of competing in international markets against the time commitment involved and the potential interference with other firm initiatives.

Product and Distribution Issues

Product issues. A firm must first determine if its products or services are suitable for overseas markets. Many pertinent questions need to be answered to make this determination. For example, are a firm's products subject to national health or product safety regulations? Do the products require local service, supplies, or spare parts distribution capability? Will the products need to be redesigned to meet the specifications of customers in foreign markets? Will foreign customers find the products desirable? All these questions must have suitable answers before entering a foreign market. A firm can't simply "assume" that its products are salable and easily serviceable in foreign countries.

Distribution issues. How will the product be transported from the United States to a foreign country? Alternatively, how would an entrepreneurial firm transport a product produced in Sweden to a market in the United States? Is the transportation reliable and affordable? Can the product be exported from the venture's home operation, or will it have to be manufactured in the country of sale?

Financial and Risk Management Issues

Financing export operations. Can the foreign initiative be funded from internal operations, or will additional funding be needed? How will foreign customers pay the firm? How will the firm collect bad debts in a foreign country? Informed answers to these questions must be obtained before the firm initiates overseas sales.

Foreign currency risk. How will the firm manage fluctuations in exchange rates? If the entrepreneurial firm is located in the United States and it sells to a buyer in Japan, will it be paid in U.S. dollars or in Japanese yen?

international markets may be an excellent choice for an entrepreneurial firm. The major impediment in this area is not fully appreciating the challenges involved.

Foreign Market Entry Strategies

The majority of entrepreneurial firms first enter foreign markets as exporters, but firms also use licensing, joint ventures, franchising, turnkey projects, and wholly owned subsidiaries to start international expansion.[13] These strategies, along with their primary advantages and disadvantages, are explained in Table 14.4.

Selling Overseas

Many entrepreneurial firms first start selling overseas by responding to an unsolicited inquiry from a foreign buyer. It is important to handle the inquiry appropriately and to observe protocols when trying to serve the needs of customers

TABLE 14.4 Primary Advantages and Disadvantages of Various Foreign-Market Entry Strategies

Foreign-Market Entry Strategy	Primary Advantage	Primary Disadvantage
Exporting. Exporting is the process of producing a product at home and shipping it to a foreign market. Most entrepreneurial firms begin their international involvement as exporters.	Exporting is a relatively inexpensive way for a firm to become involved in foreign markets.	High transportation costs can make exporting uneconomical, particularly for bulky products.
Licensing. A licensing agreement is an arrangement whereby a firm with the proprietary rights to a product grants permission to another firm to manufacture that product for specified royalties or other payments. Proprietary services and processes can also be licensed.	The licensee puts up most of the capital needed to establish the overseas operation.	A firm in effect “teaches” a foreign company how to produce its proprietary product. Eventually, the foreign company will probably break away and start producing a variation of the product on its own.
Joint ventures. A joint venture involves the establishment of a firm that is jointly owned by two or more otherwise independent firms. Fuji-Xerox, founded in 1962, for example, is a joint venture between an American and a Japanese firm.	Gaining access to the foreign partner’s knowledge of local customs and market preferences.	A firm loses partial control of its business operations.
Franchising. A franchise is an agreement between a franchisor (the parent company that has a proprietary product, service, or business method) and a franchisee (an individual or firm that is willing to pay the franchisor a fee for the right to sell its product, service, and/or use its business method). U.S. firms can sell franchises in foreign markets, with the reverse being true as well.	The franchisee puts up the majority of capital needed to operate in the foreign market.	Quality control.
Turnkey projects. In a turnkey project, a contractor from one country builds a facility in another country, trains the personnel that will operate the facility, and *turns* over the *keys* to the project when it is completed and ready to operate.	Ability to generate revenue.	It is usually a one-time activity, and the relationships that are established in a foreign market may not be valuable to facilitate future projects.
Wholly owned subsidiary. A firm that establishes a wholly owned subsidiary in a foreign country has typically made the decision to manufacture in the foreign country and establish a permanent presence.	Provides a firm total control over its foreign operations.	The cost of setting up and maintaining a manufacturing facility and permanent presence in a foreign country can be high.

in foreign markets. The following are several rules of thumb for selling products in foreign markets:

- Answer requests promptly and clearly. Do not ignore a request just because it lacks grammatical clarity and elegance. Individuals using a nonnative language to contact a business located outside their home nation may be inexperienced with using a second language.
- Replies to foreign inquires, other than e-mail or fax, should be communicated through some form of airmail or overnight delivery. Ground delivery is too slow in some areas of the world.
- A file should be set up to retain copies of all foreign inquiries. Even if an inquiry does not lead to an immediate sale, the names of firms that have made inquiries will be valuable for future prospecting.
- Keep promises. The biggest complaint from foreign buyers about U.S. businesses is failure to ship on time (or as promised). The first order is the most important in that it sets the tone for the ongoing relationship.
- All correspondence should be personally signed. Form letters are offensive in some cultures.
- Be polite, courteous, friendly, and respectful. This is simple common sense, but politeness is particularly important in some Asian cultures. In addition, avoid the use of business slang that is indigenous to the United States, in that the slang terms lack meaning in many other cultures. Stated simply, be sensitive to cultural norms and expectations.
- For a personal meeting, always make sure to send an individual who is of equal rank to the person with whom he or she will be meeting. In some cultures, it would be seen as inappropriate for a salesperson from a U.S. company to meet with the vice president or president of a foreign firm.

External Growth Strategies

LEARNING OBJECTIVE

4. Discuss different types of external growth strategies.

External growth strategies rely on establishing relationships with third parties. Mergers, acquisitions, strategic alliances, joint ventures, licensing, and franchising are examples of external growth strategies. Each of these strategic options is discussed in the following sections, with the exception of franchising, which we consider separately in Chapter 15.

An emphasis on external growth strategies typically results in a more fast-paced, collaborative approach toward growth than the slower-paced internal strategies, such as new product development and expanding to foreign markets. External growth strategies level the playing field between smaller firms and larger companies.[14] For example, Pixar, the small animation studio that produced the animated hits *Toy Story*, *Finding Nemo*, and *Piper*, had a number of key strategic alliances with Disney before Disney acquired Pixar in 2006. By partnering with Disney, Pixar effectively co-opted a portion of Disney's management savvy, technical expertise, and access to distribution channels. The relationship with Disney helped Pixar grow and enhance its ability to effectively compete in the marketplace, to the point where it became an attractive acquisition target.

There are distinct advantages and disadvantages to emphasizing external growth strategies, as shown in Table 14.5.

Mergers and Acquisitions

Many entrepreneurial firms grow through mergers and acquisitions. A **merger** is the pooling of interests to combine two or more firms into one. An **acquisition** is the outright purchase of one firm by another. In an acquisition, the surviving

Eugenio Marongiu/Shutterstock

One thing that often surprises entrepreneurs is that growing a firm is as challenging as starting one. Here, a group of three entrepreneurs is evaluating the merits of a strategic alliance with another young firm.

TABLE 14.5 Advantages and Disadvantages of Emphasizing External Growth Strategies

Advantages	Disadvantages
Reducing competition. Competition is lessened when a firm acquires a competitor. This step often helps a firm establish price stability by eliminating the possibility of getting in a price war with at least one competitor. By turning potential competitors into partners and through alliances and franchises, the firm can also reduce the amount of competition it experiences.	**Incompatibility of top management**. The top managers of the firms involved in an acquisition, an alliance, a licensing agreement, or a franchise organization may clash, making the implementation of the initiative difficult.
Getting access to proprietary products or services. Acquisitions or alliances are often motivated by a desire on the part of one firm to gain legitimate access to the proprietary property of another.	**Clash of corporate cultures**. Because external forms of growth require the combined effort of two or more firms, corporate cultures often clash, resulting in frustration and subpar performance.
Gaining access to new products and markets. Growth through acquisition, alliances, or franchising is a quick way for a firm to gain access to new products and markets. Licensing can also provide a firm an initial entry into a market.	**Operational problems**. Another problem that firms encounter when they acquire or collaborate with another company is that their equipment and business processes may lack full compatibility.
Obtaining access to technical expertise. Sometimes, businesses acquire or partner with other businesses to gain access to technical expertise. In franchise organizations, franchisors often receive useful tips and suggestions from their franchisees.	**Increased business complexity**. Although the vast majority of acquisitions and alliances involve companies that are in the same or closely related industries, some entrepreneurial firms acquire or partner with firms in unrelated industries. This approach vastly increases the complexity of the combined business. The firm acquiring a brand or partnership with another company to gain access to its brand may subsequently fail to further develop its own brand and trademarks. This failure can lead to an increased dependency on acquired or partnered brands, reducing the firm's ability to establish and maintain a unique identity in the marketplace.
Gaining access to an established brand name. A growing company that has good products or services may acquire or partner with an older, more established company to gain access to its trademark and name recognition.	**Loss of organizational flexibility**. Acquiring or establishing a partnership with one firm may foreclose the possibility of acquiring or establishing a partnership with another one.
Economies of scale. Combining two or more previously separate firms, whether through acquisition, partnering, or franchising, often leads to greater economies of scale for the combined firms.	**Antitrust implications**. Acquisitions and alliances are subject to antitrust review. In addition, some countries have strict antitrust laws prohibiting certain business relationships between firms.
Diversification of business risk. One of the principal driving forces behind all forms of collaboration or shared ownership is to diversify business risk.	

firm is called the **acquirer**, and the firm that is acquired is called the **target**. This section focuses on acquisitions rather than mergers because entrepreneurial firms are more commonly involved with acquisitions than mergers.

Acquiring another business can fulfill several of a company's needs, such as expanding its product line, gaining access to distribution channels, achieving economies of scale, gaining access to technology that will enhance its current offerings, or gaining access to talented employees. In most cases, a firm acquires a competitor or a company that has a product line or a core competence that it needs. For example, as described in Case 11.1, in 2014 Nest Labs acquired Dropcam, a maker of security cameras. Nest upgraded and rebranded the cameras, which are now called Nest Cam Indoor and Nest Cam Outdoor, and added them to its product line. Similarly, in 2017 Walmart bought three relatively small e-commerce companies, Moosejaw, Shoebuy, and Modcloth. Each of the acquisitions gives Walmart access to new online buyers, and better positions the retail giant to compete more effectively with Amazon.com for Internet shoppers.[15]

Although it can be advantageous, the decision to grow the entrepreneurial firm through acquisitions should be approached with caution.[16] Many firms have found that the process of assimilating another company into their current operation is not easy and can stretch finances to the brink.

Finding an Appropriate Acquisition Candidate. If a firm decides to grow through acquisition, it is very important for it to exercise extreme care in finding acquisition candidates. Many acquisitions fail not because the companies involved lack resolve, but because they were a poor match to begin with. There are typically two steps involved in finding an appropriate target firm. The first step is to survey the marketplace and make a "short list" of promising candidates. The second is to carefully screen each candidate to determine its suitability for acquisition. The key areas to focus on in accomplishing these two steps are as follows:

- The target firm's openness to the idea of being acquired and its ability to receive consent for its acquisition from key third parties. The third parties from whom consent may be required include bankers, investors, suppliers, employees, and key customers.
- The strength of the target firm's management team, its industry, and its physical proximity to the acquiring firm's headquarters.
- The perceived compatibility of the target company's top management team and corporate culture with the acquiring firm's top management team and corporate culture.
- The target firm's past and projected financial performance.
- The likelihood the target firm will retain its key employees and customers if acquired.
- The identification of any legal complications that might impede the purchase of the target firm and the extent to which patents, trademarks, and copyrights protect the firm's intellectual property.
- The extent to which the acquiring firm understands the business and industry of the target firm.

The screening should be as comprehensive as possible to provide the acquiring firm sufficient data to determine realistic offering prices for the firms under consideration. A common mistake among acquiring firms is to pay too much for the businesses they purchase. Firms can avoid this mistake by basing their bids on hard data rather than on guesses or intuition.

Steps Involved in an Acquisition. Completing an acquisition is a nine-step process, as illustrated in Figure 14.2.

FIGURE 14.2 The Process of Completing the Acquisition of Another Firm

Step 1 Schedule a meeting with the target firm's executives: The acquiring firm should have legal representation at this point to help structure the initial negotiations and help settle any legal issues. The acquiring firm should also have a good idea of what it thinks the acquisition target is worth.

Step 2 Evaluate the feelings of the target firm's executives about the acquisition: If the target is in a "hurry to sell," it works to the acquiring firm's advantage. If the target starts to get cold feet, the negotiations may become more difficult.

Step 3 Determine how to most appropriately finance the acquisition: The acquiring firm should be financially prepared to complete the transaction if the terms are favorable.

Step 4 Actively negotiate with the target firm: If a purchase is imminent, obtain all necessary shareholder and third-party consents and approvals.

Step 5 Make an offer if negotiations indicate that doing so is appropriate: Both parties should have the offer reviewed by attorneys and certified public accountants (CPAs) who represent their interests. Determine how payment will be structured.

Step 6 Develop a noncompete agreement with key target firm employees who will be retained: As explained in Chapter 7, this agreement limits the rights of the key employees of the acquired firm to start the same type of business in the acquiring firm's trade area for a specific amount of time.

Step 7 Hire an attorney to prepare the closing documents: Complete the transaction.

Step 8 As soon as practical, meet with all employees to explain the acquisition: A meeting should be held as soon as possible with the employees of both the acquiring firm and the target firm. Articulate a vision for the combined firm and ease employee anxiety where possible.

Step 9 Move forward with the plan for adding the acquired firm to the organization: In some cases, the acquired firm is immediately assimilated into the acquiring firm's operations. In other cases, the acquired firm is allowed to operate in a relatively autonomous manner.

Along with acquiring other firms to accelerate their growth, entrepreneurial firms are often the targets of larger firms that are looking to enter a new market or acquire proprietary technology. Selling to a large firm is often the goal of an investor-backed company, as a way of creating a liquidity event to allow investors to monetize their investment. Some entrepreneurs allow their companies to be bought by larger firms as a way of accelerating their growth. For example in 2016, Justin's Nut Butter, the subject of Case 14.2, sold itself to Hormel, primarily as a means of integrating itself into Hormel's worldwide distribution channels. Hormel is now providing Justin's access to markets it could never have penetrated on its own.[17]

Licensing

Licensing is the granting of permission by one company to another company to use a specific form of its intellectual property under clearly defined conditions. Virtually any intellectual property a company owns that is protected by a patent, trademark, or copyright can be licensed to a third party. Licensing also works well for firms that create novel products but do not have the resources to build manufacturing capabilities or distribution networks, which other firms may already have in place.

Entrepreneurial firms can also benefit by licensing technology from larger companies. For example Mint.com, which is a free, web-based personal financial management service, licenses technology from Yodlee, a larger firm. Yodlee's technology enables Mint.com to access its members' account information, such as credit card balances and payment due dates.

The terms of a license are spelled out through a **licensing agreement**, which is a formal contract between a licensor and a licensee. The **licensor** is the company that owns the intellectual property; the **licensee** is the company purchasing the right to use it. A license can be exclusive, nonexclusive, for a specific purpose, and for a specific geographic area.[18] In almost all cases, the licensee pays the licensor an initial payment plus an ongoing royalty for the right to use the intellectual property. There is no set formula for determining the amount of the initial payment or the royalties—these are issues that are part of the process of negotiating a licensing agreement.[19] Entrepreneurial firms often press for a relatively large initial payment as a way of generating immediate cash to fund their operations.

There are two principal types of licensing: technology licensing and merchandise and character licensing.

Technology Licensing. **Technology licensing** is the licensing of proprietary technology that the licensor typically controls by virtue of a utility patent.[20] This type of licensing agreement commonly involves one of two scenarios. First, firms develop technologies to enhance their own products and then find noncompetitors to license the technology to spread out the costs and risks involved. Second, companies that are tightly focused on developing new products pass on their new products through licensing agreements to companies that are more marketing oriented and that have the resources needed to bring the products to market.

Striking a licensing agreement with a large firm can involve tough negotiations. An entrepreneur should carefully investigate potential licensees to make sure they have a track record of paying licensing fees on time and are easy to work with. To obtain this information, it is appropriate to ask a potential licensee for references. It is also important that an entrepreneur not give away too much in regard to the nature of the proprietary technology in an initial meeting with a potential licensee. This challenge means finding the right balance of piquing a potential licensee's interest without revealing too much. Nondisclosure agreements, described in Chapter 7, should be used in discussing proprietary technologies with a potential licensee.

Merchandise and Character Licensing. **Merchandise and character licensing** is the licensing of a recognized trademark or brand that the licensor typically controls through a registered trademark or copyright. For example, Harley-Davidson licenses its trademark to multiple companies that place the Harley trademark on T-shirts, jackets, collectibles, gift items, jewelry, watches, bike accessories, and so on. By doing this, Harley not only generates licensing income but also promotes the sale of Harley-Davidson motorcycles. Similarly, entrepreneurial firms such as eBay and Starbucks license their trademarks not only to earn licensing income, but also to promote their products or services to a host of current and potential customers.

The key to merchandise and character licensing is to resist the temptation to license a trademark too widely and to restrict licensing to product categories that have relevance and that appeal to a company's customers. If a company licenses its trademark too broadly, it can lose control of the quality of the products with which its trademark is identified. This outcome can diminish the strength of a company's brand. For example, a company such as Rent the Runway, an online company that rents designer dresses and accessories (and is the subject of Case 3.1), might license its trademark to a watch manufacturer that is interested in producing a line of Rent the Runway women's watches. Rent the Runway would want to make sure that the watches bearing its trademark were fashionable, were of similar quality to the clothing and accessories it rents, and were appealing to its clientele. Rent the Runway can enforce these standards through the terms of its licensing agreements.

There are additional hybrid forms of licensing. Many businesses use external forms of growth such as mergers and acquisitions, strategic alliances and joint ventures, licensing, and franchising. The "Savvy Entrepreneurial Firm" feature looks at Fetchr, a shipment and delivery technology app–based service in the Middle East that solves a peculiar problem of the region—a lack of formal physical address for shipments to be completed. Fetchr has quickly grown in the region through acquisitions and alliances.

Strategic Alliances and Joint Ventures

The increase in the popularity of strategic alliances and joint ventures has been driven largely by a growing awareness that firms can't "go it alone" and succeed.[21] As with all forms of firm growth, strategic alliances and joint ventures have advantages and disadvantages. We present these points in Table 14.6.

Strategic Alliances. A **strategic alliance** is a partnership between two or more firms that is developed to achieve a specific goal. Various studies show that participation in alliances can boost a firm's rate of patenting,[22] product innovation,[23] and foreign sales.[24] Alliances tend to be informal and do not involve the creation of a new entity (such as in a joint venture). Although engaging in alliances can be tremendously helpful for an entrepreneurial firm, setting up an alliance and making it work can be tricky. This dimension of alliances is highlighted in the nearby "Partnering for Success" feature.

Technological alliances and marketing alliances are two of the most common forms of alliances.[25] **Technological alliances** feature cooperation in research and development, engineering, and manufacturing. Research-and-development alliances often bring together entrepreneurial firms with specific technical skills and larger, more mature firms with experience in development and marketing. By pooling their complementary assets, these firms can typically produce a product and bring it to market faster and cheaper than either firm could alone.[26] Pfizer's blockbuster drug Celebrex, for example, was created via a technological alliance. Celebrex is a prescription arthritis medicine. **Marketing alliances** typically match a company that has a distribution system with a company that has a product to sell in order to increase sales of a product or service. For example, an American food company may initiate an alliance with Nestlé (a Swiss food

SAVVY ENTREPRENEURIAL FIRM

Fetchr: Growing Through Acquisitions and Alliances

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Imagine that you have to deliver a package but do not have an actual address for the courier company. This is a common dilemma in most of the Middle East, where a formal street address system is lacking in many places. One company that is trying to solve this problem is the Dubai-based Fetcher, which has revolutionized the traditional shipment and delivery business in the region through its innovative services. Fetchr was launched in 2012 by two entrepreneurs, Idriss Al Rifai and Joy Ajlouny, in the city of Dubai, United Arab Emirates, and it has made sending and receiving packages smooth, easy, and simple.

The United Arab Emirates shares the rest of the Middle East's problem, making the package delivery very unpredictable. Fetcher makes it possible with patented technology; the Fetchr app uses the GPS in customers' phones to determine their location, and it allows customers to pin down their locations using Google Maps for pick-up and delivery services within the price range $8 to $13, depending on weight.

Fetchr says that its mission is to save time for its customers and make their lives easier. Its founders believe that it should be the job of the logistics company to find the customer instead of the customer having to spend hours waiting for the logistics company to arrive for shipment pick-up or delivery. The Fetchr app also allows peer-to-peer transactions and also serves business needs.

The "Fetchr NOW" feature provides an immediate delivery solution to customers: the closest available driver is notified when a request is placed, and they go directly to the shipment's pickup location and deliver it to the receiver without making any stops. The service is available 24/7, depending on the availability of drivers. Customers can track their shipments in real-time and check to see an updated estimated time of arrival (ETA) via the app. The customer is charged only when the delivery completed.

Fetchr also offers its shipment services to big businesses, SMEs, retailers, online shops, e-commerce sites, social media sellers, banks, and any business that is looking to build, launch, and grow a profitable e-commerce and online business. Fetchr believes that the digital transformation is leading many retailers and traditional businesses to move online as they realize that brick and mortar cannot be the only offered channel.

Fetchr is the first Middle Eastern start-up to raise funding of $11 million from a top-tier Silicon Valley venture capital firm. In 2016, Fetchr signed a joint venture with Patel Integrated Logistics in India to launch a dedicated e-commerce set-up. As part of the venture, both companies were to invest around half a million dollars with the aim of opening 200 branches in India. In 2017, to expand into the Bahrain market, Fetchr acquired the Bahraini courier service company KRT from YBA Kanoo, one of the largest family-owned multinational business groups, in the Middle East. The aim of the acquisition was to work collaboratively to improve customer service with cutting-edge technology.

In the five years of its operation, Fetcher has grown significantly and has expanded to Saudi Arabia, Jordan, Oman, Bahrain, and Egypt and is looking to expand to other countries as well. Its external growth has taken place through acquisitions, alliances, and joint ventures. It further fueled its international expansion in four other countries—Jordan, Oman, and two undisclosed markets—through an additional round of external funding worth $41 million backed by US-based New Enterprise Associates and other firms. According to the founders, the external funding will enable Fetchr to expand geographically and add more technical staff. The company is pursuing aggressive growth in the region by diversifying the types of services and tapping into newer markets.

Questions for Critical Thinking

1. What gaps in the market does Fetchr fill? What has Fetchr's competitive edge been compared to courier service companies in the region?
2. Do you think the merger-and-acquisition model has been a good choice for Fetchr to expand internationally? When using this method, what areas should Fetchr focus on to find the right candidates?
3. Discuss what factors Fetchr should consider if it decides to use licensing to expand internationally.
4. Fethcr has relied on external funding to fuel its growth. Discuss the pros and cons of external funding to fuel its growth.

Sources: V.W. Sathis, "UAE, Indian Firms Enter into Logistics Joint Venture," *Emirates 24 Business*, August 12, 2016 (accessed December 1, 2017); Robert Anderson, "Dubai App Fetchr to Expand in Four Markets after $41m Funding Round," *Gulf Business*, June 3, 2017 (accessed December 1, 2017).

TABLE 14.6 Advantages and Disadvantages of Participating in Strategic Alliances and Joint Ventures

Advantages	Disadvantages
Gain access to a particular resource. Firms engage in strategic alliances and joint ventures to gain access to a particular resource, such as capital, employees with specialized skills, or modern production facilities.	**Loss of proprietary information**. Proprietary information can be lost to a partner who is already a competitor or will eventually become one. This is a common worry.
Economies of scale. In many industries, high fixed costs require firms to find partners to expand production volume as a means of developing economies of scale.	**Management complexities**. Because strategic alliances and joint ventures require the combined effort of two or more firms, managing them can be challenging. Frustrations and costly delays often occur as a result.
Risk and cost sharing. Strategic alliances and joint ventures allow two or more firms to share the risk and cost of a particular business endeavor.	**Financial and organizational risks**. The failure rate for strategic alliances and joint ventures is high.
Gain access to a foreign market. Partnering with a local company is often the only practical way to gain access to a foreign market.	**Risk of becoming dependent on a partner**. A power imbalance arises if one partner becomes overly dependent on the other. This situation increases the potential for opportunism on the part of the stronger partner. Opportunistic behavior takes advantage of a partner.
Learning. Strategic alliances and joint ventures often provide the participants the opportunity to learn from their partners.	**Partial loss of decision autonomy**. Joint planning and decision making may result in a loss of decision autonomy.
Speed to market. Firms with complementary skills, such as one firm being technologically strong and another having strong market access, partner to increase speed to market in hopes of capturing first-mover advantages.	**Partners' cultures may clash**. The corporate cultures of alliance partners may clash, making the implementation and management of the alliance difficult.
Neutralizing or blocking competitors. Through strategic alliances and joint ventures, firms can gain competencies and market power that can be used to neutralize or block a competitor's actions.	**Loss of organizational flexibility**. Establishing a partnership with one firm may foreclose the possibility of establishing a partnership with another firm.

Source: Based on B. R. Barringer and J. S. Harrison, "Walking a Tightrope: Creating Value Through Interorganizational Relationships," *Journal of Management* 26, no. 3 (2002): 367–403.

company) to gain access to Nestlé's distribution channels in Europe. The strategic logic of this type of alliance for both partners is simple. By finding more outlets for its products, the partner that is supplying the product can increase its economies of scale and reduce its per-unit cost. The partner that supplies the distribution channel benefits by adding products to its product line, increasing its attractiveness to those wanting to purchase a wide array of products from a single supplier.

Both technological and marketing alliances allow firms to focus on their specific area of expertise and partner with others to fill their expertise gaps. This approach is particularly attractive to entrepreneurial firms, which often lack the financial resources or time to develop all the competencies they need to bring final products to market quickly. Michael Dell describes the early years of Dell Inc. as follows:

> As a small start-up, we didn't have the money to build the components [used to manufacture a PC] ourselves. But we also asked, "Why should we want to?" Unlike many of our competitors, we actually had an option: to buy components from the specialists, leveraging the investments they had already made and allowing us to focus on what we did best—designing and delivering solutions and systems directly to customers. In forging these early alliances with suppliers, we created exactly the right strategy for a fast-growing company.[27]

Joint Ventures. A **joint venture** is an entity created when two or more firms pool a portion of their resources to create a separate, jointly owned

PARTNERING FOR SUCCESS

Three Steps to Alliance Success

Although alliances are an increasingly popular way for entrepreneurial firms to accelerate growth, they should be approached strategically and carefully. A failed alliance can cause a firm to lose money and can be very time consuming and frustrating to exit. Alliances are often compared to marriages and other close relationships: easy to get into but very hard to get out of—at least gracefully.

There are three key steps in setting up and executing a successful alliance relationship. The following are the three steps, along with words of advice on how to handle each one.

Selecting a Partner

Any company or group of companies that has something a firm needs is a potential alliance partner. For example, small food companies often partner with large food companies to gain access to their distribution channels. But a company should remember that a potential partner is looking for a leg up too, in the form of some type of advantage, while competing in the marketplace. If the small food company has to give the large food company "exclusive" distribution rights to its best products to get the deal, it may not be worth it. Entering into an alliance should improve a company's situation—it shouldn't be a jump ball. Alliances take a great deal of effort to manage and certainly to manage successfully. If each company in an alliance breaks even in terms of outcomes, the alliance is not usually worth it, because of the time and effort it takes from other activities.

Also, a firm should always investigate the reputation of the companies with whom it is thinking about partnering. Asking for references of other businesses the company is partnering with is appropriate, even if the company is well known. If a company is reluctant or unwilling to provide references, look elsewhere.

According to Guy Kawasaki, a respected Silicon Valley entrepreneur and venture capitalist, most companies form alliances for the wrong reason: to make the press and analysts happy. Kawasaki says this is foolish. Alliances should be formed for one of two reasons in Kawasaki's opinion: to either increase revenues or decrease costs.

Cutting the Deal

Negotiating an alliance can take multiple meetings, conference calls, Skype calls, and e-mail messages. So it's best to cut to the chase, as early as possible, to discern if a deal is possible. It is easy for a small firm to get sucked into months of negotiations with a large company like Facebook or Google, only to have the deal fall through. It probably won't hurt Facebook or Google if a handful of its employees lose time failing to negotiate an alliance agreement with a small firm. The lost time on the part of the small firm may be much more damaging.

The most important consideration in cutting a deal is to make sure the potential partners truly have synergies (i.e., $2 + 2 = 5$), and that the synergies are sustainable. Otherwise, experts agree, "no contract will hold them together." Also, firms should be leery of entering into an alliance if there is any hint that the people who will actually implement the alliance aren't totally on board. The worst-case scenario is two CEOs who meet at a conference and start talking about their two firms "working together." If they start kicking around alliance ideas that don't make sense, the mid-level people in an organization need to be empowered to hold their ground. The people who have to implement the alliance, for both organizations, should be heard. If they are less than enthused about an alliance proposal, it should be scrapped.

If an alliance agreement is struck, it should be accompanied by a set of operating principles that guide its day-to-day operation. It is also smart to include an "out" clause, which allows each party in the alliance to terminate its involvement relatively easily.

Making It Work

The biggest obstacle to making an alliance work is that the corporate cultures of organizations often vary in substantially important ways. As a result, the first thing that should be determined when deciding how to manage an alliance is how decisions are made. A start-up may be used to making decisions on the fly, while a large-company partner may route decisions through several committees before a final decision is made. Unless the partners know what to expect, frustrations can result.

Each alliance partner should also appoint an internal "champion" who has direct responsibility for the alliance's health and progress. "A bunch of people helping out when they can" doesn't cut it. An alliance should have a boss inside each involved organization, just as employees have bosses.

The individuals who will make the alliance work for all the parties involved should also meet face to face. It's normally easier for people to trust one another and work together across distances if they have met at least one time and have had an opportunity to get to know one another as individuals.

Questions for Critical Thinking

1. In what ways is it easy for a firm's founder to get caught up in the potential advantages of participating in alliances without remaining equally focused on the potential disadvantages?
2. Think about the partnership arrangements with which you have been involved, even if your experience has been limited to working with other students in team settings in classes. What are some of the challenges

in making alliances work that are not mentioned in this feature?

3. Do some Internet research and find an example of an alliance between a small firm and a large firm that seems to be working well. Briefly describe the nature of the alliance and explain its success.

Sources: G. Kawasaki, *The Art of the Start 2.0*, Portfolio, 2015. "*Inc*. Guidebook, Build Business Alliances," *Inc*, June 1, 2010.

organization.[28] An example is Cereal Partners Worldwide, which is a 50-50 joint venture between General Mills and Nestle. Formed in 1991, this joint venture markets breakfast cereals in 130 countries. According to General Mills' website, the joint venture marries the manufacturing expertise of General Mills with the worldwide presence of Nestle, which also has local market knowledge and distribution strength.[29]

Gaining access to a foreign market is a common reason for a firm to form a joint venture.[30] In these cases, the joint venture typically consists of the firm trying to reach a foreign market and one or more local partners. Joint ventures created for reasons other than foreign market entry are typically described as either scale or link joint ventures.[31] In a **scale joint venture**, the partners collaborate at a single point in the value chain to gain economies of scale in production or distribution. This type of joint venture can be a good vehicle for developing new products or services. In a **link joint venture**, the position of the parties is not symmetrical, and the objectives of the partners may diverge. For example, many of the joint ventures between American and European food companies provide the American partner with access to European markets and distribution channels and the European partner with the opportunity to add to its product line.

A hybrid form of joint venture that some larger firms utilize is to take small equity stakes in promising young companies. In these instances, the large companies act in the role of corporate venture capitalists, as explained in Chapter 10. Google established a venture capital program in 2009, originally named Google Ventures and now called GV. Investing in private companies, this program seeks to help start-up ventures grow from their initial stages to a point of either issuing an initial public offering or being acquired. Notable investments include Nest Labs, Blue Bottle Coffee, Uber, 23andMe, and Farmers Business Network.[32] Firms typically make investments of this nature in companies with the potential to be suppliers, customers, or acquisition targets in the future. The equity stake provides the large company a "say" in the development of the smaller firm. On occasion, the larger firm that has a small equity stake will acquire the smaller firm. These transactions are called **spin-ins**. The opposite of a spin-in is a **spin-out**, which occurs when a larger company divests itself of one of its smaller divisions and the division becomes an independent company. Hewlett-Packard, for example, spun off its test-and-measurement equipment division as Agilent Technologies, which advertises itself as the "world's premiere measurement company."

Chapter Summary

LO1. Internal growth strategies rely on efforts generated within the firm itself, such as new product development, other product-related strategies, international expansion, and Internet-driven strategies. External growth strategies rely on establishing relationships with third parties, such as mergers, acquisitions, licensing, strategic alliances, joint ventures, and franchising. The keys to effective new product development, which is the core internal growth strategy, are as follows: find a need and fill it, develop products that add value, get quality and pricing right, focus on a specific target market, and conduct an ongoing feasibility analysis. The reasons that new products fail include an inadequate feasibility analysis, overestimation of market potential, bad timing (i.e., introducing a product at the wrong time), inadequate advertising and promotion, and poor service.

LO2. Improving an existing product or service, increasing the market penetration of an existing product or service, extending product lines, and geographic expansion are additional internal product growth strategies entrepreneurial firms use. Improving an existing product finds a firm creating more value for the customer in the form of additional product functionality. With a market penetration strategy, the firm seeks to increase the sales of a product or service through greater marketing efforts or through increased production capacity and efficiency. To extend a product line, a firm typically creates additional versions of its product that will appeal to a different—that is, new—set of customers. Through geographic expansion, a firm seeks growth by expanding its operations from an initial site to additional locations.

LO3. International new ventures are businesses that, from inception, seek to derive significant competitive advantage from the use of resources and the sale of outputs in multiple countries. To successfully use this growth strategy, firms must master the complexity of profitably selling their product or service outside their home, domestic market.

LO4. Through external growth strategies, an entrepreneurial firm establishes relationships with third parties. Mergers, acquisitions, strategic alliances, joint ventures, licensing, and franchising are examples of external growth strategies. We concentrate on acquisitions in this chapter given their frequency with entrepreneurial firms compared to mergers. Acquiring another business can fulfill several of a company's needs, such as expanding its product line, gaining access to distribution channels, achieving competitive economies of scale, or expanding the company's geographic reach. A promising acquisition candidate has the following characteristics: operates in a growing industry, has proprietary products and/or processes, has a well-defined and established market position, has a good reputation, is involved in very little, if any, litigation, is open to the idea of being acquired by another firm, is positioned to readily obtain key third-party consent to an acquisition, and is located in a geographic area that is easily accessible from the acquiring firm's headquarters' location. Licensing is the granting of permission by one company to another company to use a specific form of its intellectual property under clearly defined conditions. Virtually any intellectual property a company owns can be licensed to a third party. Licensing can be a very effective way of earning income, particularly for intellectual property–rich firms, such as software and biotech companies. A strategic alliance is a partnership between two or more firms that is developed to achieve a specific objective or goal. Technological alliances involve cooperating in areas such as research and development, engineering, and manufacturing. Marketing alliances typically match one firm with a partner's distribution system that is attractive to the company trying to increase sales of its products or services. A joint venture is an entity that is created when two or more firms pool a portion of their resources to create a separate, jointly owned organization. In a scale joint venture, the partners collaborate at a single point in the value chain to gain economies of scale in production or distribution by combining their expertise. In a link joint venture, the position of the parties is not symmetrical and the objectives of the partners may diverge.

Key Terms

acquirer, **534**
acquisition, **532**
external growth strategies, **532**
geographic expansion, **527**
improving an existing product or service, **526**
internal growth strategies, **522**
international new ventures, **528**
joint venture, **539**
licensee, **536**
licensing, **536**
licensing agreement, **536**
licensor, **536**
link joint venture, **541**
marketing alliances, **537**
market penetration strategy, **526**
merchandise and character licensing, **537**
merger, **532**
new product development, **523**
organic growth, **523**
outsourcing, **527**
product line extension strategy, **527**
scale joint venture, **541**
spin-ins, **541**
spin-outs, **541**
strategic alliance, **537**
target, **534**
technological alliances, **537**
technology licensing, **536**

MyLab Entrepreneurship

If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

14-1. What is the difference between an internal and an external growth strategy?
14-2. What are the keys to a firm's effort to achieve success through new product and service development?
14-3. How does improving an existing product or service increase a business's revenue?
14-4. What is a market penetration strategy? Provide an example of a market penetration strategy and describe how using it effectively might increase a firm's sales.
14-5. What is a product line extension strategy? Provide an example of a product line extension strategy and describe how its effective use might increase a firm's sales.
14-6. What is an international expansion strategy? What are the keys to implementing this strategy successfully in an entrepreneurial firm?
✪ 14-7. What is an international new venture? Why might it be to the benefit of an entrepreneurial start-up to position itself as an international new venture from the outset?
14-8. What are the six foreign-market entry strategies and what are the key characteristics of each one?
14-9. What rules of thumb should an entrepreneurial venture follow to successfully sell its products overseas?
14-10. What is the difference between a merger and an acquisition? How can acquisitions help firms fill their needs?
✪ 14-11. What are some of the methods of identifying new products and services?
14-12. What is the difference between a licensor and a licensee?
14-13. What is the meaning of the term *licensing*? How can licensing be used to increase a firm's revenues?
14-14. What are the factors that determine whether a firm is suitable for growth in international markets?
14-15. What is the difference between technology licensing and merchandise and character licensing? Provide examples of both types of licensing and how they can increase a firm's sales.
14-16. Over the past several years, why have strategic alliances and joint ventures become increasingly prevalent growth strategies for entrepreneurial firms?
14-17. What is the difference between technological alliances and marketing alliances? Provide examples of both types of alliances and how they can increase a firm's sales.
14-18. What is a joint venture?
14-19. How does a joint venture differ from a strategic alliance?
14-20. What is the difference between a scale joint venture and a link joint venture? Provide examples of both types of joint ventures and how their effective use can increase a firm's sales.

Application Questions

14-21. Spend some time studying Made.com, the focus of You Be the VC 14.2. Is it more likely that Made.com will grow through internal rather than external growth strategies? What internal growth strategies or external growth strategies make sense for this firm?

14-22. Jessica Martin, a classmate of yours, just returned from an entrepreneurship boot camp that your university's technology incubator sponsored. The boot camp consisted of three days of intense focus on how to successfully launch a firm. You overheard Jessica telling another classmate that the boot camp was extremely helpful and she's already signed up for another three-day boot camp that will focus on how to successfully grow a firm. The classmate looked at Jessica and said, "How in the world can you spend three days talking about how to successfully grow a firm?" Jessica opened her notebook and showed the classmate the 10-item agenda for the upcoming three-day boot camp. What do you think the 10 items consist of? (Consider the material in Chapter 13 and this chapter in formulating your answer.)

14-23. Visit a local business in your vicinity. With permission from the owner or the manager, assess its suitability for growth using internal growth strategies. You may also discuss with them the internal growth strategies adopted by the business, if any.

14-24. Zynga is a social network game developer that develops browser-based games that work both as stand-alone games and as application widgets on social networking sites like Facebook. What are the pluses and minuses of Zynga's approach to launching games that rely on another company's platform (i.e., Facebook) to reach its intended audience? Is Zynga growing primarily via internal or external growth strategies?

14-25. Cisco Systems, Microsoft, and IBM often acquire small, technology-based entrepreneurial firms. Why would Cisco Systems, Microsoft, and IBM, which each employ hundreds of product development specialists and engineers, buy other firms to acquire technology and add to their product lines, rather than developing the technology and new products in-house?

14-26. Shana Adams needs to prepare an outline of a lecture for her class on foreign market entry strategies. Explain the advantages and disadvantages of each. Shana has to highlight the foreign entry strategies that have the highest and lowest risk as well.

14-27. Arthur Drake is looking to expand his bakery. He has been in the business for the last six years and feels that it is the right time for him to grow. He has looked at many options for growth, including merger and acquisition. After thorough investigation, he has finally decided on the latter. It is very important for him now to exercise care in finding the right acquisition candidates and completing the whole process. What steps should he take?

14-28. Rupert Dwine manufactures fruit juice and is planning on expanding his business. He has been looking for new ideas for growth. Suggest some internal growth strategies that may help him pursue his dream.

14-29. Study the popular social networking site LinkedIn. What growth strategies has the company employed? What are the most appropriate growth strategies for this firm to use going forward? Why?

YOU BE THE VC 14.1 COMPANY: Farmers Business Network

• Web: https://farmersbusinessnetwork.com • Facebook: Farmers Business Network, Inc. • Twitter: @ FBNFarmers

Business Idea: Create a platform that allows farmers to share data on all of their farming practices. The data is then pooled with data from similar farms in order to create analytics that provide farmers insights about costs, the best time to plant, the optimal amount of fertilizer to apply, the best time to harvest, the optimal time to market their grain, and other important factors.

Pitch: Imagine the following. You're having breakfast at a café in a rural Iowa town. There is a long table with a group of people drinking coffee. You can tell from their conversation that they are farmers. It's March and planting season is approaching. The farmers are talking about the seed corn they are about to buy. Two of the members of the group are comparing the prices they paid for an identical variety of Pioneer seed. They bought their seed from different dealers, and one person paid 15 percent more than the other. They each spent about $60,000 on corn seed, so 15 percent is $9,000. The farmer that paid the higher price said, "I'm trying your seed corn dealer this year. My 99 cent cup of coffee may have just saved me $9,000. Thanks for the information."

This type of conversation takes place in cafés, feed stores, and other places that farmers gather across the United States. The conversation illustrates a challenge that farmers face. Price transparency for farm inputs—whether its seed, fertilizer, or pesticides—is poor. Farmers often don't know if they're paying a fair price for an input, and the consequences can be enormous. If the farmer in the example provided above was planting twice as much corn as he is, he could have paid $18,000 more for his seed corn this year than his neighbor down the road.

Farmers Business Network (FBN) was started to address this problem. Launched in 2014, it is a mission-driven company that aggregates data provided by farmer-members. For $500 to $600 a year, a farmer can tap into a database of input costs and other pertinent information based on a network of 3,400 farms (and counting), spanning 12 million acres of farmland (roughly the size of Delaware and Maryland), and 25,000 invoices to date.

There are several systemic challenges that farmers face that hinder their ability to maximize profits. First is a lack of price transparency on input costs, as illustrated in the example just provided. Second, most of the vendors that farmers buy from (for seed, fertilizer, machinery, etc.) are oligopolies, meaning there are only a small number of suppliers. Only a small number of companies sell seed corn, for example, and the same is true for machinery, such as tractors and combines. This puts the farmer at a disadvantage in terms of bargaining power. Third, farmers tend to be very loyal, which in many respects is a good thing. Where it hurts them financially is if they're buying their seed corn from a neighbor, who sells seed corn as a side business, they may remain loyal to buying from the neighbor and not shop for the best price. Finally, farmers deal with an enormous number of variables in their work—when to plant, what type of seed to plant, how much fertilizer to apply, how much pesticide to apply, when to harvest, when to market their grain, and so on. As sophisticated as many farmers are, they still rely to a certain degree on guesswork. Data not only from their farm but from similar farms that shows historically the optimal time to plant, the optimal fertilizer to apply, the optimal time to harvest, and so forth is often not available but could be extremely helpful.

Farmers Business Network was conceived to plug these holes. It has two primary products. The first is the analytics it provides, based on the data that it collects from its members. The data it collects is strictly confidential—no individual data is ever shared. Only aggregate data is reported and analyzed. Second, it sells inputs itself. If a farmer is overpaying for seed corn, for example, it offers access to seed corn from established vendors often at a price savings. Farmers Business Network makes money by receiving a small commission on each sale that is made.

14-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

14-31. If you had to make your decision on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 14.2 COMPANY: Made.com

• Web: www.made.com • Twitter: @madedotcom

Business Idea: To make good furniture design and manufacture accessible to everyone.

The Pitch: Ning Li created Made.com after trying to find stylish and affordable furniture for his flat in Paris; the more he had looked, the more frustrated he had become with the lack of choice. He was determined to create an alternative, so he assembled a team around him. The goal was to work with quality manufacturers and bring great design and ideas to all consumers.

The net result was a range of timeless and fairly versatile products that were designed with quality and price in mind. The philosophy was that if it was good enough for their own homes, then it would be good enough for their customers.

Ning Li stepped down as CEO in 2016 after seven years with the company, though he remains involved as an advisor and majority shareholder. Li's main interest is creating new businesses and getting them established in the market. At the point he stepped down, Made.com had just topped $135 million and was seeing sales growth at a rate of 50 percent per year.

The business has come a long way in a short period of time. Li's success is largely down to a conversation with a Chinese friend who happened to be a furniture manufacturer. The Chinese business owner would sell sofas to agents for around $500; the agent would then resell to European wholesalers, and eventually the sofa would be seen in a retail store priced at over $4,000. Li's business model has focused on disrupting the supply chain to allow customers to buy directly from the manufacturer.

The European furniture industry has not changed in decades, but Made.com successfully established itself at a time when home purchasing via the Internet has seen huge growth. As a result, Made.com has grown to over 400 employees and expanded from the United Kingdom into Germany, Holland, Belgium, and France.

Li has worked with the replacement CEO Philippe Chainieux for a decade, and the plan is for the new CEO to focus on international expansion. Chaineiux has experience of complex international operations and has dealt with expansion and acquisition situations. Rumors spread that Chainieux was preparing the company for sale, but this was denied by Li. Instead, the immediate plans were to increase sales closer to $400 million. Since Chainieux took over, UK revenue has risen by 38 percent and international sales by 69 percent (this now accounts for 35 percent of the business). Made.com has also opened new showrooms in Paris and Berlin (they now have seven brick-and-mortar stores).

The short-term aim is to use their Internet technology to collect customer product views and create more unique products that anticipate and exceed their expectations. The latest growth area is a move into Austria and the creation of a wide new range of homeware, accessories, and gifts.

14-32. Based on the material covered in this chapter, what questions would you ask the firm's founder before making your funding decision? What answers would satisfy you?

14-33. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 14.1

Warby Parker: Pursuing an Omni-Channel Strategy for Firm Growth

• Web: www.warbyparker.com • Facebook: Warby Parker • Twitter: @WarbyParker

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

It all started in business school. In the fall of 2008, Neil Blumenthal and David Gilboa, both 28, were in the first year of their MBA program at the University of Pennsylvania's Wharton School. They were in a computer lab kicking around business ideas with classmates Andrew Hunt and Jeffrey Raider when the topic of eyeglasses came up. Gilboa had recently lost his glasses, and was shocked to learn that a replacement pair would cost $700. He recalled thinking that his iPhone cost $200. He thought how could an iPhone, that can do unimaginable things, cost $200 and a simple pair of glasses cost $700?

Blumenthal thought he had the answer. He had spent time working for VisionSpring, a nonprofit that distributes eyewear to low-income people in developing countries. While at VisionSpring, he learned that the global eyewear industry was dominated by a single company, Luxottica. Luxottica is the world's largest eyewear company and controls over 80 percent of the world's eyewear brands. It owns Oakley, Persol, Ray-Ban, Sunglass Hut, LensCrafters, and Pearle Vision. It also owns the eyewear stores located inside several major retail chains, including Sears Optical and Target Optical. Luxottica's near-monopoly status was the reason for the $700 glasses. That was the "aha" moment. The four thought that if VisionSpring could outfox Luxottica by manufacturing its own glasses for people in developing countries, why couldn't four business students do the same thing for people just like themselves?

Eyewear Industry

Before jumping ahead, Blumenthal and his three friends spent some time studying the eyewear industry. The term "eyewear" includes glasses, contacts, and sunglasses. They discovered four interesting characteristics about the industry. First, the industry had experienced very little innovation. Buying eyewear today isn't much different than it was 20 years ago. Second, there were virtually no brands on the market that evoked passion or that people were excited to be associated with. Third, only 1 percent of eyeglasses were bought online. They figured this was because people like to try on glasses before they buy them. Finally, they learned that eyeglasses can do tremendous good. The University of Michigan conducted a study to evaluate the impact of VisionSpring's efforts to provide eyeglasses to people who couldn't afford them in "Base of the Pyramid" countries. The study found that a pair of VisionSpring eyeglasses increased the monthly income of the user by 20 percent and overall productivity by 35 percent on average. Blumenthal and his classmates concluded that the eyewear industry was ripe for disruption. What they needed was a company that (1) had the courage to do an end-run around Luxottica by manufacturing its own glasses, (2) could lower the price by selling online, (3) knew how to create a brand that people could become passionate about, and (4) was willing to give away a pair of glasses to low-income people in the developing world for every pair the firm sold.

Warby Parker is Born

Warby Parker launched in 2010 as an online eyewear company, based on the principles shown above. All four founders were involved at launch, but soon afterwards Hunt and Raider moved on. The group tried out more than 1,000 names before deciding on Warby Parker. The name comes from two characters in Jack Kerouac books—Warby Pepper and Zagg Parker. Blumenthal and Gilboa secured Chinese manufacturers to produce frames and an Italian company to make lenses, allowing them to control the production of the glasses themselves. They decided on a price of $95 (the same price they charge today). The $95 price point, which includes a frame and a set of prescription lenses, was possible because the glasses were designed in-house, were manufactured overseas, and were sold online, eliminating many of the costs associated with traditional glasses manufacturing and retailing. They also didn't pay any licensing fees. Brands like Coach, Polo Ralph Lauren, and Gucci charge up to 15 percent of the price of a pair of glasses to put their names on them.

The buying process was set-up to work like this. You access Warby Parker's website, pick a frame, provide your prescription, and the glasses are shipped. If you are unsure about the frame you'd like, you can take advantage of Warby Parker's Home-Try-On program. The program allows customers to pick five frames, which they receive to try on at home for five days, free of charge. If you like one of the frames you order it online, provide your prescription, and the glasses are on their way. All orders include free shipping, a 30-day no-questions-asked return policy, and a 1-year scratch guarantee.

From the beginning, Warby Parker set out to create a hip, urban brand, targeting 18- to 34-year-olds. They wanted to pick a market and evoke excitement. They didn't spend much on marketing, with one exception. They wanted a public relations firm to help them obtain media coverage. They interviewed over 100 public firms and freelancers to get the right fit. They settled on Brandbury Lewis. Soon, they were featured in *Vogue* and *GQ*, which boosted their visibility with individuals in their target market. The glasses themselves were part of the branding strategy. They have simple frames with slightly chunky temples that feature subdued colors: gray, blue, and burgundy. The glasses have preppy, country names like those shown in the table below.

Sample of Warby Parker Men's Glasses

Name of Frame	Description
Nash	Whatever the scenario, Nash's vintage shape—generous, square frames—will make you sit straighter.
Roosevelt	A modern classic, Roosevelt is a large frame with a keyhole bridge.
Durland	Durland's round lenses and roomy width make a sharp first impression.
Milton	Constructed from lightweight Japanese titanium, Milton is an ever-so-slightly oversized and ultra-agreeable pair with round lenses.
Hardy	Hardy separates itself from the pack with a sloped rectangular eyeframe and clever keyhole bridge.

Warby Parker also promotes a social mission in that it gives away a pair of glasses for each pair it sells. While the company's efforts appear to be heartfelt, it has also been good for business. According to a recent study, about 80 percent of Americans are likely to switch brands, and if price and quality are similar, if a company starts supporting a compelling cause. Companies that

A Warby Parker retail store in New York City.


ZUMA Press, Inc./Alamy Stock Photo

support social causes are also more naturally viral, because people feel good about supporting them.

While Warby Parker is a private company and doesn't release sales figures, it is estimated that by the end of 2012 the company had sold more than 300,000 glasses.

Growth Strategies

Between 2013 and 2015, Warby Parker's estimated revenue nearly tripled from $35 million to $100 million. It also expanded its growth strategy from strictly online sales to placing pop-up stores in select locations, opening brick-and-mortar showrooms, and entering into strategic partnerships. It has also added to its product line. The company now sells progressive lenses, transitional lenses that shift from light to dark, and limited-edition collections of its glasses. There may be other avenues for growth in the works, beyond those that are being utilized at this time. Commenting on the evolution of Warby Parker's growth strategy, cofounder and CEO David Gilboa told *Fast Company* in early 2015:

> "When we launched, a lot of people bucketed us as an e-commerce company; but, we never thought of ourselves as an e-commerce company. And I think it surprised a lot of people when we started opening these stores (referring to Warby Parker's brick-and-mortar showrooms). The only products we sell now are glasses, but we think our brand can stand for much more than that over a long period of time."

The following is an analysis of the growth strategies Warby Parker is currently pursuing, beyond its staple online eyewear sales.

Pop-Up Stores. Pop-up stores allow online retailers to make short-term appearances in select locations and get customers they couldn't reach before to connect with them in person. If the effort is successful, the people they connect with will start following them online.

In 2012, Warby Parker repurposed a school bus and turned it into a classy mobile pop-up store. The bus then took a tour, dubbed "Class Trip," across the United States to test what cities the company would perform well in (as a potential prelude to opening brick-and-mortar stores). Another approach Warby Parker has pursued is setting up kiosks in the lobbies of hotels and in high-end shopping areas. For example, the company maintains a kiosk in Brookfield Place, which is a business and retail complex near the Freedom Tower in lower Manhattan (New York City). The kiosk is a 1960s-style newsstand stocked with books, postcards, and a curated collection of Warby Parker eyewear.
In 2015, Warby Parker partnered with Nordstrom to features its eyewear as part of the department store's monthly pop-up shops. At the time, Warby Parker cofounder David Gilboa said the Nordstrom partnership was not an experiment in wholesaling its products to retailers. Warby Parker sells direct to consumers, and it has not strayed from that path except via this one short-term partnership.

Brick-and-Mortar Stores. In early 2013, Warby Parker opened its first retail store in SoHo in New York City. The initial plans were to open two stores, but the response from the SoHo store was so positive that the company now has 48 stores with a goal of 70 stores by the end of 2017. The stores reflect Warby Parker's brand. They are uncluttered, beautifully designed, and are staffed by helpful salespeople. The stores vary in terms of their appearance. The SoHo store resembles a library while one of the company's Los Angeles stores is decked out like a 1950s beach club, with midcentury furniture and a burnished concrete floor in sea blue. In each store, the company's glasses are stacked invitingly on open wood shelves. The stores also feature books, vintage arcade games, full-length mirrors, and photo booths. Eye exams are offered by appointment. Salespeople use tablets to process orders and pull up customer purchase history, including which styles they've saved online. The stores also feature locally-made items and novelties. For example, when Warby Parker's Philadelphia store opened in 2017, for a limited time it sold lens cloths featuring Philly-based artist Andy Rementer's in-store artwork. It also gave away a hand-drawn map of all the best places to sit and read a book in the neighborhood.

The idea behind the stores is to create an "omni-channel strategy" in which the company's stores and its online presence complement one another. (See the nearby figure.) Rather than take away from online sales, the stores help them. Warby Parker has found that 30—50 percent of the people who shop in its stores are people who were unlikely to buy from the company online. However, 90 percent of the people in its stores have at least been to Warby Parker's website, and many of the customers who shop in the stores (and make a personal contact with the company) will then make a second or third purchase online. As a result, the two channels—retail and online—work together to drive sales. So far, the stores have performed extremely well. Sales are about $3,000 per square foot annually, a performance that is in the same range as Apple stores and Tiffany's.

Warby Parker is thinking big in terms of its retail expansion. Cofounder Neil Blumenthal has stated that the company may one day operate 800 to 1,000 physical stores.

Partnerships. Warby Parker has a number of partnerships. It partners with VisionSpring to make good on its promise to donate a pair of glasses for each pair sold. The way it works is that each month, Warby Parker tallies up the number of glasses sold and makes a donation to VisionSpring (and similar nonprofit partners). VisionSpring and the other nonprofits with whom Warby Parker works then train men and women in developing countries to give eye exams and sell glasses to their communities at affordable prices. This approach helps create an entrepreneurial culture in the countries where the glasses are sold. The men and women who sell the glasses earn a living, and it forces Warby Parker's partners to make glasses people want to buy. Currently, 703 million people worldwide live without access to eyewear. As mentioned earlier, a simple pair of properly prescribed glasses can increase an individual's productivity and monthly income significantly.

Warby Parker also has a partnership with New York City. In mid-2015, New York City mayor Bill de Blasio announced that the city was expanding its vision screening program to all 130 community schools and will partner with Warby Parker to provide a free pair of glasses to every student in need. Based on Mayor de Blasio's estimates, that will amount to approximately 20,000 students over the next four years.

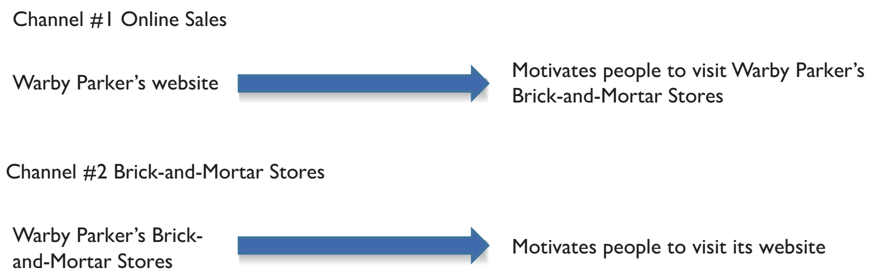
In regard to forming partnerships to grow sales, in addition to its regular offerings, Warby Parker produces a continuous stream of limited-edition collections of eyewear, generally designed and marketed with a strategic partner. Examples include a limited-edition collection with the musician Beck and David Egger's literary nonprofit 826NYC. These partnerships expose Warby Parker and its products to new sets of potential customers.

The Road Ahead

The road ahead for Warby Parker involves risks and opportunities. In regard to risks, although Warby Parker does not disclose sales and profits, the consensus is that the company is not yet profitable. While the company is deliberately focused on growth rather than near term profitability, the risk is if its losses widen and profits don't come as quickly as anticipated, the company could be forced to increase prices or cut costs. By opening stores, the company is also increasing its head count and committing itself to long-term commitments. For example, some of its stores are in locations that require 10-year leases. Its signature glasses could also go out of fashion.

In regard to opportunities, there are reasons to remain optimistic. The company is valued in excess of $1 billion. According to Crunchbase, Warby Parker has raised over $215 million. The most recent round was $100 million in April, 2015, which has been used to open stores. This amount of funding shows confidence on the part of equity investors. In regard to profitability,

Warby Parker's "Omni-Channel" Strategy



in December 2016, cofounder Neil Blumenthal told an audience at Bloomberg's headquarters in New York City that Warby Parker is "on the path to profitability," with healthy gross margins and an expanding and extremely loyal customer base. Warby Parker is also engaging and exploring new opportunities. In 2017, it will open its first optical lab to cut and insert lenses into frames. By making its own lenses, the company will be able to deliver glasses to its customers quicker. A longtime goal of the company has been to find a way to conduct eye exams via a mobile phone. Work on that ambition is ongoing.

Discussion Questions

14-34. How is Warby Parker able to sell eyewear at such a low price?

14-35. Explain the rationale behind Warby Parker's omni-channel strategy. Provide an example of another company, featured in this book that is pursuing a similar strategy. On a scale of 1 to 10 (10 is high), how much potential does this strategy have for increasing Warby Parker's sales and profitability?

14-36. In what markets, beyond eyewear, would Warby Parker's business model work? If Warby Parker decides to expand beyond eyewear, which market do you think it will tackle next?

14-37. In 2017, Warby Parker opened its first optical lab to cut and insert lenses into frames; this is the first step to becoming a vertically integrated company. Does it make sense for Warby Parker to do its own manufacturing? What are the pluses and minuses of moving in this direction?

14-38. Comment on the wisdom of Warby Parker's growth strategy.

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CASE 14.2

Justin's Nut Butter: Why do Large Companies Acquire Start-Ups and Why do Start-Ups Agree to be Acquired?

• *Web: www.justins.com* • *Facebook: Justin's* • *Twitter: @justins*

Bruce R. Barringer, *Oklahoma State University*

R. Duane Ireland, *Texas A&M University*

Introduction

After graduating from college in 2000, Justin Gold spent a year in California before settling in Boulder, CO. He waited tables to pay the rent, and enjoyed outdoor activities including hiking, climbing, and exploring. Gold was a vegetarian, and to get the protein he needed he started eating a lot of peanut butter and nut butter. He owned a food processor and found that making peanut butter was easy. To spice things up he started making different flavors of peanut butter by adding ingredients such as honey, cinnamon, dried blueberries, and banana chips. The whole idea was to create something for him to eat. Gold's roommates loved the stuff, and kept stealing it from the refrigerator. To discourage the thievery, Gold, in a good-natured way, scrawled his first name—Justin's—across each jar.

Gold's roommates encouraged him to set up a table at the Boulder Farmer's Market to see if his nut butter would sell. He gave it a try and the nut butter was a hit. The experience got Justin thinking. To sell at the Boulder Farmer's Market he had to make his nut butter in an FDA-approved facility. Today, many states allow small producers to make certain items out of their homes, but that wasn't the case in Colorado at the time. Gold figured that as long as he was going to the trouble of using an FDA–approved kitchen to make his nut butter for the farmer's market, he might approach some stores as well.

The Beginnings of a Business

To educate himself on how to convert his hobby into a business, Gold spent hours thumbing through business books. He found a book that contained business plans, and one plan caught his eye. It was for a tomato canning company. Gold used that plan as the model for his first business plan. He also reached out for advice. At one point, he went to a local grocery store and found the area that featured locally produced products. He wrote down the names and contact information for every area company he could find and told them about his ideas. After receiving feedback, he wrote his first business plan in 2002. Based on the strength of the plan, he was able to raise $25,000 from friends and family.

Gold struck a deal with a Salsa company in Denver to make his product and slowly started getting distribution. While it took some persistence, he landed Whole Foods Market, which initially placed his product in its Rocky Market Region. He also wondered whether he could sell his peanut butter and nut butter in small gel packs. He called everyone he could think of that placed products in small squeeze packs, including Heinz, which packages ketchup in small packs (the types of packs you get at fast-food restaurants). Because no one offered to help him, he decided to go it alone. At one point he rewrote his business plan to include the cost of a squeeze-pack machine. Based on his new idea, he was able to raise an additional $120,000 from friends and family. After experimenting some with how to position the squeeze packs in a grocery store, they started selling.

Growth Years

The next 10 years were growth years for Justin's. Gold hired an experienced CEO, Lance Gentry, to help build the company and spur growth. Gentry had helped build Izzy, a local beverage company, which grew from a start-up to $25 million in sales before it was acquired by Pepsi. He also put together an experienced Board of Advisors. By 2009, Justin's was able to raise $1 million in funding. In 2010, Gold got the idea to make peanut butter cups. He wanted to produce an organic, all-natural peanut butter cup, as an alternative to Reese's. It took time to locate a chocolatier to work with him, but he finally found a small family-oriented company that would make his product. Gold considered this to be a pivotal juncture for his company. If he could produce and sell another product, Justin's could essentially become a platform from which multiple products could be conceived, produced, and sold. The peanut butter cups were a hit. They quickly became the company's biggest revenue producer.

As he built his team, Gold used a unique formula. Each employee he hired was paid a below-average salary but was given stock in Justin's to compensate. Justin maintained that by giving everyone stock he incented each employee to treat the company as if it were her or his own.

After operating for a few years, Justin's was hitting on all cylinders. Its products were available in Whole Foods Markets, Target, Safeway, Kroger, and a number of specialty retailers and coffee shops across the country. Its products included several flavor combinations for nut butter and peanut butter, squeeze packs with the same flavor combinations, several flavors of peanut butter cups, and a new product, called Snack Packs. The Snack Packs were small packs, the kind a mom might put in one of her kid's school lunch bag. Snack Packs' choices include Maple Almond Butter and Pretzels, Honey Peanut Butter and Banana Chips, Classic Almond Butter and Pretzels, and several other combinations. Justin's also sold a cookbook titled *Justin My Kitchen*.

During its growth years, Justin's remained in Boulder, CO. It also built a unique culture, based on its cadre of owner-employees. In 2015, *The Wall Street Journal* reported that Justin's annual revenue exceed $50 million. Justin's also hired a former Hain Celestial executive, Peter Burns, as its co-CEO.

Two significant events took place, one in 2013 and one in 2016 that further advanced Justin's potential for growth.

Merger with VMG Partners

In October 2013, Justin's merged with VMG Partners, a California-based private equity firm. VMG specializes in investing in and building branded consumer products companies. The merger netted Justin's $47 million in a combination of equity, options, and securities. When asked to comment on the merger, Gold said "We (are) having a hard time keeping up with demand, and when you grow really fast, quality sometimes can suffer. This was a need to find smart capital to invest in us and help us achieve our goals." He also said the company would stay in Boulder, it would be hiring new people as a result of the merger, and that its day-to-day operations would not change. Speaking on behalf of VMG Partners, Wayne K. Wu, a VMG principal, said that in addition to providing capital his firm could assist Justin's in the sophistication of its operations and in its sales strategy. True to his word, Gold kept the company in Boulder and the company's growth accelerated. Reflecting on Justin's 2013 merger with VMG Partners, Peter Burns, President and CEO of Justin's later said:

> "Working with VMG (was) a unique partnership because they completely understood our business and provided extremely helpful guidance, financing, and resources. Importantly, they also let us operate with the autonomy needed to rapidly grow our business while maintaining our entrepreneurial culture."

Acquisition by Hormel

In March 2016, Justin's (along with VMG Partners' interest in Justin's) was acquired by Hormel, a large food company, for $286 million. Hormel is the maker of SKIPPY Peanut Butter along with other well-known food brands such as Applegate Meats, Spam, Jennie-O, Dinty Moore, Vital Cuisine, and Hormel Foods. Unlike the merger with VMG Partners, in which the private equity firm took a minority position in Justin's, leaving Justin's in control of its future, the acquisition by Hormel garnered considerable attention. The following is an analysis of the rationale for the acquisition, from both Justin's and Hormel's points of view. Not only does the following help us understand the rational for Hormel's acquisition of Justin's, we also gain insights regarding the broader question of "Why large companies acquire start-ups and why start-ups agree to be acquired."

Hormel's Rationale for Acquiring Justin's. In acquiring Justin's, Hormel achieved two main objectives: (1) it added strength to its peanut butter and nut butter offerings and (2) it added a brand to its portfolio that appeals to a younger, more health-conscious and on-the-go consumer than many of its traditional brands.

In regard to the former, in commenting on the acquisition, Hormel CEO Jim Snee said that "The Justin's brand gives us a great platform in natural and organic specialty nut butter spreads, the fastest growing portion of the nut butter category." Hormel entered the peanut and nut butter market in 2013 when it bought SKIPPY. At the time, the acquisition was part of a larger effort on Hormel's part to diversify away from meat, its staple category of product. Adding to the comments shown above, Snee said, "Since Justin's was founded in 2004, the business has experienced tremendous growth. Looking forward, we expect Justin's to grow at low double-digit rates from a starting point of approximately $100 million in F.Y. (fiscal year) 17 net sales."

In regard to appealing to a younger, more health-conscious and on-the-go consumer, while SKIPPY already has a "natural" line of nut butters, Snee said that SKIPPY's natural products appeal to a different, more conventional shopper, leaving space in the company's product line for a more premium brand to reach a different customer set. "A lot of the research we've done around (SKIPPY) tells us that it's not extendable into the space where Justin's plays," Snee said. "We know that (Justin's) attracts a younger, more health-conscious, on-the-go, millennial consumer."

Justin's Rationale for Agreeing to be Acquired by Hormel. The day the Hormel acquisition was announced, Justin Gold posted a video on the company's Facebook page, explaining the rationale for the acquisition from Justin's perspective. The video, along with other statements made by Gold, suggest that Justin's achieved three goals via the acquisition.

First, Justin's needed more resources to grow. "The goal has been to get the business to enough scale where we can find the right operational partner to help us to the next level," Gold says in the video. Justin's need for resources seemed to have multiple layers. In the video, Gold went on to say, "They (referring to Hormel) get protein, they love our business, they love our community, they're going to support all of our sustainability efforts, and they can truly help scale our business in a meaningful way, around sourcing raw materials, quality, safety, and expanding our distribution." In regard to Hormel's potential to expand Justin's distribution, Hormel has products in virtually every grocery store in the United States and exports to more than 50 countries. In contrast, at the time of the acquisition, Justin's #1 product, Classic Almond Butter, was in only 35 percent of U.S. grocery stores and no foreign countries. Justin's also had no presence in convenience stores.

The second objective that Justin's achieved via the Hormel acquisition was finding a like-minded partner. Along with posting the video on Justin's Facebook page, on the day the acquisition was announced, Gold also posted a statement on Justin's website. Prior to revealing the name of the company that was acquiring Justin's, he said his top three priorities in finding an acquisition partner were:

1. We must stay in Boulder, with our people, and remain an independent operating unit.
2. We must maintain and amplify our mission, vision, and values.
3. Our partner must share in our core competency of nut butter manufacturing and distribution.

Gold proceeded to say, in revealing the name of the company acquiring Justin's, "We are very fortunate. What happens if you build a company, need help to get to the next level, but can't find the right operational partner who believes in your mission? With that said, we have joined with Hormel Foods due to their commitment to our mission and their operational capabilities with their SKIPPY brand." Gold reiterated these sentiments in other statements. For example, he told Project NOSH (which is a website that covers entrepreneurial food companies) that "They (referring to Hormel) believe in our mission. They want to support organics, they want to support our sustainability efforts, so all the things that make Justin's special, they want to support."

The third objective Justin's achieved via the acquisition, which wasn't talked about in the news but is evident, is that it created a liquidity event for Justin's stockholders, which included Justin's investors, employees and Justin Gold himself. Gold hinted at this in the statement he posted on Justin's website. Part of the statement read, "This (the acquisition) is a win-win for us! Everyone in our company is an owner and now we have an even larger platform to further our mission." Recall, part of Justin's hiring philosophy was to pay employees a below-average salary but give them stock in the company to compensate. The acquisition created a mechanism for everyone who owned Justin's stock to convert their stock to cash.

Justin's Moving Forward

A question mark surrounding Hormel's acquisition of Justin's is whether Justin's customers will remain loyal. At the time the acquisition was announced there was considerable negative chatter on social media, along the lines of why would Justin's, an independent home-grown company, sell-out to a corporate giant? Questions were also posed about whether Justin's culture, the quality of its products, and its commitment

An assortment of Justin's products.

to sustainability would be compromised. Perhaps anticipating this reaction, in the statement Gold posted on Justin's website the day the acquisition was announced he said, "The food landscape is evolving and although our investors at Justin's are selling their shares, we are not selling out, Hormel is buying in."

It is too early to tell the impact that the Hormel acquisition will have on Justin's operations and products. Interestingly though, a quick survey of Justin's website, one year after the acquisition, suggests Hormel is sticking to its pledge to allow Justin's to operate as an independent brand.

Discussion Questions

14-39. Why do you think Hormel acquired Justin's to add to the strength of its peanut and nut butter offerings and to add a product to its portfolio that appealed to a younger, more health-conscious consumer rather than creating a similar product from scratch in its own R&D labs?

14-40. Why do you think Justin's didn't try to raise additional funds to acquire more resources to manage its growth rather than selling itself to Hormel?

14-41. If you had been a loyal Justin's customer when the Hormel acquisition was announced would you have reacted adversely to the acquisition? Why or why not?

14-42. What is a liquidity event? Why do firms that take money from investors strive to find a liquidity event within a 5–7 year time frame? In your judgment, did Justin's have a favorable exit (or liquidity event)? Explain your answer.

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ESSAY QUESTIONS

1. Which of the growth strategies discussed in the chapter are the most risky? Which are the least risky? What role should risk play in a company's decision to pursue a particular growth strategy? Write a few paragraphs to describe your answers to these questions.
2. Established 15 years ago in Dubai, Sumo Sushi and Bento (sumosushibento.com) has spread across the Middle East and has plans to open in the United States, Canada, and India. In one or two paragraphs, outline the growth strategies that the business has used. What challenges does the business face in the future in terms of its growth, and how will it address these challenges?

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Getting Personal with UPTOWN CHEAPSKATE

Uptown Cheapskate/Photo credit: Holly Simmonds

Cofounders

CHELSEA SLOAN

BYU, 2012, BS in Business Management

SCOTT SLOAN

University of Utah, 2008, BS in Marketing

Dialogue with Chelsea Sloan

BEST ADVICE I'VE RECEIVED
Being an entrepreneur means that you can make other people's lives better. Do that

FIRST ENTREPRENRIAL EXPERIENCE
Sloan Spook Alley: Admission $.50 (age 8)

FAVORITE BAND ON MY SMARTPHONE MUSIC LIST
Tchaikovsky, the Imagine Dragons

MY FAVORITE SMARTPHONE APP
Airbnb

WHAT I DO WHEN I'M NOT WORKING
Wakeboard and read

MY BIGGEST SURPRISE AS AN ENTREPRENEUR
Not every franchisee follows direction

CHAPTER 15
Franchising

OPENING PROFILE

UPTOWN CHEAPSKATE

Franchising as a Form of Business Ownership and Growth

• *Web: www.uptowncheapskate.com* • *Facebook: Uptown Cheapskate* • *Twitter: @ucheapskate*

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When Chelsea Sloan was young, she lived with her family for a period of time in Ohio where her father was a shopping center re-development manager. Her mother shopped resale stores to help clothe her four children, all of whom were under age ten (two additional children came later). Once Upon a Child, a store that bought and sold gently used children's clothing, caught the attention of Sloan's parents. Her parents considered buying a Once Upon a Child franchise, but thought they could improve upon the concept. So they moved the family to Utah to develop a children's clothing franchise organization of their own. In 1992, they opened the first Kid to Kid resale store with fixtures they made themselves. Although initial sales were modest, they quickly developed a successful business model, and have grown Kid to Kid to over 120 franchise locations in the United States and Portugal.

By the time Sloan was 10 she was working in Kid to Kid stores, helping tag merchandise, cleaning toys, and doing odd jobs. As the child of entrepreneurs, she participated in numerous dinnertime conversations that centered on franchising and related topics. By 2006, Sloan was a student at Brigham Young University, and she had already helped open and run multiple Kid to Kid stores. At the University of Utah, her older brother Scott was finishing his degree in marketing and was working for Kid to Kid. The two knew they wanted to own their own company, and they decided to work together. They kicked around several ideas and settled on an upscale resale store for gently used men's and women's clothing. They would differentiate themselves by creating a store atmosphere that felt like the mall, not like a thrift shop. They would hand select their products so that the clothing was clean, fresh, and stylish as well.

The business didn't come together immediately. Sloan took a one-and-a-half-year break to do a mission in Alaska. While she was gone, she and her brother Scott corresponded frequently, sharing ideas about the potential business. One thing that took some time was choosing a name. It had to be a name that was catchy, was trademarkable, and had an available URL. After considering hundreds of alternatives, they settled on Uptown Cheapskate. They also talked about their growth strategy, long before opening their first (or pilot) location. They wanted to grow quickly without having to make huge investments in store locations. They settled on franchising.

LEARNING OBJECTIVES

After studying this chapter you should be ready to:

1. Explain franchising and how this form of business ownership works.
2. Describe steps entrepreneurs can take to establish a franchise system.
3. Become familiar with the advantages and disadvantages of establishing a franchise system.
4. Describe actions and issues associated with a decision to buy a franchise.
5. Explain the steps an entrepreneur goes through to buy a franchise.
6. Identify and explain the various legal aspects associated with the franchise relationship.
7. Discuss two additional issues—franchise ethics and international franchising—entrepreneurs should think about when considering franchising.

When Sloan returned from her mission, she arrived in Salt Lake City at 10:00 am and was working on Uptown Cheapskate with her brother by 2:00 pm the same day. They knew that to become a successful franchise organization, they had to consistently deliver as much value to their franchisees as the franchisees paid them in franchise fees and royalties. As a result, Sloan and her brother spent the next eight months fine-tuning the Uptown Cheapskate concept. They focused on the critical aspects of building both the front end and the back end of a unique retail offering. One of the first things they worked on was creating a proprietary software platform that would allow their franchisees to quickly determine what to pay for an item brought into the store. The challenge of developing this type of system is to pay people fairly for items brought in while leaving room to price the items competitively for shoppers and make a profit. The platform also had to be populated with the current brands, clothing selections, and reasonable price ranges. Building this platform took months, but it was completed. A lot of thought was also put into the Uptown Cheapskate brand, store layout, and sales reporting mechanisms for franchisees.

The first Uptown Cheapskate opened in mid-2009 in Salt Lake City, UT. The first franchise was sold later that year to an individual in Greensboro, NC. The company has grown steadily since, with two stores after Year 1, six stores after Year 2, 14 stores after Year 3, and upwards of 50 stores today. The average store earns a net profit of over six figures, which is excellent in the retail store industry. As a result of these numbers, many of the company's franchisees are opening multiple locations. Sloan and her brother credit much of their success to the upfront work they did in fleshing out the Uptown Cheapskate concept and the support they offer their franchisees. The following is a partial list of the types of support that Uptown Cheapskate offers to its franchisees:

- *Proprietary Software Platform.* Referred to above, the platform allows a franchisee's buyer to quickly determine what to pay for items brought into the store. Over time, the platform has become very robust. It now contains over 4,000 brands and nearly 300 subcategories. If a seller brings in a pair of gently worn size-five Abercrombie & Fitch women's jeans, for example, the platform will instantly provide a price range to offer for the garment. This feature allows a single buyer to purchase hundreds of pieces of merchandise per day, and pay an intelligent price for each piece of merchandise acquired.
- *Franchise in a Box.* Uptown Cheapskate helps franchisees configure their stores. Based on a description of the available space, the franchisee is provided a plan for exactly how to build out the store, arrange the fixtures, and display the merchandise. This service allows a franchisee to get up and running quickly.
- *Buyer Training.* Franchisees are provided substantial support in terms of knowing what fashions and articles of clothing are hot and are likely to sell well and which aren't. The training is provided in the form of monthly podcasts, training videos, and other forms of support.
- *Marketing Materials.* Uptown maintains an in-house marketing team that develops everything from in-store signage to radio ads to billboards and mass media.
- *Back-End Systems to Track Sales and Other Metrics.* Uptown owners have access to back-end reports that update store numbers in live time. For example, a franchisee can compare their sales and other metrics against the other stores. The company has

found that this functionality results in healthy competition among franchisees. A suite of back-end systems has been developed, which track sales and other metrics.

Uptown Cheapskate continues to grow. The firm is routinely listed in *Entrepreneur* magazine's Franchise 500 (currently ranked #182) along with its sister company, Kid to Kid. Sloan enjoys talking about franchising, and says that one of her most enjoyable experiences is sharing her story with college students. In November 2012, Sloan became the first female to win the Entrepreneurs' Organization's Global Student Entrepreneur Award. The competition included 1,700 candidates from 20 countries. In 2013 and 2015, Sloan was named as one of *Inc.* magazine's 30 under 30. Uptown Cheapskate also enjoys providing recognition to its most successful franchises. For example, in March 2017, the Uptown Cheapskate franchise in Boardman, OH received the "Grand Opening of the Year" award during the company's annual meeting in Salt Lake City.

As with Uptown Cheapskate, many retail and service organizations find franchising to be an attractive form of business ownership and growth.[1] In some industries, such as automotive and retail food, franchising is a dominant business ownership. Franchising is less common in other industries, although it is used in industries as diverse as Internet service providers, furniture restoration, personnel staffing, and senior care.

There are instances in which franchising is not appropriate. For example, new technologies are typically not introduced through franchise systems, particularly if the technology is proprietary or complex. Why? Because by its nature, franchising involves sharing of knowledge between a franchisor and its franchisees; in large franchise organizations, thousands of people may be involved in doing this. The inventors of new technologies typically involve as few people as possible in the process of rolling out their new products or services because they want to keep their trade secrets secret. They typically reserve their new technologies for their own use or license them to a relatively small number of companies, with strict confidentiality agreements in place.[2]

Still, franchising is a common method of business expansion and is growing in popularity. In 2016, there were 732,842 business format franchise establishments operating in the United States. These operations accounted for 7.6 million jobs and a combined economic output of $674 billion.[3] You can even go to a website (www.franchising.com) to examine the array of franchises available for potential entrepreneurs to consider. This website groups franchising opportunities by industry, state, investment required, and several other criteria. These categorizations highlight the breadth of franchising opportunities now available for consideration.[4]

Unfortunately, not all the news about franchising is positive. Some entire franchise systems fail. In addition, some individual franchisees fail, even if they are a part of an otherwise successful system. Franchising is also a relatively poorly understood form of business ownership and growth. While most students and entrepreneurs generally know what franchising is and what it entails, the many subtle aspects of franchising can be learned only through experience or careful study.

This chapter is dedicated to franchising as an important potential path to entrepreneurship and subsequent venture growth. We begin the chapter with a description of franchising and when to use it. We then explore setting up a franchise system from the franchisor's perspective and buying a franchise from the franchisee's point of view. Next, we look at the legal aspects of franchising. We close this chapter by considering a few additional topics related to the successful use of franchising.

What Is Franchising and How Does It Work?

LEARNING OBJECTIVE

1. Explain franchising and how this form of business ownership works.

Franchising is a form of business organization in which a firm that already has a successful product or service (**franchisor**) licenses its trademark and method of doing business to other businesses (**franchisees**) in exchange for an initial franchise fee and an ongoing royalty.[5] Some franchisors are established firms; others are first-time enterprises that entrepreneurs are launching. This section explores the origins of franchising and how franchising works.

What Is Franchising?

The word *franchise* comes from an old dialect of French and means "privilege" or "freedom." Franchising has a long history. In the Middle Ages kings and lords granted franchises to specific individuals or groups to hunt on their land or to conduct certain forms of commerce. In the 1840s, breweries in Germany granted franchises to certain taverns to be the exclusive distributors of their beer for the region. Shortly after the U.S. Civil War, the Singer Sewing Machine Company began granting distribution franchises for its sewing machines and pioneered the use of written franchise agreements. Many of the most familiar franchises in the United States, including Kentucky Fried Chicken (1952), McDonald's (1955), Burger King (1955), Midas Muffler (1956), and H&R Block (1958), started in the post–World War II era of the 1940s and 1950s.

The franchise organization Comfort Keepers demonstrates how franchises are started. A year before the company was founded, Kristina Clum, a registered nurse, noticed that her parents were having trouble with ordinary daily chores. She wanted someone to come into their home to help them but was unable to find people willing to do so. So Kristina and her husband Jerry founded a business dedicated to helping seniors cope with everyday nonmedical tasks, such as meal preparation, light housekeeping, grocery shopping, laundry, and errands. The first Comfort Keepers office was opened in Springfield, OH, in March 1998; the second one was opened in Dayton a year later.

Comfort Keepers is a timely idea that addresses a need for a particular target market. As we discussed in earlier chapters, having a solid business idea is critical to achieving firm growth. In 2015, 14.9 percent of the U.S. population, or 44.9 million people, was 65 years old or older.[6] That number is expected to steadily increase in coming years. Comfort Keepers's services may provide some seniors the option of staying in their homes as opposed to entering more costly assisted living centers. In August 1999, the company began franchising, and by 2017 it had over 700 franchise outlets throughout the United States, Canada, and several other countries.[7]

The Comfort Keepers business idea lends itself to franchising because the company has a good trademark and a good business method. Moreover, because the nature of the business keeps the cost of starting a Comfort Keepers franchise relatively low, there is a substantial pool of people available to purchase the franchise. For Comfort Keepers and its franchisees, franchising is a win-win proposition. Comfort Keepers wins because it is able to use its franchisees' money to quickly grow its business and strengthen its brand. The franchisees win because they are able to start a business in a growing industry relatively inexpensively and benefit by adopting the Comfort Keepers trademark and method of doing business.

How Does Franchising Work?

There is nothing magical about franchising. It is a form of growth that allows a business to get its products or services to market through the efforts of business

Many fast-food and casual dining restaurants are business format franchises. Here, a group of friends is enjoying some time together and some smoothies in a business format franchise.

partners or "franchisees." As described previously, a franchise is an agreement between a franchisor (the parent company, such as Uptown Cheapskate or Comfort Keepers) and a franchisee (an individual or firm that is willing to pay the franchisor a fee for the right to sell its product, service, and/or business method).[8] Planet Smoothie, for example, is a very successful franchise system. The franchisor (Planet Smoothie, Inc.) provides the rights to individual businesspersons (the local franchisees) to use the Planet Smoothie trademark and business methods. In turn, the franchisees pay Planet Smoothie a franchise fee and an ongoing royalty for these privileges and agree to operate their Planet Smoothie restaurants according to Planet Smoothie Inc.'s standards.

There are two distinctly different types of franchise systems: the product and trademark franchise and the business format franchise. A **product and trademark franchise** is an arrangement under which the franchisor grants to the franchisee the right to buy its products and use its trade name. This approach typically connects a single manufacturer with a network of dealers or distributors. For example, General Motors has established a network of dealers that sell GM cars and use the GM trademark in their advertising and promotions. Similarly, ExxonMobil has established a network of franchisee-owned gasoline stations to distribute its gasoline. Product and trademark franchisees are typically permitted to operate in a fairly autonomous manner. The parent company, such as GM or ExxonMobil, is generally concerned more with maintaining the integrity of its products than with monitoring the day-to-day activities of its dealers or station owners. Other examples of product and trademark franchise systems include agricultural machinery dealers, soft-drink bottlers, and beer distributorships. Rather than obtaining a royalty or franchise fee, the product and trademark franchisor obtains the majority of its income from selling its products to its dealers or distributors at a markup.

The second type of franchise, the **business format franchise**, is by far the more popular approach to franchising and is more commonly used by entrepreneurs and entrepreneurial ventures. In a business format franchise, the franchisor provides a formula for doing business to the franchisee along with training, advertising, and other forms of assistance. Table 15.1 shows 10 industries in which business format franchises have a significant presence. While a

TABLE 15.1 10 Industries in Which Business Format Franchises Are Used Prominently

- Automotive
- Business Services
- Commercial & Residential Services
- Food Retailing
- Lodging
- Personal Services
- Quick Service Restaurants
- Real Estate
- Retail Products & Services
- Table/Full Service Restaurants

Source: The Economic Impact of Franchised Businesses: Volume IV, 2016, PWC, 2016.

business format franchise provides a franchisee a formula for conducting business, it can also be very rigid and demanding. For example, fast-food restaurants such as McDonald's and Burger King teach their franchisees every detail of how to run their restaurants, from how many seconds to cook french fries to the exact words their employees should use when they greet customers (such as "Will this be dining in or carry out?"). Business format franchisors obtain the majority of their revenues from their franchisees in the form of royalties and franchise fees.

For both product and trademark franchises and business format franchises, the franchisor–franchisee relationship takes one of three forms of a franchise agreement (see Figure 15.1). The most common type of franchise arrangement is an individual franchise agreement. An **individual franchise agreement** involves the sale of a single franchise for a specific location. For example, an individual may purchase a Play It Again Sports franchise to be constructed and operated at 901 Pearl Street in Boulder, CO. An **area franchise agreement** allows a franchisee to own and operate a specific number of outlets in a particular geographic area. For example, a franchisee may purchase the rights to open five Play It Again Sports franchises within the city limits of Sioux Falls, SD. This is a very popular franchise arrangement, because in most cases it gives the franchisee exclusive rights for a given area. Finally, a **master franchise agreement** is similar to an area franchise agreement, with one major difference. A master franchisee, in addition to having the right to open and operate a specific number of locations in a particular area, also has the right to offer and sell the franchise to other people in its area. The people who buy franchises from master franchisees are typically called **subfranchisees**.

A person who owns and operates more than one outlet of the same franchisor, whether through an area or a master franchise agreement, is called a **multiple-unit franchisee**. For the franchisee, there are advantages and disadvantages to multiple-unit franchising. By owning more than one unit, a multiple-unit franchisee can capture economies of scale and reduce its administrative overhead per unit of sale. The disadvantages of multiple-unit franchising are that the franchisor takes more risk and makes a deeper commitment to a single franchisee. In general, franchisors encourage multiple-unit franchising. By selling an additional franchise to an existing franchisee, a franchisor can grow its business without adding to the total number of franchisees with whom it must maintain a relationship to conduct its business.

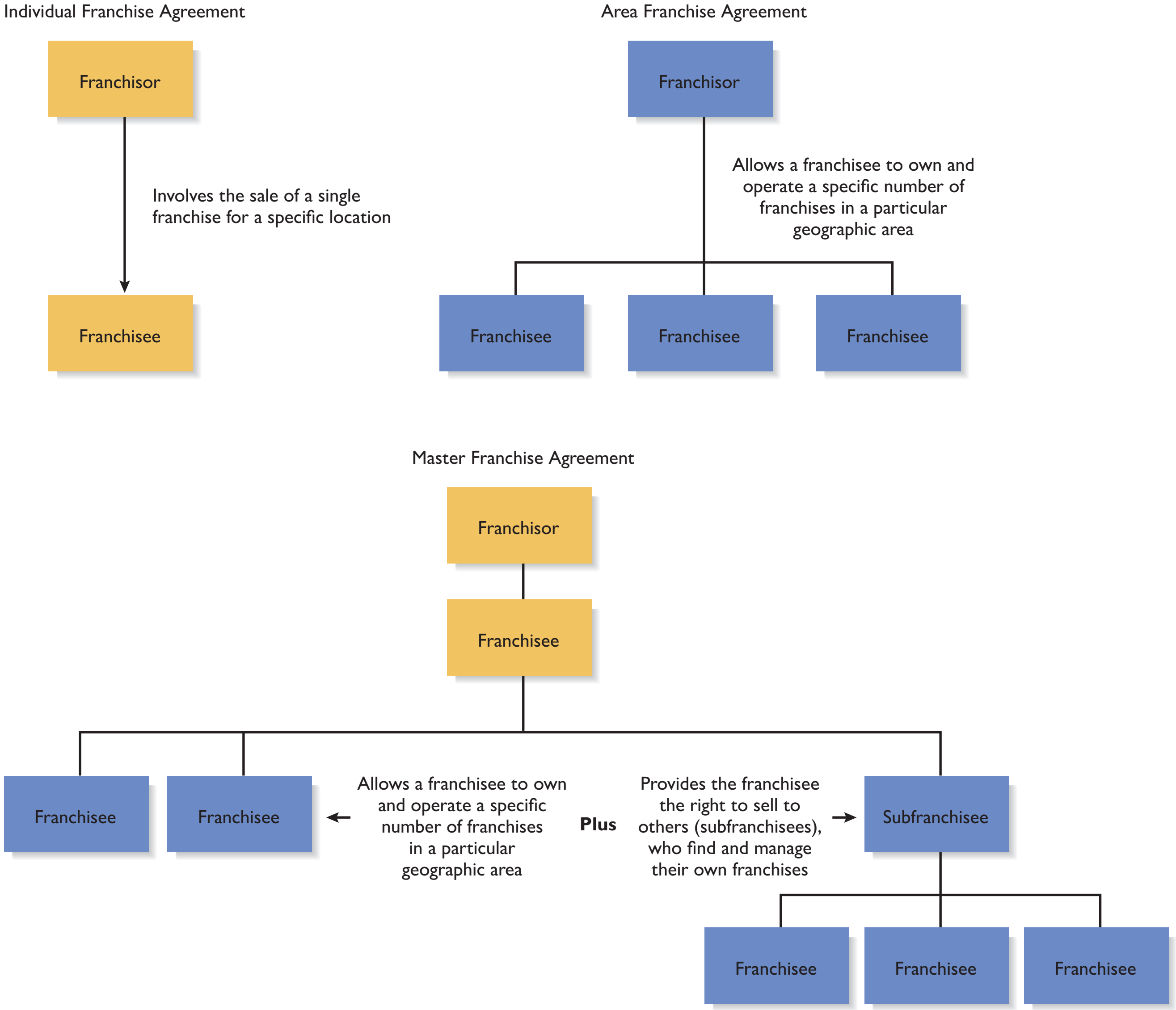

FIGURE 15.1
Different Types of Franchise Systems

Establishing a Franchise System

LEARNING OBJECTIVE

2. Describe steps entrepreneurs can take to establish a franchise system.

Establishing a franchise system should be approached carefully and deliberately. While the process is a familiar one to a company such as McDonald's, which in early 2017 had 36,899 restaurants in over 100 countries, franchising is an unfamiliar process to a new franchise organization. Franchising is a complicated business endeavor, which means that an entrepreneur must look closely at all of its aspects before deciding to franchise. Indeed, franchising often involves the managerially demanding tasks of training, supporting, supervising, and nurturing franchisees.

An entrepreneur should also be aware that over the years a number of fraudulent franchise organizations have come and gone and left financially ruined franchisees in their wake. Because of this, franchising is fairly heavily regulated. Even with this regulation, though, caution is in order for those pursuing franchising as a business opportunity.

Despite the challenges, franchising is a popular form of growth. It is particularly attractive to new firms in retailing and services because it helps firms grow and alleviates the challenge of raising substantial amounts of money. There is some anecdotal evidence, however, that many companies are hasty in putting together their franchise programs and as a result do a poorer job than they might have were they to take their time.[9] Although franchising is often touted as an easy way to rapidly expand a business, an effective franchise system needs to be as consciously initiated, managed, and supported as any other form of business expansion.[10] An example of a franchise organization that has been consciously managed and has grown in a sensible manner is Wahoo's Fish Taco, as illustrated in the nearby "Savvy Entrepreneurial Firm" feature.

Now let's look more closely at the issues to consider when an entrepreneur is trying to decide if franchising is an appropriate approach to growing a business.

When to Franchise

Retail firms, in a brick-and-mortar context, grow when two things happen: first, when the attractiveness of a firm's products or services becomes well known, whether it is a new restaurant or a fitness center, and, second, when a firm has the financial capability to build the outlets needed to satisfy the demand for its products or services.

There are at least two options firms have as a means to grow brick-and-mortar outlets. Building company-owned outlets is one of these options. However, this choice presents a company with the challenge of raising the money to fund its expansion. As discussed in Chapter 10, this option is typically pursued through debt, investment capital, or earnings, none of which is easy to achieve for a start-up venture.

Franchising is a second growth alternative available to firms. Franchising is perhaps especially attractive to young firms in that the majority of the money needed for expansion comes from the franchisees. Franchising is appropriate when a firm has a strong or potentially strong trademark, a well-designed business model, and a desire to grow. A franchise system will ultimately fail if the franchisee's brand doesn't create value for customers and its business model is flawed or poorly developed.

In some instances, franchising is simply not appropriate. For example, franchising works for Burger King but would not work for Walmart. While Burger King has a large number of franchise outlets, each individual outlet is relatively small and has a limited menu, and policies and procedures can be written to cover almost any contingency. In contrast, although Walmart is similar to Burger King in that it, too, has a strong trademark and thousands of outlets, Walmart stores are much larger, more expensive to build, and more complex to run compared to the complexity of running a Burger King restaurant. It would be nearly impossible for Walmart to find an adequate number of qualified people who would have the financial capital and expertise to open and successfully operate a Walmart store.

Steps to Franchising a Business

Let's assume that as an entrepreneur you have decided to use franchising as a means of growing your venture. What steps should you take to develop a franchise system? As illustrated in Figure 15.2, you, as an entrepreneur, should take nine steps in order to successfully set up a franchise system.

Step 1 **Develop a franchise business plan:** The franchise business plan should follow the format of a conventional business plan, which we discussed in Chapter 6, and should fully describe the rationale for franchising the business and act as a blueprint for rolling out the franchise

SAVVY ENTREPRENEURIAL FIRM

Wahoo's Fish Taco: A Moderate-Growth Yet Highly Successful Franchise Organization

• Web: www.wahoos.com • Facebook: Wahoo's Fish Taco • Twitter: @WahoosFish Taco

Wahoo's Fish Taco is a franchise organization that offers Mexican food mixed with Brazilian and Asian flavors. It is a "fast-casual" restaurant that was founded in Costa Mesa, CA, in 1988 by Chinese-Brazilian brothers Eduardo Lee, Mingo Lee, and Wing Lam, who mixed traditional Chinese and Brazilian flavors with dishes they encountered while traveling in Mexico. The first Wahoo's Fish Taco restaurant was launched to combine the brothers' love for surfing and food.

Wahoo's is now 30 years old and has 51 locations in California, Colorado, Texas, Nevada, Nebraska, Hawaii, Pennsylvania, and Japan. The firm is known for its specialty charbroiled fish, steak, chicken tacos, and burritos. Although it has been very successful, it couldn't be characterized as a "rapid growth" franchise system. Instead, the founders have elected to make Wahoo's Fish Taco a relatively slow growth system, focusing on branding and service quality rather than rapid growth. This philosophy has been an entrenched part of the way Wahoo's Fish Taco has done business since the beginning. It started with a single restaurant in 1988; the second unit was added only when the founders had saved enough money to build it debt free. This pattern has characterized the company's growth. Early on, it only added one new restaurant a year, then two, then three, and so on. Despite its success, it has averaged less than two new restaurants per year since its founding. For many years, the company only sold franchises to people the founders personally knew and trusted.

Wahoo's pace of expansion has picked up some in recent years, but not dramatically. Its brand has been built around its enthusiasm for surfing and other extreme sports. More than 70 percent of its restaurants are in California, and its locations in other states are largely in college towns or "hip" communities. The company has only one international location, which is in Tokyo, Japan.

Along with its staple dishes, Wahoo's Fish Taco offers many vegetarian and vegan options, such as tofu, banzai veggies, and brown rice. Its restaurants are very attractive inside and out, and offer a relaxed environment with a definite "surfer" feel. Buying a Wahoo Fish Taco franchise requires a major financial commitment. The initial franchise fee is $35,000. The ongoing royalty is 5 percent of gross sales plus an additional 2 percent for marketing. The cost to build a Wahoo Fish Taco restaurant runs from $425,000 to $715,000 depending on location, size of restaurant, landscaping, and local ordinances.

Questions for Critical Thinking

1. What are the advantages and disadvantages of Wahoo's Fish Taco's slow growth philosophy of franchise expansion?
2. Spend some time looking at Wahoo's Fish Taco's website, focusing particularly on its menu and its store layout. Do you think the business is well positioned or poorly positioned to take advantage of current trends in the types of restaurants that are doing well and in light of today's food preferences? Explain your answer.
3. To what degree do you think Wahoo's Fish Taco has been too conservative in its expansion?
4. Spend some time studying the cost of becoming a Wahoo's Fish Taco franchisee compared to similar franchise organizations. Is the cost of acquiring and owning a Wahoo Fish Taco franchise on the high end, in the middle, or on the low end compared to its closest competitors? To what degree do you believe your answer has affected Wahoo's pace of growth?

Sources: Wahoo's Fish Taco's website, www.wahoos.com (accessed April 3, 2017); Wikipedia, Wahoo's Fish Taco, www.wikipedia.org (accessed April 3, 2017).

operation. Particular attention should be paid to the location of the proposed franchise outlet. For example, just because a Baskin-Robbins franchise has been successful in the food court of a mall in an upscale area doesn't mean that it will be successful in a less heavily trafficked strip mall in an average-income neighborhood.

Step 2 **Get professional advice:** Before going too far, a potential franchisor should seek advice from a qualified franchise attorney, consultant, or certified public accountant. If the business cannot be realistically turned into a franchise, then a qualified professional can save a potential franchisor a lot of time, money, and frustration by urging that the process be stopped. If the business can be turned into a franchise, then it is advisable to get professional advice to help direct the entire process.

FIGURE 15.2
Nine Steps in Setting Up a Franchise System

Step 3 **Conduct an intellectual property audit:** As we discussed in Chapter 12, this step is necessary to determine the intellectual property a company owns and to ensure that the property is properly registered and protected. All original written, audio, and visual material, including operating manuals, training videos, advertising brochures, and similar matter, should be afforded copyright protection. If a firm has a unique business model that includes a unique business method, it should consider obtaining a patent for its business method. These protective measures are vital because once a company begins franchising, its trademarks and business model and any unique business methods are disseminated, making them more visible to customers and competitors. In addition, a franchisor should make sure that its trademark is not infringing on the trademark of any other firm.

Step 4 **Develop franchise documents:** Later in the chapter, we discuss the documents that are required to franchise a business. Here, we note that at the beginning of the franchise evaluation process, a prospective franchisor should prepare the Franchise Disclosure Document (formally called the Uniform Franchise Offering Circular) and the franchise agreement. A franchise attorney can provide specific information regarding the content and format of these documents.

Step 5 **Prepare operating manuals:** Businesses that are suitable for franchising typically have a polished business system that can be taught fairly easily to qualified franchisees. The franchisor should prepare manuals that document all aspects of its business model.

Step 6 **Plan an advertising strategy and a franchisee training program:** Prospective franchisees will want to see an advertising strategy and a franchisee training program in place. The scope of each program should match the speed at which the franchisor wants to grow its business.

Step 7 **Put together a team for opening new franchise units:** A team should be developed and prepared to help new franchisees open their franchise units. The team should be well trained and equipped to provide the franchisee a broad range of training and guidance.

Step 8 **Plan a strategy for soliciting prospective franchisees:** There are many channels available to franchisors to solicit and attract potential franchisees. Franchise trade fairs, newspaper ads, franchise publications, social media platforms, and Internet advertising are examples of these channels.

Step 9 **Help franchisees with site selection and the grand opening of their franchise outlets:** Location is very important to most retail businesses, so a franchisor should be heavily involved in the site selection of its franchisees' outlets. The franchisor should also help the franchisee with the grand opening of the franchise outlet.

Along with the specific steps shown in Figure 15.2, it is important for a franchisor to remember that the quality of the relationships it maintains with its franchisees often defines the ultimate success of the franchise system. It is to the franchisor's advantage to follow through on all promises and to establish an exemplary reputation. This is an ongoing commitment that a franchisor should make to its franchisees.

Selecting and Developing Effective Franchisees

The franchisor's ability to select and develop effective franchisees strongly influences the degree to which a franchise system is successful. For most systems, the ideal franchisee is someone who has solid ideas and suggestions but is willing to work within the franchise system's rules. Bold, aggressive entrepreneurs typically do not make good franchisees. Franchisees must be team players to properly fit within the context of a successful franchise system.

Once franchisees are selected, it is important that franchisors work to develop their franchisees' potential. Table 15.2 contains a list of the qualities that franchisors look for in prospective franchisees and the steps that franchisors can take to develop their franchisees' potential.

TABLE 15.2 Selecting and Developing Effective Franchisees

Qualities to Look for in Prospective Franchisees

- Good work ethic
- Ability to follow instructions
- Ability to operate with minimal supervision
- Team oriented
- Experience in the industry in which the franchise competes
- Adequate financial resources and a good credit history
- Ability to make suggestions without becoming confrontational or upset if the suggestions are not adopted
- Ability to represent the franchisor in a positive manner

Ways Franchisors Can Develop Their Franchisees' Potential

- Provide mentoring that supersedes routine training
- Keep operating manuals up-to-date
- Keep product, services, and business systems up-to-date
- Solicit input from franchisees to reinforce their importance in the larger system
- Encourage franchisees to develop a franchise association
- Maintain the franchise system's integrity

Advantages and Disadvantages of Establishing a Franchise System

LEARNING OBJECTIVE

3. Become familiar with the advantages and disadvantages of establishing a franchise system.

There are two primary advantages to franchising. First, early in the life of an organization, capital is typically scarce, and rapid growth is needed to achieve brand recognition and economies of scale. Franchising helps a venture grow quickly because franchisees provide the majority of the capital.[11] For example, if Comfort Keepers were growing via company-owned outlets rather than franchising, it would probably have only a handful of outlets rather than the more than 700 it has today. Many franchisors even admit that they would have rather grown through company-owned stores but that the capital requirements needed to grow their firms dictated franchising. This sentiment is affirmed by an executive at Hardee's, who wrote the following about the growth of this fast-food chain:

> Hardee's would have preferred not to have franchised a single location. We prefer company-owned locations. But due to the heavy capital investment required, we could only expand company-owned locations to a certain degree—from there we had to stop. Each operation represents an investment in excess of $100,000; therefore, we entered the franchise business.[12]

Second, a concept called **agency theory** argues that for organizations with multiple units (such as restaurant chains), it is more effective for the units to be run by franchisees than by managers who run company-owned stores. The theory is that managers, because they are usually paid a salary, may not be as committed to the success of their individual units as franchisees, who are in effect the owners of the units they manage.[13]

The primary disadvantage of franchising is that an organization allows others to profit from its trademark and business model. For example, each time Comfort Keepers sells a franchise it receives a $45,000 initial franchise fee and an ongoing royalty, which is 5 percent of gross sales. However, if Comfort Keepers had provided its service itself in the same location, it would be getting 100 percent of the gross sales and net profits from the location. This is the main reason some organizations that are perfectly suitable for franchising grow through company-owned stores rather than franchising. An example is Darden Restaurants Inc., the parent company of Olive Garden, Bahama Breeze, LongHorn Steakhouse, The Capital Grille, Seasons 52, Eddie V's, and Yard House. With over 1,500 locations, the firm employs more than 150,000 people, serves more than 320 million meals a year, and generates over $6.8 billion in sales revenue.[14] All of Darden's units are company owned. Starbucks is another company that is suitable for franchising but has only a small number of franchise outlets. We provide a more complete list of the advantages and disadvantages of franchising as a means of business expansion in Table 15.3.

When a company decides to investigate franchising as a means of growth, it should ensure that it and its product or service meet several criteria. Businesses that fail to satisfy these criteria are less likely to make effective franchise systems. Before deciding to franchise, a firm should consider the following:

- **The uniqueness of its product or service:** The business' product or service should be unique along some dimension that creates value for customers. Businesses with a unique product or service typically have the best potential to expand.
- **The consistent profitability of the firm:** The business should be consistently profitable, and the future profitability of the business should be fairly easy to predict. When developing a franchise system, a company

TABLE 15.3 Advantages and Disadvantages of Franchising as a Method of Business Expansion

Advantages	Disadvantages
Rapid, low-cost market expansion. Because franchisees provide most of the cost of expansion, the franchisor can expand the size of its business fairly rapidly.	**Profit sharing**. By selling franchises instead of operating company-owned stores, franchisors share the profits derived from their proprietary products or services with their franchisees. For example, the vast majority of Starbucks's are company-owned outlets, allowing Starbucks to retain nearly all the profits.
Income from franchise fees and royalties. By collecting franchise fees, the franchisor gets a fairly quick return on the proprietary nature of its products/services and business model. The franchisor also receives ongoing royalties from its franchisees without incurring substantial risk.	**Loss of control**. It is typically more difficult for a franchisor to control its franchisees than it is for a company to control its employees. Franchisees, despite the rules governing the franchise system, still often view themselves as independent businesspeople.
Franchisee motivation. Because franchisees put their personal capital at risk, they are highly motivated to make their franchise outlets successful. In contrast, the managers of company-owned outlets typically do not have their own capital at risk. As a result, these managers may not be prone to work as hard as franchisees or be as attentive to cost savings.	**Friction with franchisees**. A common complaint of franchisors is dealing with the friction that often develops between franchisors and franchisees. Friction can develop over issues such as the payment of fees, hours of operation, caveats in the franchise agreement, and surprise inspections.
Access to ideas and suggestions. Franchisees represent a source of intellectual capital and often make suggestions to their franchisors. By incorporating these ideas into their business model, franchisors can, in effect, leverage the ideas and suggestions of their individual franchisees.	**Managing growth**. Franchisors that are in growing industries and have a strong trademark often grow quickly. Although this might seem like an advantage, rapid growth can be difficult to manage. A franchisor provides each of its franchisees a number of services, such as site selection and employee training. If a franchise system is growing rapidly, the franchisor will have to continually add personnel to its own staff to properly support its growing number of franchisees.
Cost savings. Franchisees share many of the franchisors' expenses, such as the cost of regional and national advertising.	**Differences in required business skills**. The business skills that made a franchisor successful in the original business are typically not the same skills needed to manage a franchise system. For example, Sam Jones may be a very effective owner/manager of a seafood restaurant. That does not necessarily mean, however, that he will be an effective manager of a franchise system if he decided to franchise his seafood restaurant concept.
Increased buying power. Franchisees provide franchisors increased buying power by enlarging the size of their business, allowing them to purchase larger quantities of products and services when buying those items.	**Legal expenses**. Many states have specific laws pertaining to franchising. As a result, if a franchisor sells franchises in multiple states, legal expenses can be high to properly interpret and comply with each state's laws. Unfortunately, from the franchisor's point of view, some of the toughest laws are in the most populated states.

should have several prototype outlets up and running to test and ensure the viability of the business idea. Remember, a franchisee is supposed to be buying a way of doing business (in the form of a business model) that is "proven"—at least to a certain extent. Franchisors that learn how to run their businesses through the trial and error of their franchisees have typically franchised their businesses prematurely (especially from the franchisees' point of view).

- **The firm's year-round profitability:** The business should be profitable year-round, not only during specific seasons. For example, a lawn and garden care franchise in North Dakota should be set up to provide the franchisee supplemental products and services to sell during off-peak seasons. Otherwise, owning the franchise may not be an attractive form of business ownership. This issue is particularly problematic for some ice cream and smoothie franchises in northern states, which experience a significant decline in sales during winter months.

- **The degree of refinement of the firm's business systems:** The systems and procedures for operating the business should be polished and the procedures documented in written form. The systems and procedures should also be fairly easy to teach to qualified candidates.
- **The clarity of the business proposition:** The business proposition should be crystal clear so that prospective franchisees fully understand the business proposition to which they are committing. The relationship between the franchisor and the franchisee should be completely open, and communication between them should be candid.

After determining that the firm satisfies these criteria, the entrepreneur should step back and review all the alternatives for business expansion. No single form of business expansion is the best under all circumstances. For any entrepreneurial venture, the best form of expansion is the one that increases the likelihood that the venture will reach its objectives.

Many companies expand internationally through the franchising model, which offers advantages for the franchisor and franchisee. "What Went Wrong?" presents the case of JF Street Food, the United Arab Emirates' fastest falafel chain, which experienced rapid growth but then had to halt its expansion after encountering challenges in its growth model.

Buying a Franchise

LEARNING OBJECTIVE

4. Describe actions and issues associated with a decision to buy a franchise.

Now let's look at franchising from the franchisee's perspective. Purchasing a franchise is an important business decision involving a substantial financial commitment. Potential franchise owners should strive to be as well informed as possible before purchasing a franchise and should be well aware that it is often legally and financially difficult to exit a franchise relationship. Indeed, an individual franchise opportunity should be meticulously scrutinized. Close scrutiny of a potential franchise opportunity includes activities such as meeting with the franchisor and carefully reading the Franchise Disclosure Document, soliciting legal and financial advice, and talking to former franchisees that have dropped out of the system one is considering. In particularly heavily franchised industries, such as fast food and automobile repair, a prospective franchisee may have 20 or more franchisors from which to make a selection. It is well worth franchisees' time to carefully select the franchisor that best meets their individual needs.[15]

Some franchise organizations are designed to provide their franchisees a part-time rather than a full-time income, which is attractive to some people. An example is e2 Engineers, a company that has created a variety of different programs to teach science, technology, engineering, and math (STEM) to school-age children. The initial franchise fee ranges between $36,400 and $59,183, depending on circumstances involved. Owning an e2 Engineers franchise is ideal for a person who wants to work two to three hours a day rather than eight, and who is passionate about STEM education.

Franchising may be a particularly good choice for someone who wants to start a business but has no prior business experience. Along with offering a refined business system, well-run franchise organizations provide their franchisees training, technical expertise, and other forms of ongoing support.

Is Franchising Right for You?

Entrepreneurs should weigh the possibility of purchasing a franchise against the alternatives of buying an existing business or launching their own venture from scratch. Answering the following questions will help determine whether

WHAT WENT WRONG?

Slowing Down Growth: Why Did Just Falafel Become JF Street Food?

• Web: www.jfstreetfood.com • Facebook: JFStreet Food • Twitter: @jf_streetfood

Falafel is among the most well-known Middle Eastern and Mediterranean dishes. A popular street food, these fried vegetarian balls are typically sold with pita bread and made into wraps. Falafel has been selling as a generic food item in small restaurants and cafeterias for a very long time across the Middle East and beyond, but one company decided that falafel could be turned into a branded fast-food item. Thus, Just Falafel opened its first outlet in the city of Abu Dhabi, United Arab Emirates, in 2007. It soon became the world's largest falafel franchise.

According to its founders, Just Falafel was launched with a mission to redefine tradition and revolutionize stereotypes by providing authentic and nutritious food, but more trendy and modern, with a brand image. Its selling point was traditional food made healthy and modern. The owners had ambitious plans to expand an innovative yet traditional falafel brand around the world, so they opened cool, hip outlets and used traditional and non-traditional advertising strategies across TV, print, billboards, and especially social media.

Just Falafel became one of the United Arab Emirates' most successful brands, opening chains in more than 12 countries. By 2014, the company's website listed over 42 restaurants, mostly in Middle East, with plans to open many more in the coming years. The restaurant had branches in Bahrain; Doha, Qatar; Amman, Jordan; Riyadh, Saudi Arabia; Tripoli, Libya; Beirut, Lebanon; Bangalore, India; Sydney, Australia; Toronto, Canada; San Francisco, United States, and London, United Kingdom, among others.

Just Falafel had pursued ambitious growth and international expansion through the franchising model. The company planned to open 1000 restaurants in 18 countries by 2020, out of which 200 were to be opened in the United Kingdom alone. Just Falafel aimed to be a healthy alternative to McDonald's and hired Mike Biggins, who had spent 25 years at the burger group, to lead its aggressive UK expansion plans.

Although the franchise model offered the advantages of rapid expansion to the company, it came with its share of challenges and difficulties. The firm's rapid growth proved to be more difficult than anticipated, and the company started to face problems, including customer complaints, lack of focus on quality, poor performance of some outlets, lack of variety in the menu, and the difficulty of managing a single brand in different international markets. The seemingly straightforward growth path filled with questions and required reassessment of its strategic decisions and goals.

In 2015, Just Falafel closed its branches in several locations, including Jordan, Lebanon, and London. As the company scaled back its international expansion by closing the last of its four UK branches, its founder admitted that they had made some mistakes during the course of their rapid growth, the most glaring one being focusing too strongly on franchising and not enough on the food. For example, in the United Kingdom, their initial research showed that the country had a large vegetarian market, but it did not translate into revenues for Just Falafel with its mostly vegetarian menu. This was true in other global markets as well, leading the company to add non-vegetarian items to its menu and re-brand as JF Street Food. Introducing chicken and beef items was important for the company's new product offering and its new look and feel.

The newly rebranded company decided to change its strategic focus from operating a large number of branches to focusing on fewer but high-performing locations. The change in strategy came as the company made efforts to bring more consistency in its business model and branding across the globe. Moving forward, JF Street Food said it would work with new experienced restaurant operators with the right skills to launch JF Street Food's new menu, look, and feel.

Questions for Critical Thinking

1. Keeping in mind the advantages of the franchising system, do you think Just Falafel was able to benefit fully from it? Discuss the main reasons its international expansion stalled while pursuing the franchising model. How could it have been avoided?
2. What are some of the lessons that food franchisors and franchisees can learn from Just Falafel's experience?
3. Do you think JF Street Food's change in strategy through re-branding, the new menu items, and the change in look and feel will help to put its international expansion on track? How can JF Street Food manage its growth better now?
4. On a scale of one to ten, how likely is JF Street Food to succeed in achieving its new, re-adjusted, slower growth plans? Explain your answer.

Sources: Adam Bouyamourn, "From Just Falafel to JF Street Food and a Hunger to Succeed," *The National*, January 22, 2015, https://www.thenational.ae/business/from-just-falafel-to-jf-street-food-and-a-hunger-to-succeed-1.111508 (accessed December, 20, 2017); Sananda Sahoo, "JF Street Food Scales Back Expansion as London Outlets Are Closed," March 3, 2015, https://www.thenational.ae/business/jf-street-food-scales-back-expansion-as-london-outlets-are-closed-1.66496 (accessed December, 20, 2017); Dominic Walsh "Just Falafel Chain Runs out of Beans," *The Times*, February 25, 2015, https://www.thetimes.co.uk/article/just-falafel-chain-runs-out-of-beans-mnxgn665kx0 (accessed December 20, 2017).

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This man just purchased an auto repair franchise. Prospective franchise owners should carefully determine whether they're willing to be part of a structured franchise system before buying in.

franchising is a good fit for people thinking about starting their own entrepreneurial venture:

- Are you willing to take orders? Franchisors are typically very particular about how their outlets operate. For example, McDonald's and other successful fast-food chains are very strict in terms of their restaurants' appearance and how each unit's food is prepared. Franchising is typically not a good fit for people who like to experiment with their own ideas or are independent minded.
- Are you willing to be part of a franchise "system" rather than an independent businessperson? For example, as a franchisee you may be required to pay into an advertising fund that covers the costs of advertising aimed at regional or national markets rather than the market for your individual outlet. Will it bother you to have someone use your money to develop ads that benefit the "system" rather than only your outlet or store? Are you willing to lose creative control over how your business is promoted?
- How will you react if you make a suggestion to your franchisor and your suggestion is rejected? How will you feel if you are told that your suggestion might work for you but can be put in place only if it works in all parts of the system?
- What are you looking for in a business? How hard do you want to work?
- How willing are you to put your money at risk? How will you feel if your business is operating at a net loss but you still have to pay royalties on your gross income?

None of these questions is meant to suggest that franchising is not an attractive method of business ownership for entrepreneurs. It is important, however, that a potential franchisee be fully aware of the subtleties involved with franchising before purchasing a franchise outlet.

The Cost of a Franchise

The initial cost of a business format franchise varies, depending on the franchise fee, the capital needed to start the business, and the strength of the franchisor. For example, some franchisors, such as McDonald's, own the land and buildings that their franchisees use, and lease the property to the franchisees. In contrast, other organizations require their franchisees to purchase the land, buildings, and equipment needed to run their franchise outlets. Table 15.4 shows the total costs of buying into several franchise organizations. As you can see, the total initial cost varies from a low of $58,700 for a Liberty Tax Service franchise up to $14.9 million for a Hampton Inn Hotel franchise.

Also shown in Table 15.4 is a breakdown of the number of company-owned units and the number of franchise units maintained by different organizations. Company-owned units are managed and operated by company personnel, and there is no franchisee involved. Franchise organizations vary in their philosophies regarding company-owned versus franchised units. As we noted earlier in this chapter, some companies (e.g., Budget Blinds) are strictly franchisors and have no company-owned units. Other companies, such as Qdoba Mexican Grill, have roughly the same number of franchises and company-owned stores. In addition, some U.S.-based franchise systems have more foreign franchises than domestic franchises. For example, KFC has 10,567 franchises in international markets and 4,064 in the United States. In fact, KFC has more units in China (approximately 5,000) than in the United States.

When evaluating the cost of a franchise, prospective franchisees should consider all the costs involved. Franchisors are required by law to disclose all their costs in a document called the Franchise Disclosure Document and send it to the franchisee. (We'll talk about this document in more detail later in this chapter.) To avoid making a hasty judgment, a franchisee may not purchase a franchise for 14 days from the time the circular is received. The following costs are typically associated with buying a business format franchise:[16]

- **Initial franchise fee:** The initial franchise fee varies, depending on the franchisor, as shown in Table 15.4. High-overhead, brick-and-mortar franchises charge less (4 to 5 percent of gross sales), while low-overhead, home-based, and service businesses charge more (8 to 10 percent of gross sales).
- **Capital requirements:** These costs vary, depending on the franchisor, but may include the cost of buying real estate, the cost of constructing

TABLE 15.4 Initial Costs to the Franchisee of a Sample of Franchise Organizations

Franchise Organization	Year Started Franchising	Company-Owned Units	Franchised Units	Franchise Fee	Ongoing Royalty Fee	Total Initial Investment
Anytime Fitness	2002	38	3,386	$19,000–$37,500	$449–$549/mth	$80,020–$490,100
Budget Blinds	1994	0	1,087	$19,950	Varies	$99,240–$202,070
Edible Arrangements	2001	8	1,245	$30,000	5%	$196,610–$327,810
Hampton Inn Hotels	1984	1	2,148	$75,000	6%	$4.2–$14.9 million
Liberty Tax Service	1973	351	3,753	$40,000	14%	$58,700–$71,900
Pinkberry	2006	33	242	$35,000	6%	$310,842–$615,145
Play It Again Sports	1988	0	285	$25,000	5%	$240,300–$397,200
Qdoba Mexican Grill	1997	359	330	$30,000	5%	$851,600–$1,131,000
The UPS Store	1980	0	4,910	$29,950	5%	$159,224–$434,521
Wetzel's Pretzels	1996	9	294	$35,000	7%	$164,950–$405,850

Source: Based on Entrepreneur.com, www.entrepreneur.com (accessed March 31, 2017).

a building, the purchase of initial inventory, and the cost of obtaining a business license. Some franchisors also require a new franchisee to pay a "grand opening" fee for its assistance in opening the business.

- **Continuing royalty payment:** In the majority of cases, a franchisee pays a royalty based on a percentage of weekly or monthly gross income. Note that because the fee is typically assessed on gross income rather than net income, a franchisee may have to pay a monthly royalty even if the business is losing money. Royalty fees are usually around 5 percent of gross income.[17]
- **Advertising fees:** Franchisees are often required to pay into a national or regional advertising fund, even if the advertisements are directed at goals other than promoting the franchisor's product or service. (For example, advertising could focus on the franchisor's attempt at attracting new franchisees.) Advertising fees are typically less than 3 percent of gross income.
- **Other fees:** Other fees may be charged for various activities, including training additional staff, providing management expertise when needed, providing computer assistance, or providing a host of other items or support services.

Although not technically a fee, many franchise organizations sell their franchisee products that they use in their businesses, such as restaurant supplies for a restaurant franchise. The products are often sold at a markup and may be more expensive than those the franchisee could obtain on the open market.

The most important question a prospective franchisee should consider is whether the fees and royalties charged by a franchisor are consistent with the franchise's value or worth. If they are, then the pricing structure may be fair and equitable. If they are not, then the terms should be renegotiated or the prospective franchisee should look elsewhere.

Finding a Franchise

There are thousands of franchise opportunities available to prospective franchisees. The most critical step in the early stages of investigating franchise opportunities is for the entrepreneur to determine the type of franchise that is the best fit. For example, it is typically unrealistic for someone who is not a mechanic to consider buying a muffler repair franchise. A franchisor teaches a franchisee how to use the contents of a business model, not a trade. Before buying a franchise, a potential franchisee should imagine operating the prospective franchise or, better yet, should spend a period of time working in one of the franchisor's outlets. After working in a print shop for a week, for example, someone who thought she might enjoy running a print shop might find out that she hates it. This type of experience could help avoid making a mistake that is costly both to the franchisee and to the franchisor.

There are many periodicals, websites, and associations that provide information about franchise opportunities. *The Wall Street Journal* and *USA Today* regularly run ads for franchise opportunities. Periodicals featuring franchise opportunities include *Inc.* and *Entrepreneur*, and franchise-specific magazines to review include *The Franchise Handbook* and *Franchise Times*. Prospective franchisees should also consider attending franchise opportunity shows that are held periodically in major U.S. cities and the International Franchise Expo, which is held annually in different cities across the United States. The U.S. Small Business Administration is another good source of franchise information. There are also several excellent franchise-focused individuals and organizations that post frequently on Twitter. Examples include Franchise Expert (@FranchiseBiz), International Franchise Association (@Franchising411), Franchise Direct USA (@TopFranchises), and Franchise Update Media (@franupdatemedia). Because of the risks involved in franchising, the selection of a franchisor should be a careful, deliberate process. One of the smartest moves a potential franchise owner can make is to talk to current franchisees and inquire if they are making money and if they are satisfied with their franchisor. Reflecting on how this approach helped ease her inhibitions about buying a franchise, Carleen Peaper, the owner of a Cruise Planner franchise, said:

> I was really apprehensive about making an investment of my time and money into a franchise, so I e-mailed 50 Cruise Planner agents with a set of questions, asking for honest feedback. Everyone responded. That was a big thing and helped me determine that I wanted to join them.[18]

Table 15.5 contains a list of sample questions to ask a franchisor and some of its current franchisees before investing. Potential entrepreneurs can expect to learn a great deal by studying the answers they receive in response to these questions.

Advantages and Disadvantages of Buying a Franchise

There are two primary advantages to buying a franchise over other forms of business ownership. First, franchising provides an entrepreneur the opportunity to own a business using a tested and refined business model. This attribute lessens the probability of business failure. In addition, the trademark that comes with the franchise often provides instant legitimacy for a business.[19] For example, an entrepreneur opening a new Gold's Gym would likely attract more customers than an entrepreneur opening a new, independently owned fitness center because many people who are a part of the target market of Gold's Gym

TABLE 15.5 Questions to Ask before Buying a Franchise

Questions to Ask a Franchisor

- What is the background of the company and its performance record?
- What is the company's current financial status?
- What are the names, addresses, and phone numbers of existing franchisees in my trade area?
- How do you train and mentor your franchisees?
- If at some point I decide to exit the franchise relationship, how does the exit process work?
- In what ways do you work with a franchisee who is struggling?

Questions to Ask Current Franchisees

- How much does your franchise gross per year? How much does it net? Are the procedures followed to make royalty payments to the franchisee burdensome?
- Are the financial projections of revenues, expenses, and profits that the franchisor provided me accurate in your judgment?
- Does the franchisor give you enough assistance in operating your business?
- How many hours, on average, do you work per week?
- How often are you able to take a vacation?
- Have you been caught off-guard by any unexpected costs or expectations?
- Does your franchisor provide you with ongoing training and support?
- If you had to do it all over again, would you purchase a franchise in this system? Why or why not?

have already heard of the firm and have a positive impression of it. Second, when an individual purchases a franchise, the franchisor typically provides training, technical expertise, and other forms of support. For example, many franchise organizations provide their franchisees periodic training both at their headquarters location and in their individual franchise outlets.

The cost involved is the main disadvantage of buying and operating a franchise. As mentioned earlier, the franchisee must pay an initial franchise fee. The franchisee must also pay the franchisor an ongoing royalty as well as pay into a variety of funds, depending on the franchise organization. Thus, franchisees have both immediate (i.e., the initial franchise fee) and long-term (i.e., continuing royalty payments) costs. By opening an independent business, an entrepreneur can keep 100 percent of the profits if it is successful.

Table 15.6 contains a list of the advantages and disadvantages of buying a franchise.

TABLE 15.6 Advantages and Disadvantages of Buying a Franchise

Advantages	Disadvantages
A proven product or service within an established market. The most compelling advantage to buying a franchise is that the franchise offers a proven product or service within an established market.	**Cost of the franchise**. The initial cost of purchasing and setting up a franchise operation can be quite high, as illustrated in Table 15.4.
An established trademark or business system. The purchase of a franchise with an established trademark provides franchisees with considerable market power. For example, the purchaser of a McDonald's franchise has a trademark with proven market power.	**Restrictions on creativity**. Many franchise systems are very rigid and leave little opportunity for individual franchisees to exercise their creativity. This is an often-cited frustration of franchisees.
Franchisor's training, technical expertise, and managerial experience. Another important attribute of franchising is the training, technical expertise, and managerial experience that the franchisor provides the franchisee.	**Duration and nature of the commitment**. For a variety of reasons, many franchise agreements are difficult to exit. In addition, virtually every franchise agreement contains a noncompete clause. These clauses vary in terms of severity, but a typical clause prevents a former franchisee from competing with the franchisor for a period of two years or more.
An established marketing network. Franchisees who buy into a powerful franchise system are part of a system that has tremendous buying power and substantial advertising power and marketing prowess.	**Risk of fraud, misunderstandings, or lack of franchisor commitment**. Along with the many encouraging stories of franchise success, there are also many stories of individuals who purchase a franchise only to be disappointed by the franchisor's broken promises.
Franchisor's ongoing support. One of the most attractive advantages of purchasing a franchise rather than owning a store outright is the notion that the franchisor provides the franchisee ongoing support in terms of training, product updates, management assistance, and advertising. A popular slogan in franchising is that people buy franchises to "be in business for themselves but not by themselves."	**Problems of termination or transfer**. Some franchise agreements are very difficult and expensive to terminate or transfer. Often, a franchisee cannot terminate a franchise agreement without paying the franchisor substantial monetary damages.
Availability of financing. Some franchisors offer financing to their franchisees, although these cases are the exception rather than the rule. This information is available in section 10 of the Franchise Disclosure Document.	**Poor performance on the part of other franchisees**. If some of the franchisees in a franchise system start performing poorly and make an ineffective impression on the public, that poor performance can affect the reputation and eventually the sales of a well-run franchise unit in the same system.
Potential for business growth. If a franchisee is successful in the original location, the franchisee is often provided the opportunity to buy additional franchises from the same franchisor. For many franchisees, this prospect offers a powerful incentive to work hard to be as successful as possible.	**Potential for failure**. Some franchise systems simply fail to reach their objectives. When this happens, franchisees' wealth can be negatively affected. Indeed, when a franchise system fails, it commonly brings its franchisees down with it.

Steps in Purchasing a Franchise

LEARNING OBJECTIVE

5. Explain the steps an entrepreneur goes through to buy a franchise.

Purchasing a franchise system is a seven-step process, as illustrated in Figure 15.3. The first rule of buying a franchise is to avoid making a hasty decision. Again, owning a franchise is typically costly and labor-intensive, and the purchase of a franchise should be a careful, deliberate decision. Once the decision to purchase a franchise has been nearly made, however, the following steps should be taken. If at any time prior to signing the franchise agreement the prospective franchisee has second thoughts, the process should be stopped until the prospective franchisee's concerns are adequately addressed.

Step 1 **Visit several of the franchisor's outlets:** Prior to meeting with the franchisor, the prospective franchisee should visit several of the franchisor's outlets and talk with their owners and employees. During the visits, the prospective franchisee should continually ask, "Is this the type of business I would enjoy owning and operating or managing?"

Step 2 **Meet with a franchise attorney:** Prospective franchisees should have an attorney who represents their interests, not the franchisor's. The attorney should prepare the prospective franchisee for meeting with the franchisor and should review all franchise documents before they are signed. If the franchisor tries to discourage the prospective franchisee from retaining an attorney, this is a red flag.

Step 3 **Meet with the franchisor and check the franchisor's references:** The prospective franchisee should meet with the franchisor, preferably at the franchisor's headquarters. During the meeting, the prospective franchisee should compare what was observed firsthand in the franchised outlets with what the franchisor is saying. Additional references should also be checked. The Franchise Disclosure Document is a good source for references. In section 20 of this document, there is a list of all the franchisees that have dropped out of the system in the past three years along with their contact information. Several of these should be called. Although it may seem to be overkill, the mantra for prospective franchisees is to check, double-check, and triple-check a franchisor's references.

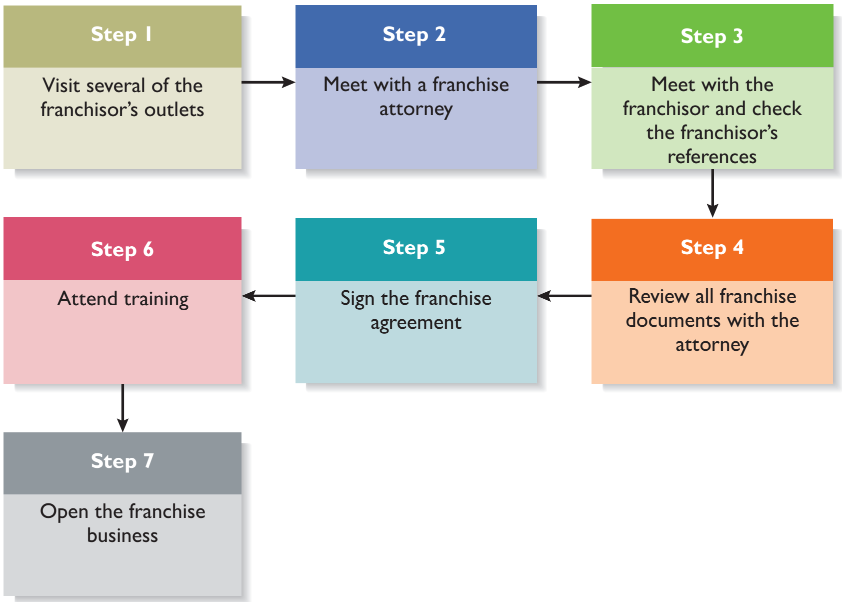

FIGURE 15.3
Seven Steps in Purchasing a Franchise

Step 4 **Review all franchise documents with the attorney:** The franchise attorney should review all of the franchise documents, including the Franchise Disclosure Document and the franchise agreement.

Step 5 **Sign the franchise agreement:** If everything is a go at this point, the franchise agreement can be signed. The franchise agreement is the document in which the provisions of the franchisor–franchisee relationship are outlined. We discuss this agreement in greater detail later in this chapter.

Step 6 **Attend training:** Almost all franchise organizations provide training for their franchisees. For example, Comfort Keepers requires each of its new franchisees to attend Comfort Keeper's Academy, the company's training center, for 40 hours of training before they open their Comfort Keepers franchise.

Step 7 **Open the franchise business:** For many franchises, particularly restaurants, the first two to three weeks after the business is opened may be its busiest period, as prospective customers "try it out." This is why many franchise organizations send experienced personnel to help the franchisee open the business as smoothly as possible. One goal of a franchisee is generating positive word of mouth about the business right from the start.

Watch Out! Common Misconceptions About Franchising

Despite the abundance of advice available to them, many franchisees make false assumptions about franchising. Part of the explanation for this is that franchising has an attractive lure. It is easy to become enthralled with the promise of franchising and not spend an adequate amount of time examining the potential pitfalls. The following is a list of misconceptions franchisees often have about franchising:

- **Franchising is a safe investment:** Franchising, in and of itself, is no safer as an investment than is any other form of business ownership.
- **A strong industry ensures franchise success:** Although it is generally important to operate in a growing industry, the strength of an industry does not make up for a poor product, a poor business model, poor management, or inappropriate advertising. There are many firms that fail in growing industries just as there are firms that succeed in unattractive ones.
- **A franchise is a "proven" business system:** A franchisor sells a franchisee the right to use a particular business model. Whether the model is proven or not is subject to the test of time. Obviously, companies such as Subway, Papa John's Pizza, and H&R Block are using models that are polished and that have worked well over time. Most prospective franchisees, however, cannot afford a Papa John's Pizza or a Subway unit and will be considering a lesser-known franchise. All too frequently, companies start selling franchises before their systems are anywhere close to being proven—a fact that should cause entrepreneurs to be wary.
- **There is no need to hire a franchise attorney or an accountant:** Professional advice is almost always needed to guide a prospective franchisee through the franchise purchase process. A prospective franchisee should never give in to the temptation to save money by relying solely on the franchisor's advice.

- **The best systems grow rapidly, and it is best to be a part of a rapid-growth system:** While some franchise systems grow rapidly because they have a good trademark and a polished business model, other franchise systems grow quickly because their major emphasis is on selling franchises. It is to a franchisee's benefit to be part of a system that has a solid trademark and business system—as that trademark and system will attract more customers—but some franchise systems grow so quickly that they outrun their ability to provide their franchisees adequate support.
- **I can operate my franchise outlet for less than the franchisor predicts:** The operation of a franchise outlet usually costs just as much as the franchisor predicts.
- **The franchisor is a nice person—he'll help me out if I need it:** Although it may be human nature to rely on the goodwill of others, don't expect anything from your franchisor that isn't spelled out in the franchise agreement.

Because these misconceptions are often hard to detect, some prospective franchisees attend seminars or franchise "boot camps" that teach them the ins and outs of franchising, including the things to watch out for when they talk to prospective franchisors. These types of seminars and boot camps are regularly offered by organizations such as Women in Franchising, the United States Hispanic Chamber of Commerce, and the International Franchising Organization.

Legal Aspects of the Franchise Relationship

LEARNING OBJECTIVE

6. Identify and explain the various legal aspects associated with the franchise relationship.

According to the Federal Trade Commission (FTC), a franchise exists any time that the operations of a business involve: (1) the selling of goods or services that bear a trademark, (2) the retention of significant control or assistance by the holder of the trademark on the operation of the business, and (3) royalty payments by the purchaser of the business to the owner of the trademark for the right to use the trademark in the business.

The legal and regulatory environment surrounding franchising is based on the premise that the public interest is served if prospective franchisees are as informed as possible regarding the characteristics of a particular franchisor. The offer and sale of a franchise is regulated at both the state and the federal level. The legal aspects of the franchise relationship are unique enough that some attorneys specialize in franchise law.

Federal Rules and Regulations

Except for the automobile and petroleum industries, federal laws do not directly address the franchisor–franchisee relationship. Instead, franchise disputes are matters of contract law and are litigated at the state level. During the 1990s, Congress considered several proposals for federal legislation to govern franchise relationships, but none became law.

However, the offer and sale of a franchise is regulated at the federal level. Under the Franchise Rule, which is enforced by the Federal Trade Commission (FTC), franchisors must furnish potential franchisees with written disclosures that provide information about the franchisor, the franchised business, and the franchise relationship. The disclosures must be supplied at least 14 business days before a franchise agreement can be signed or the franchisee pays the franchisor any money.[20] In most cases, the disclosures are made through the Franchise Disclosure Document, which is accepted in all 50 states and parts of

Canada. The **Franchise Disclosure Document (FDD)** contains 23 categories of information that give a prospective franchisee a broad base of information about the background and financial health of the franchisor. A summary of the information contained in the FDD is provided in Table 15.7. A prospective franchisee should fully understand all the information contained in the FDD before a franchise agreement is signed.

The FDD requires the franchisor to attach a copy of the franchise agreement and any other related contractual documents to the circular. The **franchise agreement**, or contract, is the document that consummates the sale of a franchise. Franchise agreements vary, but each agreement typically contains two sections: the purchase agreement and the franchise or license agreement. The purchase agreement typically spells out the price, the services to be provided by the franchisor to the franchisee, and the "franchise package," which refers to all the items the franchisee has been told to expect. The franchise or license agreement typically stipulates the rights granted to the franchisee (including the right to use the franchisor's trademark), the obligations and duties of the franchisor, the obligations and duties of the franchisee, trade restrictions, rights and limitations regarding the transfer or termination of the franchise agreement, and who is responsible for attorney fees if disputes arise. Most states have enacted a statute of frauds that requires franchise agreements to be in writing.

The federal government does not require franchisors to register with the FTC. The offer of a franchise for sale does not imply that the FTC has examined the franchisor and has determined that the information contained in the franchisor's FDD is accurate. The franchisor is responsible for voluntarily complying with the law, and it is the responsibility of prospective franchisees to exercise due diligence in investigating franchise opportunities. Although most franchisor–franchisee relationships are conducted in an entirely ethical manner, it is a mistake to assume that a franchisor has a fiduciary obligation to its franchisees. What this means is that if a franchisor had a **fiduciary obligation** to its franchisees, it would always act in their best interest, or be on the franchisees' "side." Commenting on this issue, Robert Purvin, an experienced franchise attorney, wrote:

> While the conventional wisdom talks about the proactive relationship of the franchisor to its franchisees, virtually every court case decided in the U.S. has ruled that a franchisor has no fiduciary obligation to its franchisees. Instead, U.S. courts have agreed with franchisors that franchise agreements are "arms length" business transactions.[21]

Purvin's statement suggests that a potential franchisee should not rely solely on the goodwill of a franchisor when negotiating a franchise agreement. A potential franchisee should have a lawyer who is fully acquainted with franchise law and should closely scrutinize all franchise-related legal documents.

State Rules and Regulations

In addition to the FTC disclosure requirements, 15 states have franchise investment laws that provide additional protection to potential franchisees.[22] These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. The franchise investment laws require franchisors to provide presale disclosures, known as "offering circulars," to potential franchisees. Thirteen of the states have laws that treat the sale of a franchise like the sale of a security. These states require that a franchisor's FDD be filed with a designated state agency and be placed into public record.

By requiring franchisors to file their FDDs with a state agency, these states provide franchise purchasers important legal protection, including the right to sue a franchisor for violation of state disclosure requirements (if the franchise

TABLE 15.7 Information Contained in the Franchise Disclosure Document (FDD) along with Explanations of Their Meanings

Section and Item	Explanation
1. The franchisor, its predecessors, and affiliates **2.** Business experience of the franchisor **3.** Litigation experience of the franchisor **4.** Bankruptcy on the part of the franchisor	These items provide information about the franchisor's operating history, business affiliations, and past litigation and bankruptcy experience, if any. It is not uncommon for a large company to have experienced some litigation. It would be a red flag, however, if a disproportionate percentage of the litigation involved suits with current or former franchisees.
5. Initial franchise fee **6.** Other fees **7.** Initial investment	These items specify the fees that the franchisee is subject to along with the franchisee's initial investment, which can be quite substantial. The "other fees" section should be carefully studied to avoid any surprises.
8. Restrictions on sources of products and services	These items stipulate the franchisee's obligations, along with restrictions pertaining to where the franchisee is permitted to purchase supplies and services.
9. Franchisee's obligations	Some franchise agreements require the franchisee to purchase supplies from the franchisor.
10. Financing available **11.** Franchisor's obligations	These items spell out the franchisor's obligations, along with a description of the financing (if any) that the franchisor offers to the franchisee. The franchisor's obligations typically include providing assistance in opening the franchisee's unit, ongoing training, and advertising.
12. Territory **13.** Trademarks	These items describe the territorial rights granted the franchisee (if any) and the franchisor's right to grant other franchises and open company-owned outlets.
14. Patents, copyrights, and proprietary information	In addition, items 13 and 14 specify the principal trademarks, patents, and copyrights and other proprietary information owned by the franchisor and the extent to which these items can be used by the franchisee.
15. Obligation to participate in the actual operation of the franchise business	This section addresses the franchisee's obligation to participate personally in the operation of the franchise. Franchisors typically do not want absentee franchisees.
16. Restrictions on what the franchisee may sell **17.** Renewal, termination, transfer, and dispute resolution	These sections deal with what the franchisee may sell and how the franchisor resolves disputes with its franchisees. Item 17 also contains important information about the manner in which franchisees can renew, terminate, and/or transfer their franchise.
18. Public figures	This section lists public figures affiliated with the franchise through advertising and other means.
19. Earnings claim	If a franchisor makes an earnings claim in connection with an offer of a franchise, then certain past and projected earnings information must be provided.
20. List of outlets	This section is quite exhaustive and contains (1) the number of franchises sold by the franchisor, (2) the number of company-owned outlets, (3) the names of all franchisees and the addresses and telephone numbers of all their outlets (within certain limitations), (4) an estimate of the number of franchises to be sold in the next year, and (5) a list of all franchisees (covering the past three years) who have dropped out of the system, including their last-known home addresses and telephone numbers.
21. Financial statements	This section contains the franchisor's previous two years of independently audited financial statements.
22. Contracts	These last two sections contain copies of the documents that franchisees have to sign.
23. Receipt **Attachments:** Franchise Agreement (or contract) Equipment Lease Lease for Premises Loan Agreement	These are the common exhibits attached to the FDD.

purchaser feels that full disclosure in the offering circular was not made). For example, if someone purchased a franchise in one of the states fitting the profile described previously and six months later discovered that the franchisor did not disclose an issue required by the FDD (and, as a result, felt that he or she had been damaged), that person could seek relief by suing the franchisor in state court. All 15 states providing additional measures of protection for franchisees also regulate some aspect of the termination process. Although the provisions vary by state, they typically restrict a franchisor from terminating the franchise before the expiration of the franchise agreement, unless the franchisor has "good cause" for its action.

Although not as comprehensive as in the United States, at least 24 countries now have laws regulating franchising in some manner. Australia, Brazil, Romania, South Korea, and Spain are five of these countries.[23]

More about Franchising

LEARNING OBJECTIVE

7. Discuss two additional issues—franchise ethics and international franchising—entrepreneurs should think about when considering franchising.

There are a number of additional issues pertaining to the franchisor–franchisee relationship. Three important topics, for both franchisors and franchisees, are franchise ethics, international franchising, and the future of franchising as a method of business ownership and growth.

Franchise Ethics

The majority of franchisors and franchisees are highly ethical individuals who are interested only in making a fair return on their investment. In fact, instances of problems between franchisors and their franchisees tend to be isolated occurrences rather than prevalent practices.[24] There are certain features of franchising, however, that make it subject to ethical abuse. An understanding of these features can help franchisors and franchisees guard against making ethical mistakes. These features are the following:

- **The get-rich-quick mentality:** Some franchisors see franchising as a get-rich-quick scheme and become more interested in selling franchises than in using franchising as a legitimate means of distributing their product or service. These franchisors have a tendency to either oversell the potential of their franchise or overpromise the support they will offer to their franchisees.
- **The false assumption that buying a franchise is a guarantee of business success:** Buying a franchise, as with all other business investments, involves risk. Any statement to the contrary is typically misleading or unethical. A franchisor must steer clear of claims that it has the "key" to business success, and a franchisee needs to be wary of all such claims.
- **Conflicts of interest between franchisors and their franchisees:** The structure of the franchise relationship can create conflicts of interest between franchisors and their franchisees. For example, franchisees benefit from the profits of a unit, while franchisors benefit from increased revenues (recall that a franchisor's royalty is typically paid on a percentage of gross profits rather than net profits). This anomaly in the franchise arrangement can motivate franchisors to take steps that boost revenues for the entire system but hurt profits for individual franchisees. For example, a franchisor might insist that a franchisee sell a product that has high revenue but low margins (or net income). Similarly, a franchisor might sell several franchises in a given geographic area to maximize the revenue potential of the area regardless of the effect on each individual franchisee's net income. These actions can at times be ethically questionable and can often lead to contentious conflicts of interest in franchise systems.

Despite the protection of law and the advocacy of franchise associations, individual franchisors and franchisees must practice due diligence in their relationships. "Buyer beware" is a good motto for franchisors selecting franchisees and prospective franchisees selecting franchisors. Entering into a franchise relationship is a major step for both parties and should be treated accordingly. The metaphor used frequently to describe the franchisor–franchisee relationship is marriage. Similar to marriage, the franchisor–franchisee relationship is typically close, long-term, and painful to terminate. Each side of the franchise partnership should scrutinize the past ethical behavior of the other before a franchise agreement is executed.

International Franchising

International opportunities for franchising are becoming more prevalent as the markets for certain franchised products in the United States have become saturated.[25] Indeed, heavily franchised companies, such as McDonald's, KFC, and Century 21 Real Estate, are experiencing much of their growth in international markets. The trend toward globalization in many industries is also hastening the trend toward international franchising, and the growing middle classes in many countries are creating large populations of consumers eager for American-style goods. In fact, to illustrate how global many familiar franchise systems have become, there is a McDonald's in Taupo, New Zealand, a Starbucks in the Forbidden City in China, and a Pizza Hut in Kabul, Afghanistan.

A U.S. citizen who is thinking about buying a franchise abroad may be confronted with the choice of buying from an American company or a foreign company, regardless of the location in the world. For U.S. citizens, these are some of the steps to take before buying a franchise in a foreign country:

- **Consider the value of the franchisor's name in the foreign country:** There are very few franchise systems whose names are known worldwide. Beyond a select few—McDonald's, Coca-Cola, Starbucks, and KFC come to mind—the majority of trademarks well known to Americans may be known to only a small percentage of the population of a foreign country. When considering the purchase of a U.S.-based franchise in a foreign country, carefully evaluate the value of the trademark in that country.
- **Work with a knowledgeable lawyer:** Many of the legal protections afforded to prospective franchisees in the United States are unavailable in foreign countries, highlighting the need for the purchaser of a franchise in a foreign country to obtain excellent legal advice. All the hazards involved with purchasing a domestic franchise are magnified when purchasing a franchise in a foreign country.
- **Determine whether the product or service is salable in a foreign country:** Just because a product or service is desirable to Americans is no guarantee of success in a foreign culture. Before buying a franchise in a foreign country, determine if sufficient marketing research has been conducted to ensure that the product or service will have a sufficient market in the foreign country.
- **Uncover whether the franchisor has experience in international markets:** It is typically not a good idea to be a franchisor's "test case" to see if the franchisor wants to operate in foreign markets. Be leery of franchisors with aggressive expansion plans but little international experience.
- **Find out how much training and support you will receive from the franchisor:** If your franchise unit will be in a foreign country and the franchisor remains headquartered in the United States, make sure you fully understand the amount of training and support you can expect. Will the franchisor have an area representative in your country? If not, do

you have to make an international phone call each time you want to talk to your franchisor? Will your franchisor be willing to travel to the foreign country to offer you training and support? Who pays for the international travel of the franchisor's training staff? Who is responsible for advertising in the foreign country, the franchisor or the franchisee?

- **Evaluate currency restrictions:** Evaluate any restrictions that the foreign country places on the convertibility of its currency into U.S. dollars.

To avoid some of the potential problems alluded to here, U.S. franchisors typically structure their expansion into a foreign country through the following:

- **Direct franchising arrangement:** Under a direct franchise arrangement, the U.S. franchisor grants the rights to an individual or a company (the developer) to develop multiple franchised businesses within a country or territory. For example, if Play It Again Sports decided to sell franchises for the first time in Spain, Play It Again Sports may grant the rights to a Spanish company to develop multiple Play It Again Sports franchises there.
- **Master franchise agreement:** Under a master franchise arrangement, the U.S. firm grants the right to an individual or company (the master franchisee) to develop one or more franchise businesses and to license others to develop one or more franchise businesses within the country or territory.
- **Other agreements:** Combinations of other arrangements are also employed by franchisors expanding to foreign markets. Examples include joint-venture arrangements, direct-sales arrangements, or straight franchising agreements.

The Future of Franchising

The future of franchising appears bright. Franchising represents a large and growing segment of the retail and service sectors of U.S. businesses and is in some cases replacing more traditional forms of business ownership. More and more college graduates are choosing careers in industries that are heavily dominated by franchising. Franchising is also becoming more popular among seniors. At the same time, the number of franchises focusing on "senior care" is increasing. Aging Excellence, FirstLight HomeCare, and Visiting Angels are examples of senior care franchises, as is Comfort Keepers, which we discussed previously in this chapter.[26] Many franchise organization also have a history of "giving back" by engaging their employees in volunteer activities and/or raising money for charities, a trend that is particularly popular among millennials. The nearby "Partnering for Success" feature highlights this trend and provides three rules of thumb that franchise organizations with successful partnerships with nonprofits tend to follow.

There are also innovations taking place today in franchising, such as the extensive use of social media that is occurring in many franchise organizations.[27] There are additional innovations as well, including the extensive use of instant couponing to encourage people to drop in and make a purchase. Many restaurant franchises are revamping their menus to appeal to health-conscious consumers. There are also franchising organizations that are teaching skills that have only become critical in the past several years. An example is Code Ninjas, a franchise organization that teaches kids ages 7–14 to code in an upbeat and enjoyable atmosphere. Code Ninja believes that in the future, learning to code will be as important to a young person's career as learning a second language. Each Code Ninja franchise provides a location where kids are exposed to a high-quality, continuous curriculum that teaches coding, math, logic, and problem solving.[28]

PARTNERING FOR SUCCESS

Franchises Partner with Nonprofits to Give Back

An increasing number of franchise organizations are partnering with nonprofit organizations in an effort to give back. An example is Panera Bread. At the end of each day, Panera's bakery-cafés donate their unsold bread and baked goods to local hunger relief and charitable organizations. By doing this, Panera Bread extends its goal of providing wholesome food to people in the communities in which it operates.

The following are three rules-of-thumb that franchise organizations with successful partnerships with nonprofits follow.

#1 Find the Right Partner

Most franchise organizations have a mission or set of values that defines their purpose. For example, a franchise organization that sells children's clothing or provides after-school tutoring for kids might partner with an organization like St. Jude Children's Research Hospital. St. Jude provides medical assistance to children who are sick free of charge. By raising money for St. Jude or a similar nonprofit, a franchise organization that caters to children allows the children and their families to provide help to other children who are less fortunate than they are.

#2 Involve Your Employees and Customers

It is important that franchise organizations that partner with nonprofits involve their employees and customers. This provides employees and customers an extra emotional attachment with the company and a higher sense of brand loyalty. For example, a home repair or home improvement franchise might partner with Habitat for Humanity, or a similar nonprofit. Habitat for Humanity has a program called "corporate volunteering" where it welcomes organized groups to pitch in and assist in building one of the houses on which it is working. Businesses that participate in this program often allow employees the opportunity to do at least part of their volunteering on company time. Habitat for Humanity has found that a business' employees benefit by working on a home building project together by: (1) getting to know one another on a more personal level, (2) gaining a deeper connection to the community in which they live, and (3) sharing a positive experience that can be taken back to the office or shop. If customers can also get involved, all the better. From the franchise organization's standpoint, involving employees and customers in volunteer activities deepens their commitment to the organization. The organization is telling their employees and customers that they have a higher purpose than just making money.

#3 Have Skin in the Game

For a partnership between a franchise organization and a nonprofit to be authentic, it is important that the franchise organization have skin in the game. Employees and customers respond more positively when they are not only being asked to donate money or time but the franchise organization is making a sacrifice, too. For example, in 2014, about 1,400 Denny's restaurants sold coupons in support of No Kid Hungry's efforts to help more than 16 million American children who struggle with hunger. For a $3 donation, customers received $9 worth of coupons that could be used at participating Denny's restaurants. Similarly, Sport Clips Haircuts sponsors an annual campaign titled "Saving Lives Never Looked So Good." It's a partnership between the sports-theme barbershop franchise and the American Red Cross. During the annual month-long campaign, Sports Clips gives a free haircut coupon to everyone who donates blood.

Questions for Critical Thinking

1. Identify an ideal nonprofit for a fitness center franchise that caters to college students to partner with. Describe the rationale for your selection. You can pick a nonprofit that's local to your area or a nonprofit that has a national presence.
2. If you worked for a home improvement or home repair franchise organization, to what degree would it enhance your commitment to the organization if they allowed you to donate a certain number of hours to a nonprofit such as Habitat for Humanity "on the clock?"
3. Do some Internet research and identify a partnership between a franchise organization and a nonprofit that is not mentioned in this feature. Describe the purpose of the partnership and how the franchise organization and the nonprofit both benefit.
4. Brainstorm a fourth potential rule-of-thumb that would facilitate a successful franchise organization/nonprofit partnership.

Sources: B. Litalien, "Era of the Social Franchise: Where Franchising and Nonprofits Come Together," *Franchise World*, June 2006; Franchising Gives Back, "2015 Award Winners," Franchise Gives Back, https://franchisinggivesback.org (accessed March 31, 2017); Habitat for Humanity Homepage, www.habitforhumanity.com (accessed March 31, 2017).

Chapter Summary

LO1. A franchise is an agreement between a franchisor (the parent company, such as McDonald's) and a franchisee (an individual or firm that is willing to pay the franchisor a fee for the right to sell its product or service). There are two distinctly different types of franchise systems: the product trademark franchise and the business format franchise. A product trademark franchise is an arrangement under which the franchisor grants to the franchisee the right to buy its products and use its trade name. Automobile dealerships and soft-drink distributorships are examples of product trademark franchises. In a business format franchise, the franchisor provides a formula for doing business to the franchisee along with training, advertising, and other forms of assistance. Comfort Keepers is an example of this type of franchise system. An individual franchise agreement involves the sale of a single franchise for a specific location. An area franchise agreement allows a franchisee to own and operate a specific number of outlets in a particular geographic area. A master franchise agreement is similar to an area franchise agreement with one major exception: in addition to having the right to operate a specific number of locations in a particular area, the franchisee also has the right to offer and sell the franchise to other people in the area.

LO2. Entrepreneurs take the following nine steps to establish a franchise system: (1) develop a franchise business plan, (2) get professional advice, (3) conduct an intellectual property audit, (4) develop franchise documents, (5) prepare operating manuals, (6) plan an advertising strategy and a franchise training program, (7) put together a team for opening new franchise units, (8) plan a strategy for soliciting prospective franchisees, and (9) help franchisees with site selection and the grand opening of their franchise outlets.

LO3. The advantages of setting up a franchise system include rapid, low-cost market expansion; income from franchise fees and royalties; franchisee motivation; access to ideas and suggestions; cost savings; and increased buying power. The disadvantages of setting up a franchise system include sharing profits with franchisees, loss of control, friction with franchisees, managing growth, differences in required business skills, and legal expenses.

LO4. Preparing answers to the following questions helps the entrepreneur determine if buying a franchise is a good or effective decision for him or her. Questions for which the entrepreneur should prepare carefully thought out answers are: (1) Are you willing to take orders? (2) Are you willing to be part of a franchise system rather than to seek to operate primarily independently? (3) How will you react if you make a suggestion to your franchisor and your suggestion is rejected? (4) What are you looking for in a business? and (5) How willing are you to put your money at risk?

LO5. Once an entrepreneur has decided to buy a franchise as part of an ongoing franchise system, she or he should expect to take the following steps to complete the purchase transaction: (1) visit several of the franchisor's outlets, (2) meet with a franchise attorney, (3) meet with the franchisor and check the franchisor's references, (4) review all franchise documents with the attorney, (5) sign the franchise agreement, (6) attend training, and (7) open the franchise business unit.

LO6. In the United States, there are a number of rules and regulations at both the federal and individual state levels that pertain to franchising. The premise behind all of these rules and regulations is that the public interest is best served when prospective franchisees have as much accurate information as possible about the characteristics of individual franchisors. The offer and sale of a franchise is regulated at the federal level. Increasingly, franchising is being regulated in some form or fashion in countries outside the United States. The Franchise Disclosure Document (FDD) is a document with 23 categories of information that is used prominently in the United States. This document provides a prospective franchisee a broad base of information about a franchisor's background and financial health. The FDD must be provided by the franchisor to a prospective franchisee at least 14 business days before a franchise contract can be signed or the franchisee pays the franchisor any money.

LO7. Entrepreneurs considering franchising also need to be aware of the role of ethics within franchising relationships. Evidence suggests that most franchisors and franchisees are ethical parties who want to support each other in the pursuit of profit-generating business transactions. On the other hand, entrepreneurs should understand that three features of franchising—a get-rich-quick mentality, a false assumption that purchasing a franchise is a guarantee of entrepreneurial success, and potential conflicts of interest between the franchisee and the franchisor—have the potential to create ethical issues. Entrepreneurs thinking of franchising should also recognize that franchising is not strictly a U.S. phenomenon. In fact, opportunities to engage in international franchising are becoming more and more prevalent. Although potentially attractive, entrepreneurs from any country thinking of buying a franchise in a different country should carefully examine all local rules and regulations, as well as the franchisor itself, prior to deciding to purchase a franchise.

Key Terms

agency theory, **568**
area franchise agreement, **562**
business format franchise, **561**
fiduciary obligation, **580**
franchise agreement, **580**
Franchise Disclosure Document (FDD), **580**
franchisees, **560**
franchising, **560**
franchisor, **560**
individual franchise agreement, **562**
master franchise agreement, **562**
multiple-unit franchisee, **562**
product and trademark franchise, **561**
subfranchisees, **562**

MyLab Entrepreneurship
If your instructor is using MyLab Entrepreneurship, go to **www.pearson.com/mylab/entrepreneurship** to complete the problems marked with this icon ✪.

Review Questions

15-1. What is franchising?
✪ 15-2. How does franchising differ from other forms of business ownership?
15-3. What are the differences between a product and trademark franchise and a business format franchise? Provide at least two examples of both types of franchise arrangements.
15-4. What are the differences among an individual franchise agreement, an area franchise agreement, and a master franchise agreement?
15-5. What are the steps involved in setting up a franchise system?
15-6. What are the advantages and disadvantages of establishing a franchise system?
15-7. What are the qualities to look for in a prospective franchisee?
15-8. What are the advantages and disadvantages of buying a franchise?
✪ 15-9. What are some of the issues an entrepreneur should consider when answering the question, "Is franchising a good choice for me?"
15-10. What are the costs involved in purchasing a business format franchise? Are these costs similar across franchise systems, or do they vary widely? Which costs are one-time costs and which costs continue indefinitely?
15-11. What is the meaning of fiduciary obligation?
15-12. What are the innovations taking place in franchising today?

15-13. What are the principal advantages and disadvantages of buying a franchise?

15-14. Why is it important for a prospective franchisee to retain his or her own franchise attorney?

15-15. "Franchising is a safe investment." What would you think if you saw this statement in a magazine or on a blog?

15-16. What is the purpose of the Franchise Disclosure Document (FDD)? Are there any regulations regarding when the FDD must be provided to a prospective franchisee? If so, what are they?

15-17. What is the purpose of a franchise agreement?

15-18. What are some aspects of franchising that make it subject to ethical abuses?

15-19. For U.S. citizens, what are the main issues that should be considered before buying a franchise in a foreign country?

15-20. What are the main reasons that many U.S. franchise systems are expanding into global markets? Do you think this expansion will continue to gain momentum or decline over time?

Application Questions

15-21. A friend of yours heard her roommates talking about different kinds of franchises. Before she could ask questions, they left for a team meeting to work on a class project. Your friend knows that you are taking an entrepreneurship course. She asks you: "What are the differences between a product and trademark franchise and a business format franchise?" For a first-time entrepreneur, she wonders, is there an advantage to one of these types of franchise agreements compared to the other one? If so, which one is more advantageous for the first-time entrepreneur to pursue and why? What responses would you provide to your friend?

15-22. Identify a franchise location near where you live and ask to talk to the owner. Show the owner one of the two "You Be the VC" features at the end of this chapter and ask the person whether he or she thinks the company will be successful. Write a brief summary of the owner's response.

15-23. Bill Watts has decided to buy a sub shop franchise called Super Subs. He lives in Cedar Falls, IA, and will be the first Super Subs franchisee in the state. Along with buying a Super Subs franchise, Bill would also like to purchase the rights to offer and sell Super Subs franchises to other people in the Cedar Falls area. What type of franchise agreement should Bill negotiate with Super Subs? For Bill, what are the advantages and disadvantages of this type of arrangement?

15-24. As a lead trainer in the "How to Create a Successful Franchise" seminar, you need to address your audience on the do's and don'ts of franchising. One particular participant approaches you at the end of the seminar. He is still confused about the legal aspects of franchising and needs personal tutoring. Guide him.

15-25. Look at Table 15.4. If you were offered the opportunity to buy into any one of the franchise organizations listed in Table 15.4, which one would it be? Explain the rationale for your selection.

15-26. Franchise Arabia (franarabia.com) is one of many websites that offer direct links to franchise opportunities around the world. The particular focus of this site is the Middle East and North Africa region, though they have links to franchises in other parts of the world. Their filters are industry type, location, and intended investment level. Choose one of each and comment on the information and range offered. In their small print, they describe themselves as lead generators, which implies that their focus is on the franchisor and not the franchisee. What other information would you need in order to make a sound judgment as to the quality of the opportunity being offered?

15-27. Suppose you became interested in opening a School of Rock franchise (see Case 15.2 for more information about this company). You fly to Philadelphia and visit the company's headquarters. After learning more about the opportunity, you tell the School of Rock representatives that you're really interested and would like to move forward. If School of Rock follows the procedures it is supposed to in negotiating with you as a prospective franchisee, what should you expect from this point forward?

YOU BE THE VC 15.1 COMPANY: Privilee

• Web: privilee.ae • Facebook: Privilee • Twitter: @privilee_UAE

Business Idea: Offer personal membership to an array of prestigious five-star hotels, gyms, and beach clubs with a single subscription.

Pitch: As any resident or visitor to the UAE will attest, a luxury lifestyle does not come cheap. A day pass to a top resort, along with lunch, drinks by the pool, a massage, and dinner will cost a fortune. For Danish national and entrepreneur Lars Johannesen, this posed an intriguing challenge. Johannesen had moved to Dubai from Denmark after visiting the region frequently and falling in love with it. One of his favorite activities was spending weekends, or "daycations," at resorts with family and friends. He loved the freedom of trying out different properties, which made membership at a single resort unnecessary but involved crippling day pass rates. Was it possible, he wondered, to benefit from the multiple discounts offered to year-round members? The answer was lifestyle brand Privilee, which was launched in 2015 to offer a single membership for multiple sites.

Johannesen started by tackling hotels, and it was an uphill struggle at first to get hotel owners to listen to him, as they were concerned that Privilee membership would undercut their own membership fees. Eventually, prestigious hotels began to realize the upside of partnering with Privilee: a cash injection, year-round revenue, upselling, and increased brand awareness among Dubai residents, who proved to be enthusiastic repeat visitors. Next, Johannesen turned to gym memberships and offered Privilee members fitness membership at a lower price with the added benefit of access to pools and beach clubs. Again, Johannesen had to persuade gym owners that Privilee would expand membership and bring in more business rather than cannibalize their existing numbers. In every case, he says, he has brought more business to the gyms, not less.

Today, the membership service, which is administered via an app, offers access to 50 pools and beach clubs across the UAE as well as more than 50 five-star gyms. There are discounts at affiliated restaurants too, from Atlantis The Palm and the Address Montgomerie in Dubai to the Saadiyat Beach Club and Park Hyatt in Abu Dhabi. Membership packages start at Dh529 per month if you sign up for a year. The most expensive option, a one-month membership, costs Dh1,199.

The UAE's hospitality sector is growing at a tremendous rate; the sector's direct contribution to GDP increased by 138 percent from 2007 to 2017, with sectoral employment growing by 119 percent. Privilee now has its eyes on international expansion, but Johannesen is aware that he must choose new locations carefully. Hotels in Europe, for example, are not based on a resort culture. Ask someone in Greece or Italy for €1,000 a year to use a sun lounger, and they aren't likely to bite. However, locations such as Miami and Singapore, which have a good number of five-star resorts, are ripe for the service. There are options to expand into other areas of the leisure market too.

15-28. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

15-29. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

YOU BE THE VC 15.2 COMPANY: Copper Branch

• Web: eatcopperbranch.com • Facebook: Copper Branch • Twitter: @Copperbranch

Business Idea: A fast-food, casual dining concept offering tasty and affordable plant-based dishes as an alternative to typical fast-food fare.

Pitch: As the number of those choosing a plant-based diet continues to grow year-on-year, it is clear that veganism is here to stay. In the United Kingdom, the movement has really taken off thanks in part to Veganuary, where people pledge to eat vegan for the month of January. The number of British vegans has quadrupled between 2014 and 2019, and one in six new food products launched there are plant-based. In the United States, the number of vegans has grown by 600 percent over a similar period, and two in three Americans are stopping or reducing meat consumption.

Serial entrepreneur Rio Infantino has recognized the opportunity in all this. The Canada-based businessman sold his stakes in more than a dozen Subway franchises to pump more than $2 million of his own money into Copper Branch, a new, healthier franchise brand, based solely on plant-based food. The chain launched in Quebec, quickly building up to more than 20 stores in Canada, before branching into the United States. Now with more than 50 stores, it is eyeing rapid expansion in France, Belgium, Luxembourg, Monaco, and the Netherlands with the goal of growing to 2,000 units over nine years.

The menu is not simply targeted at confirmed vegans. The food on offer, which includes everything from Asian Fusion Power Bowls to Mushroom Galaxy Burgers, is for anyone who wants to live more healthily and have access to tasty, quality food—and that is a pretty big market. Developing the menu was not without its challenges, though. Initial dishes created ahead of the first outlet's launch had to be scrapped at the cost of $30,000. Though delicious, they didn't suit the quick-service model, where everything needs to be prepared by people with limited food experience.

Copper Branch has attracted a diverse mix of franchisees who are all keen believers in the plant-based movement, including a large number of millennials (40 percent of this generation have adopted a plant-based diet). Franchisees also include a varied mix of professionals, including doctors and engineers, buoyed by the enthusiasm of bringing healthy eating to the fore. Such passion for making the world a better place has encouraged Copper Branch to team up with the Rainforest Trust to run a loyalty program where a percentage of sales go toward rainforest landmass purchases.

Rio Infantino says he is motivated by a far greater pull than that of making money—he wants to help the planet, make people's lives better, and save a lot of animals by delivering plant-based offerings. With one eye on McDonald's famous "billions served" slogan, he wants to one day use "billions saved" for Copper Branch.

15-30. Based on the material covered in this chapter, what questions would you ask the firm's founders before making your funding decision? What answers would satisfy you?

15-31. If you had to make your decision based on just the information provided in the pitch and on the company's website, would you fund this company? Why or why not?

CASE 15.1

Quiznos: Will It Regain a Leadership Position in the Sandwich and Sub Shop Franchise Industry?

• *Web: www.quiznos.com* • *Facebook: Quiznos* • *Twitter: @Quiznos*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

In the early 1980s, Jimmy Lambatos moved from New York City to Denver to attend college. Growing up in New York, he frequently ate sub sandwiches made with crusty Italian bread. It was artisan bread, the flavorful kind with spices, oils, and vinegars. Once in Denver, Lambatos kept eating sub sandwiches, but couldn't find a sandwich shop that used artisan bread. He caught himself one day eating a sub sandwich on a hotdog bun, and thought there has to be a better way. This occurrence led to the opening of the first Quiznos sub sandwich shop at 13th and Grant in Denver, which Lambatos opened with Todd Disner. The first Quiznos is still there—open from 10:00 am–9:00 pm Monday through Saturday and 11:00 am–8:00 pm on Sunday. The original Quiznos was an instant hit. Several sub sandwich franchises opened about the same time, including Subway and Blimpie. The other chains used a soft bread. Quiznos featured richer-tasting artisan bread, like its popular Italian Sub Sandwich. It also toasted its sandwiches, something the other sub shops weren't doing, at least initially. It fact, one of the novelties of the first Quiznos restaurants is that they used a conveyer type oven. They could handle long lines quickly and still take time to toast the sandwiches by placing cold sandwiches in one end of the oven and they would come out the other end toasted. The idea behind toasting the sandwiches wasn't just that some people like their sandwiches warm, but that the heat brings out the flavor in artisan breads. After operating solely from Grant and 13th in Denver for two years, Quiznos started franchising in 1983. By 1987, 12 Quiznos restaurants were operating in the United States. That year, Richard Schaden, at the age of 23, and his father, who was an aviation attorney, opened a Quiznos franchise in Boulder, CO. They opened three additional Quiznos sub shops before buying the 18-restaurant chain from the founders in January 1991.

The Schadens had big plans for Quiznos, and the next 10–15 years were marked by success. By 2001, Quiznos was one of the fastest growing fast-food franchises in the United States. At its peak in 2007, there were more than 5,000 Quiznos franchise locations. The financial crisis hit in 2007 and 2008, and Quiznos' fortunes changed. Between 2007 and 2009, the sub shop franchisor closed over 1,000 stores. Additional closures continued. In 2014, Quiznos filed for Chapter 11 bankruptcy to restructure debt and make operational improvements. Its company-wide sales had declined from an estimated $1.6 billion in 2008 to $716 million in 2013, according to an October 2013 report from *IBIS World*. That's an annualized decline of 15.5 percent. It stayed in bankruptcy for about four months. By 2015, there were fewer than 1,000 Quiznos restaurants in the United States. In 2016, Quiznos launched a turnaround effort that involved new leadership, changes in its menu and positioning strategy, and improved relationships with franchisees. Will the turnaround effort work? Continue reading and then decide.

What Went Wrong at Quiznos?

It wasn't just the financial crises of 2007 and 2008 that caused Quiznos to take a 180-degree turn from rapid growth to closing thousands of stores. There were a number of problems brewing at Quiznos, and the financial crisis brought them to the forefront. The following is an overview of four issues that contributed to Quiznos rapid decline.

Identity Crises. Quiznos started as a premium brand built around its unique toasting techniques and meatier subs. This combination allowed Quiznos' franchises to charge higher prices than their competitors. That strategy worked until 2008 when the recession hit. In an effort to appeal to cash strapped consumers, Quiznos pivoted and started competing with Subway, Jimmy John's, and others on price. Competing on price caused financial problems for Quiznos' franchisees. Not only did they have to absorb the cost of meatier subs, but many had leased space in upscale locations consistent with a premium brand. In 2012, Quiznos reversed its strategy of competing on price and started competing on freshness and natural ingredients, following the fast-casual trend created by Panera Bread, Potbelly, and others. It introduced a new menu that featured artisan breads, all-natural chicken, natural cheeses, and raw vegetables. It also eliminated its cheaper sandwiches. The switch left Quiznos in a difficult position. Its prices weren't low enough nor was its infrastructure cost-effective enough to compete with Subway's $5.00 footlongs, and it wasn't different enough in terms of quality of its ingredients and the ambience of its units to compete against Panera Bread and Potbelly. As the figure shown nearby depicts, it was stuck-in-the-middle with no real competitive advantage. It also lost its greatest differentiator, toasted sandwiches. In 2004, Subway neutralized that advantage by installing TurboChef toasting ovens in nearly all of its outlets.

At Odds with Franchisees. Quiznos has a history of rocky relations with its franchisees. Its franchisees have persistently accused it of selling rights to too many locations and taking advantage of franchisees by making them buy supplies from the company rather than from local, lower-cost providers. The first accusation—selling rights to too many locations—is an inherent challenge associated with franchising. A franchisor (i.e., Quiznos corporate) earns revenue based on a percentage of its franchisees' (system-wide) gross income. Thus, if it can raise gross income in a community by increasing the number of franchise units from four to six, it has an incentive to do that. Franchise owners don't like this. The owners of four original Quiznos franchises, for example, would probably have preferred to keep the number at four instead of six. Adding two more Quiznos franchises to their trade area runs the risk of cutting into their individual sales and net profits.

In regard to requiring franchises to buy supplies from the company rather than from local, lower-cost providers, there is at least anecdotal evidence that Quiznos' franchisees had a point. Most restaurant franchisors negotiate with vendors on behalf of their franchisees, who then buy bread, meat, and other commodities directly from the vendors. In most cases, franchisees are also able to negotiate directly with local vendors if they can get a better price for similar quality. In contrast, Quiznos bought commodities and supplies directly from vendors and then resold them to their franchisees at a markup. The franchisees couldn't buy local, even if they could get a better price. Quiznos franchisees argued that this practice put them at a competitive disadvantage and took money directly away from their bottom lines.

The acrimonious relationship between Quiznos and its franchisees resulted in several lawsuits. Things came to a head when a large number of Quiznos' franchisees filed a class action lawsuit accusing the company of selling rights to too many locations and making its franchisees "captive customers." The suit was settled in 2009, with Quiznos agreeing to pay $95 million to settle a series of class-action franchisee lawsuits.

Inconsistent Advertising. Observers have scratched their heads several times in recent years regarding Quiznos's marketing strategy. In 2004, while Quiznos was still growing, it launched a campaign starring the Spongmonkeys, which were strange monkey-human hybrids that floated in mid-air and sang out-of-tune songs with a Quiznos restaurant in the background. If you'd like to see one of the ads, go to YouTube and type "Quiznos Spongmonkeys" into the search bar. It's hard to see the logic of the ad. In 2009, the company launched a series of ads for its $4 Toasty Torpedo subs—a competing offering to Subway's $5 footlongs. The ads featured a toaster oven speaking with a Quiznos employee about the new offering. The odd humor in the ad failed to appeal to the mainstream and was off-putting to many. You can see this ad by typing "Quiznos' Toasty Torpedo" into the search bar. Quiznos has run other ads that have been controversial. You can view them by typing "Quiznos Controversial Ads" into the YouTube search bar.

Quiznos Gets Stuck in the Middle in 2012

Viable Strategic Position	Nonviable Strategic Position	Viable Strategic Position
Compete on Price via Cost Leadership	Compete Effectively Neither on Price nor Differentiation	Compete on Differentiation via Natural, Quality Ingredients
Subway	Quiznos	Panera Bread, Potbelly

Quiznos has also run successful ads. In 2006, it revealed a new slogan: "Eat Up." Ads, which ran nationwide, feature a Quiznos sub with steam emanating from it with the tagline, "Mmmm . . . toasty."

Leadership Changes. In the past seven years Quiznos has had five CEOs. Greg MacDonald was named CEO in 2010 to replace Rich Schaden, who bought Quiznos from its founders in 1991. MacDonald led Quiznos from 2010–2012, during which Quiznos closed hundreds of locations and continued to compete on price. In 2012, MacDonald was replaced by Stuart Mathis who was the former president of The UPS Store network and executive vice president of franchise operations for Domino's Pizza. Mathis led Quiznos through its pivot from competing on price to competing on quality ingredients, a strategy that has had only mixed results. In early 2015, Mathis stepped down to make way for Douglas Pendergast, the former CEO of the Krystal burger chain. Pendergast made headway in several areas. In particular, he did away with Quiznos' policy of requiring its franchisees to buy ingredients and supplies from the parent company, and opened it up so they could buy goods from the lowest-cost provider. After only 16 months on the job, Pendergast was replaced by current CEO Susan Lintonsmith. Lintonsmith is a Quiznos' insider, and was instrumental in opening the China market, where Quiznos plans to open 1,500 stores. After many false starts, it's now Lintonsmith's job to right the ship and place Quiznos on a positive trajectory again.

One factor that's missing from the list that explains "what went wrong?" at Quiznos is increased competition. While Quiznos does compete in a competitive marketplace, the marketplace itself has remained healthy and growing. According to *IBIS World*, the "sandwich and sub store franchise" industry grew at a rate of 2.8 percent per year from 2011–2016, the exact period when Quiznos was closing hundreds of stores. By comparison, during that same five-year stretch Subway added 8,910 restaurants, Jimmy John's added 1,408, and Jersey Mike's added 682.

Can Quiznos Reestablish Itself as a Market Leader?

Quiznos' goal is to reestablish itself as a leader in the sub shop franchise industry. The firm is now opening new franchise units in the United States, is expanding internationally, and has a refreshed, healthy menu. It is also making operational improvements. In 2016, it conducted 18,000 customer surveys to assess its progress. It found that it has made significant strides in speed of service, accuracy of orders, and customer satisfaction, three important metrics in the quick-serve sub sandwich industry.

An increased international footprint is a large part of Quiznos' plans. It has inked or plans to ink major franchisee deals in China and 40 other countries. The other countries it has its sights on include locations in Europe, the Middle East, Southeast Asia, and Central and South America. A bright spot for all the competitors in Quiznos' industry is that the industry continues to grow. *IBIS World* projects a 1.6 percent annualized growth rate for the five-year period 2016–2021. Sub shops are perceived to have healthier food than other types of fast-food restaurants. Subway, for example, is well known for its low-calorie menu options. Quiznos is following this trend with low-calorie, tasty offerings of its own. Quiznos recently added breakfast items to its menu in order to compete in the profitable breakfast segment.

While Quiznos was once among the market leaders in the sub sandwich industry, that is no longer the case. The two largest competitors, along with their market share, are Subway at 53.5 percent and Jimmy John's at 11 percent. Quiznos is a category below Subway and Jimmy John's, and has a similar number of outlets as Firehouse Subs and Jersey Mike's Subs. Both Jersey Mike's Subs and Firehouse Subs have distinct strategies. Jersey Mike's Subs, which has a presence in 33 states, differentiates itself by offering high-quality ingredients at a slightly elevated price point. Firehouse Subs, which is present in 35 states, specializes in hot sub sandwiches. The company was founded by former firefighters and also runs the Firehouse Subs Public Safety Foundation, which provides community support for firefighters. Quiznos' current differentiation strategy is less clear. It features a wide line of subs from its classic subs, like its Turkey Ranch & Swiss for $6.00, to its premium subs, like its Lobster Sub for $7.00. It also serves salads, mac & cheese, soups, chips, and desserts, and a variety of beverages.

Discussion Questions

15-32. To what degree do you think Quiznos' brand has been permanently damaged by its missteps? Is Quiznos doing everything it can to repair its brand? What, if anything, would you do differently to revive Quiznos' brand if you were the company's CEO?

15-33. Why do you think Quiznos established the policies that caused so much angst among its franchisees?

15-34. At one time, Quiznos' major source of competitive advantage was the fact that it toasted its subs. What was the inherent danger in promoting toasted subs as the franchise chain's primary source of competitive advantage?

15-35. Of the four factors that caused Quiznos to lose market share, including identity crises, being at odds with franchisees, inconsistent advertising, and leadership changes, which factor do you think was the most damaging? Explain your answer.

15-36. To what degree do you think Quiznos will be able to re-establish itself as a leader in the sandwich and sub shop franchise industry?

Sources: Quiznos Homepage, www.quiznos.com (accessed April 1, 2017); A. Alvarez, "Sandwich & Sub Store Franchises in the U.S.," IBISWorld Industry Report OD5550, December, 2016; C. Zillman, "Quiznos and Potbelly: A Tale of Two Sandwich Chains," *Fortune*, March 18, 2014; K. Strauss, "Is Quiznos Toast?" *Forbes*, June 17, 2015; E. Sealover, "Quiznos, Still Shedding Stores, Begins Turnaround Effort with New Concept (Slideshow)," *Denver Business Journal*, March 4, 2016; E. Sealover, "Quiznos Picks a New CEO," *Denver Business Journal*, July 14, 2016; J. Daley, "Why These 3 Once Thriving Franchises Have Fallen on Hard Times, *Entrepreneur*, August 6, 2014.

CASE 15.2

School of Rock: Filling a Gap in Music Education and Growing via Franchising

• *Web: www.schoolofrock.com* • *Facebook: School of Rock* • *Twitter: SchoolofRockUSA*

Bruce R. Barringer, *Oklahoma State University*
R. Duane Ireland, *Texas A&M University*

Introduction

In 1996 Paul Green, a University of Pennsylvania philosophy graduate, started giving guitar lessons in his home. At one point, he invited a group of his students to sit in, or "jam," with his own band. The results were initially disappointing. But over time, he found that the students who played in a group did better than the students who received only individual instruction. As a result, he modified his teaching methods to supplement individual lessons with group practices. He compared it to the difference between shooting hoops and playing basketball.

Green continued combining individual instruction with group jam sessions. In 1998, he decided to expand beyond his home, and opened the Paul Green School of Rock Music in Philadelphia. The building he chose had a number of small rooms for individual lessons along with a larger space for jam sessions and concerts. He also started organizing students, with similar skill levels, into bands. His top students were put into what he called the school's AllStars band. The band started getting gigs in the Philadelphia area, and attracted media attention. In 2003, filmmakers Sheena M. Joyce and Don Argott attended a concert by the students, and decided to make a documentary about the Paul Green School of Rock Music and how it transformed high school students into performing musicians. A film crew followed a class of students through a nine-month school year and produced a documentary titled *Rock School*. Shortly after the documentary was released, Paramount released a fictional film called *School of Rock*, which featured an aspiring musician teaching kids to play rock music. Many observers felt the film was based on Green and the way he worked with students.

Early Growth

By 2002, Green had more than 100 students, and decided to open an additional location in Dowingtown, PA, which is 35 miles west of Philadelphia. Expansion continued in counties around Philadelphia and then in New Jersey and Delaware. Along the way Green's dentist, Dr. Joseph Roberts, became interested in what Green was doing, and provided funding to open School of Rock locations in several additional states, including California, New York, and Texas. At some point along the way Green shortened the name of his business from the Paul Green School of Rock Music to the School of Rock.

In 2009, Green sold the School of Rock to Sterling Partners, a private equity firm. Sterling has kept the original vision for the School of Rock intact and has used its financial resources to fuel further expansion.

How It Works

Each School of Rock location provides a place for kids with a passion for rock music to either learn how to play a rock instrument or sharpen their existing skills. It's also a wholesome and safe place for kids to learn to play rock music and become part of a rock band. Beginning students enroll in the Rock 101 program, where they learn the fundamentals and create a foundation for success. The program includes weekly private instruction along with group rehearsals. More advanced students enroll in the Performance Program, which also includes weekly private lessons and band rehearsals involving more challenging music. The students are also placed into groups where they put on real rock shows at real music venues. The top students in each school become members of an AllStars band and tour nationally. A recent School of Rock AllStars band completed a 27-city tour, which kicked off at the Knitting Factory in Hollywood, CA. As a result of experiences like this, a number of School of Rock graduates are now performing musicians or are making a living in the music industry in other ways.

Most School of Rock instructors are music teachers who also play in an active band. From time to time, prominent rock musicians make guest appearances at School of Rock locations. The instructors help students hone their musical skills and inspire them with tales of their own successes and recoveries from failures. The company's foundational belief is that the best way to learn to do something is by doing it, so students are handed instruments and are playing rock music from the minute they enroll. The curriculum is formulaic, depending on a particular student's skill level, and is driven by the added motivation that students will be placed in bands and play in front of live audiences. The schools are set up much like a club, where students are encouraged to visit to jam, work on their songs with other students, form bands, or write original music. The school becomes a community for its participants, where they not only learn music but also form lasting friendships. Many students enroll for multiple 12-week sessions, where their skills are allowed to advance and flourish. The schools operate year-round.

Franchising

The School of Rock is a franchise organization. It currently has 16 company-owned units and 172 franchise locations, located in the United States and eight foreign countries. According to *Entrepreneur* magazine, purchasing a franchise costs between $113,100 and $334,600, depending on the location and the size of the facility. The costs include a $49,500 initial franchise fee. The ongoing royalty is 8 percent of gross income and there is a 3 percent ongoing ad royalty fee.

In exchange for the fees and royalties, the franchisees receive training in how to run a School of Rock location, along with IT support including a website, assistance with real estate selection, help with facility design, and ongoing marketing support. One third of all School of Rock franchisees own more than one location. To obtain a School of Rock franchise, you must commit to actively running and managing the location you acquire (i.e., no absentee ownership).

New Programs

Along with its staple 12-week music instruction programs for 7- to 19-year-olds, the School of Rock is adding additional programs. It now has a program called Little Wing, after the Jimi Hendrix song by the same name, for preschool age children. The children participate in 45-minute, music-related activities by age group. There is a program named Rookies for first and second graders. This hour-long program is entirely group based, so kids learn how to play in a band from the start. There is now a program for adult amateur musicians called "Adult Performance Program" where adult students get individual lessons on guitar, bass, drums, keys, and vocals along with weekly band rehearsals. School of Rock also offers summer, winter, and spring break rock music camps, designed for musicians of all skill levels who play guitar, bass, drums, keyboard, and vocals. The camps are designed to hone music performance and ensemble skills in a fun and creative environment.

School of Rock Future

There are two factors to suggest a strong future for the School of Rock. The first is a reduction in music

High-school students with an interest in the guitar, like this teenager, are ideal candidates for the School of Rock's program.

michaeljung/Shutterstock

programs in public schools. Regrettably, as a result of tight budgets, a growing number of schools across the United States are cutting back on music programs. The School of Rock is poised to fill the gap. It is already the largest after-school music program in the United States. Second, there are currently 41.7 million kids ages 10–19 in the United States, all looking for a place to fit in and shine. The School of Rock offers a one-of-a-kind experience for 7- to 19-year-olds willing to commit to the rigors and joys of becoming successful musicians.

Discussion Questions

15-37. What types of characteristics do you anticipate School of Rock looks for in franchisees?

15-38. Look at Table 15.2. Of the ways mentioned in this table for franchisors to develop franchisees, which ones are the most important for School of Rock to emphasize to support its franchisees?

15-39. If you were to consider buying a School of Rock franchise, what issues would concern you the most about your ability to be successful as a franchisee for this company?

15-40. Over the next 10 years, what do you think lies ahead for School of Rock? What are some things that could go "right" for the firm and some of the things that could go "wrong" as the firm continues selling franchise locations as a means of growth?

Sources: School of Rock Homepage (www.schoolofrock.com) (accessed April 3, 2017); Wikipedia, School of Rock, www.wikipedia.com (accessed April 3, 2017); W. Boast, "A School for Brooklyn's Youngest Hipsters," *New Yorker,* May 12, 2014; *Entrepreneur*, School of Rock, available at https://www.entrepreneur.com/franchises/schoolofrock/333874-0.html (accessed April 2, 2017); D. Homan, "Small Business Snapshot: School of Rock," *Business News Daily*, October 3, 2016.

ESSAY QUESTIONS

1. Suppose you ran into an old friend who is about to buy into a replacement batteries retail franchise. He tells you that he is excited about the opportunity because the system he is about to buy into (1) is in an industry that virtually guarantees its success, (2) has a "proven" business model, and (3) is operated by people who are so honest that he can skip the expense of hiring a franchise attorney to review the documents he has to sign. If your friend asked you, "What do you think? Am I approaching this opportunity correctly?" how would you respond? Write a paragraph or two to detail the response you would provide to your friend.

2. If you were considering buying a franchise, there is no reason why you should either restrict your search to your own country or fail to consider ideas from overseas being offered in your own country. Buying a franchise with an internationally recognized brand or new concept from overseas might be just the opportunity you are looking for. What are the pros and cons for a franchisee in these cases? Write two paragraphs outlining the pros and cons.

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Glossary

7(A) Loan Guaranty Program. The main Small Business Administration (SBA) program available to small businesses operating through private sector lenders providing loans that are guaranteed by the SBA; loan guarantees reserved for small businesses that are unable to secure financing through normal lending channels. (388)

10-K. A report that is similar to the annual report, except that it contains more detailed information about the company's business. (307)

accounts receivable. The money owed to a firm by its customers. (304)

accredited investor. A person who is permitted to invest in high-risk investments such as business start-ups. (390)

acquirer. The surviving firm in an acquisition. (534)

acquisition. The outright purchase of one firm by another. (532)

adverse selection. The challenge a firm must face as it grows such that as the number of employees a firm needs increases, it becomes more difficult to find the right employees, place them in appropriate positions, and provide adequate supervision. (503)

advertising. Making people aware of a product or service in hopes of persuading them to buy it. (426)

advisory board. A panel of experts who are asked by a firm's managers to provide counsel and advice on an ongoing basis; unlike a board of directors, an advisory board possesses no legal responsibilities for the firm and gives nonbinding advice. (352)

agency theory. A management concept that argues that managers, because they are paid a salary, may not be as committed to the success of the businesses they manage as the owners, who capture the business' profits. This theory supports the notion of franchising, because franchisees are, in effect, the owners of the units they manage. (568)

area franchise agreement. Agreement that allows a franchisee to own and operate a specific number of outlets in a particular geographic area. (562)

articles of incorporation. Documents forming a legal corporation that are filed with the secretary of state's office in the state of incorporation. (281)

assignment of invention agreement. A document signed by an employee as part of the employment agreement that assigns the employer the right to apply for the patent of an invention made by the employee during the course of his or her employment. (459)

assumptions sheet. An explanation in a new firm's business plan of the sources of the numbers for its financial forecast and the assumptions used to generate them. (241, 315)

balance sheet. A snapshot of a company's assets, liabilities, and owners' equity at a specific point in time. (309)

barrier to entry. Conditions that create disincentives for a new firm to enter an industry. (194)

basis of differentiation. What causes consumers to pick one company's products over another's. (158)

board of advisors. A panel of experts asked by a firm's management to provide counsel and advice on an ongoing basis. (240)

board of directors. A panel of individuals who are elected by a corporation's shareholders to oversee the management of the firm. (240, 350)

bootstrapping. Using creativity, ingenuity, or any means possible to obtain resources other than borrowing money or raising capital from traditional sources. (377)

brainstorming. A technique used to quickly generate a large number of ideas and solutions to problems; conducted to generate ideas that might represent product or business opportunities. (89)

brand. The set of attributes—positive or negative—that people associate with a company. (416)

brand equity. The set of assets and liabilities that is linked to a brand and enables it to raise a firm's valuation. (420)

brand management. A program that protects the image and value of an organization's brand in consumers' minds. (418)

break-even point. The point at which total revenue received equals total costs associated with the output. (321)

budgets. Itemized forecasts of a company's income, expenses, and capital needs that are also important tools for financial planning and control. (304)

bug report. A popular technique that is used in classrooms to teach brainstorming. (91)

burn rate. The rate at which a company is spending its capital until it reaches profitability. (374)

business angels. Individuals who invest their personal capital directly in new ventures. (381)

business format franchise. By far the most popular approach to franchising in which the franchisor provides a formula for doing business to the franchisee along with training, advertising, and other forms of assistance. (561)

business method patent. A patent that protects an invention that is or facilitates a method of doing business. (458)

business model. A company's plan for how it competes, uses its resources, structures its relationships, interfaces with customers, and creates value to sustain itself on the basis of the profits it generates. (53, 148)

business plan. A written document describing all the aspects of a business venture, which is usually necessary to raise money and attract high quality business partners. (53, 222)

buyback clause. A clause found in most founders' agreements that legally obligates the departing founder to sell to the remaining founders his or her interest in the firm if the remaining founders are interested. (269)

buzz. An awareness and sense of anticipation about a company and its offerings. (419)

C corporation. A legal entity that, in the eyes of the law, is separate from its owners. (281)

carry. The percentage of the profits the venture capitalists receive is called the carry. (383)

certification marks. Marks, words, names, symbols, or devices used by a person other than its owner to certify a particular quality about a product or service. (466)

channels. A company's description of how it delivers its product or service to its customers. (166)

churn. Refers to the number of subscribers that a subscription-based business loses each month. (153)

closely held corporation. A corporation in which the voting stock is held by a small number of individuals and is very thinly or infrequently traded. (281)

code of conduct. A formal statement of an organization's values on certain ethical and social issues. (265)

collective marks. Trademarks or service marks used by the members of a cooperative, association, or other collective group, including marks indicating membership in a union or similar organization. (466)

common stock. Stock that is issued more broadly than preferred stock and that gives the stockholders voting rights to elect the firm's board of directors. (281)

competitive analysis grid. A tool for organizing the information a firm collects about its competitors to see how it stacks up against its competitors, provide ideas for markets to pursue, and identify its primary sources of competitive advantage. (207)

competitive intelligence. The information that is gathered by a firm to learn about its competitors. (207)

competitor analysis. A detailed evaluation of a firm's direct, indirect, and future competitors. (189, 235)

Computer Software Copyright Act. In 1980, Congress passed this act, which amended previous copyright acts; now, all forms of computer programs are protected. (471)

concept statement. A preliminary description of a business that includes descriptions of the product or service being offered, the intended target market, the benefits of the product or service, the product's position in the market, and how the product or service will be sold and distributed. (111)

concept test. A representation of the product or service to prospective users to gauge customer interest, desirability, and purchase intent. (111)

confirmation bias. A tendency to search for information that validates your preconceptions. (116)

constant ratio method of forecasting. A forecasting approach using the percent of sales method in which expense items on a firm's income statement are expected to grow at the same rate as sales. (317)

consultant. An individual who gives professional or expert advice. Consultants fall into two categories: paid consultants and consultants who are made available for free or at a reduced rate through a nonprofit or governmental agency. (355)

contribution margin. The amount per unit of sale that is left over and is available to "contribute" to covering the firm's fixed costs and producing a profit. (236)

copyright. A form of intellectual property protection that grants to the owner of a work of authorship the legal right to determine how the work is used and to obtain the economic benefits of the work. (471)

copyright bug. The letter c inside a circle with the first year of publication and the author copyright owner (e.g., © 2018 Dell Inc). (472)

copyright infringement. Violation of another's copyright that occurs when one work derives from another work or is an exact copy or shows substantial similarity to the original copyrighted work. (473)

core competency. A unique skill or capability that transcends products or markets, makes a significant contribution to the customer's perceived benefit, is difficult to imitate, and serves as a source of a firm's competitive advantage over its rivals. (160, 493)

core strategy. The overall manner in which a firm competes relative to its rivals. (156)

corporate entrepreneurship. Behavioral orientation exhibited by established firms with an entrepreneurial emphasis that is proactive, innovative, and risk taking. (33)

corporate venture capital. A type of capital similar to traditional venture capital, except that the money comes from corporations that invest in new ventures related to their areas of interest. (384)

corporation. A separate legal entity organized under the authority of a state. (280)

cost-based pricing. A pricing method in which the list price is determined by adding a markup percentage to the product's cost. (423)

cost of goods sold. The materials and direct labor needed to produce a firm's revenue. (236)

cost of sales. All of the direct costs associated with producing or delivering a product or service, including the material costs and direct labor costs (also cost of goods sold). (308)

cost reduction strategy. A strategy that is accomplished by achieving lower costs than industry incumbents through process improvements. (203)

cost structure. A description of the most important costs a business incurs to support its business model. (163)

creative destruction. The process by which new products and technologies developed by entrepreneurs over time make current products and technologies obsolete; stimulus of economic activity. (49)

creativity. The process of generating a novel or useful idea. (88)

crowdfunding. A method of funding in which people pool their money and other resources, usually via the Internet, to support efforts initiated by other people or organizations. (390)

current assets. Cash plus items that are readily convertible to cash, such as accounts receivable, inventories, and marketable securities. (311)

current liabilities. Obligations that are payable within a year, including accounts payable, accrued expenses, and the current portion of long-term debt. (311)

current ratio. A ratio that equals the firm's current assets divided by its current liabilities. (311)

customer advisory boards. Panels of individuals set up by some companies to meet regularly to discuss needs, wants, and problems that may lead to new product, service, or customer service ideas. (94)

day-in-the-life research. A form of anthropological research used by companies to make sure customers are satisfied and to probe for new product ideas by sending researchers to the customers' homes or businesses. (94)

debt financing. Getting a loan; most common sources of debt financing are commercial banks and the Small Business Administration's (SBA's) guaranteed loan program. (379)

debt-to-equity ratio. A ratio calculated by dividing the firm's long-term debt by its shareholders' equity. (304)

declining industry. An industry that is experiencing a reduction in demand. (203)

derivative works. Works that are new renditions of something that is already copyrighted, which are also copyrightable. (471)

design patents. The second most common type of patent covering the invention of new, original, and ornamental designs for manufactured products. (458)

disintermediation. The process of eliminating layers of intermediaries, such as distributors and retailers, to sell directly to customers. (433)

disruptive business models. Business models that are rare, that do not fit the profile of a standard business model, and that are impactful enough that they disrupt or change the way business is conducted in an industry or an important niche within an industry. (153)

distribution channel. The route a product takes from the place it is made to the customer who is the end user. (433)

double taxation. Form of taxation in which a corporation is taxed on its net income. When the same income is distributed to shareholders in the form of dividends, it is taxed again on shareholders' personal income tax returns. (281)

due diligence. The process of investigating the merits of a potential venture and verifying the key claims made in the business plan. (383)

Economic Espionage Act. Passed in 1996, an act that makes the theft of trade secrets a crime. (475)

economies of scale. A phenomenon that occurs when mass producing a product results in lower average costs. (194, 495)

economies of scope. The advantage a firm accrues through the scope (or range) of its operations rather than from the scale of its production. (497)

efficiency. How productively a firm utilizes its assets relative to its rate of return. (304)

elevator speech (or pitch). A brief, carefully constructed statement that outlines the merits of a business opportunity. (379)

emerging industry. A new industry in which standard operating procedures have yet to be developed. (201)

employee. Someone who works for a business, at the business' location or virtually, utilizing the business' tools and equipment and according to the business' policies and procedures. (346)

entrepreneurial alertness. The ability to notice things without engaging in deliberate search. (87)

entrepreneurial firms. Companies that bring new products and services to market by creating and seizing opportunities. (45)

entrepreneurial intensity. The position of a firm on a conceptual continuum that ranges from highly conservative to highly entrepreneurial. (33)

entrepreneurial services. Those services that generate new market, product, and service ideas. (503)

entrepreneurship. The process by which individuals pursue opportunities without regard to resources they currently control. (32)

equity-based crowdfunding. This type of funding helps businesses raise money by tapping individuals who provide funding in exchange for equity in the business. (390)

equity financing. A means of raising money by exchanging partial ownership in a firm, usually in the form of stock, for funding. (378)

ethical dilemma. A situation that involves doing something that is beneficial to oneself or the organization, but may be unethical. (265)

ethics training programs. Programs designed to teach employees how to respond to the types of ethical dilemmas that might arise on their jobs. (265)

exclusive distribution arrangements. An agreement that gives a retailer or other intermediary the exclusive rights to sell a company's products in a specific area for a specific period of time. (434)

execution intelligence. The ability to fashion a solid business idea into a viable business; it is a key characteristic of successful entrepreneurs. (40)

executive summary. A quick overview of the entire business plan that provides a busy reader everything that he or she needs to know about the distinctive nature of the new venture. (230)

external growth strategies. Growth strategies that rely on establishing relationships with third parties, such as mergers, acquisitions, strategic alliances, joint ventures, licensing, and franchising. (532)

factoring. A financial transaction whereby a business sells its accounts receivable to a third party, called a factor, at a discount in exchange for cash. (389)

fair use. The limited use of copyrighted material for purposes such as criticism, comment, news reporting, teaching, or scholarship. (474)

feasibility analysis. A preliminary evaluation of a business idea to determine if it is worth pursuing. (109)

Federal Employee Identification Number (EIN). A tax identification number used when filing various tax returns. (275)

fictitious business name permit. A permit that's required for businesses that plan to use a fictitious name, which is any name other than the business owner's name (also called dba or doing business as). (275)

fiduciary obligation. The obligation to always act in another's best interest; it is a mistake to assume that a franchisor has a fiduciary obligation to its franchisees. (580)

final prospectus. Documents issued by the investment bank after the Securities and Exchange Commission (SEC) has approved the offering that sets a date and issuing price for the offering. (386)

financial feasibility analysis. A preliminary financial assessment of a new venture that considers the total start up cash needed, financial performance of similar businesses, and the overall financial attractiveness of the proposed venture. (124)

financial management. The process of raising money and managing a company's finances in a way that achieves the highest rate of return. (302)

financial ratios. Ratios showing the relationships between items on a firm's financial statements that are used to discern whether a firm is meeting its financial objectives and how it stacks up against industry peers. (305)

financial statement. Written report that quantitatively describes a firm's financial health. (304)

financing activities. Activities that raise cash during a certain period by borrowing money or selling stock, and/or use cash during a certain period by paying dividends, buying back outstanding stock, or buying back outstanding bonds. (313)

first-mover advantage. A sometimes significant advantage, created by the opportunity to establish brand recognition and/or market power, gained by the first company to produce a product or service or the first company to move into a market. (201)

fixed assets. Assets used over a longer time frame, such as real estate, buildings, equipment, and furniture. (311)

fixed costs. The costs that a company incurs in operating a business whether it sells something or not (e.g., overhead). (164, 236, 497)

focus group. A gathering of 5 to 10 people who have been selected based on their common characteristics relative to the issue being discussed. The purpose of the group is to generate ideas that might represent product or business opportunities. (91)

follow-on funding. Additional funding for a firm following the initial investment made by investors. (383)

forecasts. Estimates of a firm's future income and expenses, based on its past performance, its current circumstances, and its future plans. (317, 315)

founders' agreement. A written document that deals with issues such as the relative split of the equity among the founders of a firm, how individual founders will be compensated for the cash or the "sweat equity" they put into the firm, and how long the founders will have to remain with the firm for their shares to fully vest (also shareholders' agreement). (269)

founding team. A team of individuals chosen to start a new venture. A firm with this team has an advantage over firms started by an individual because a team brings more talent, resources, ideas, and professional contacts to a new venture than does a sole entrepreneur. (340)

fragmented industry. An industry characterized by a large number of firms approximately equal in size. (202)

franchise agreement. The document that consummates the sale of a franchise, which typically contains two sections: (1) the purchase agreement and (2) the franchise or license agreement. (580)

Franchise Disclosure Document (FDD). Accepted in all 50 states and parts of Canada, a lengthy document that contains 23 categories of information that give a prospective franchisee a broad base of information about the background and financial health of the franchisor. (580)

franchisee. An individual or firm that enters into a franchise agreement and pays an initial fee and an ongoing royalty to a franchisor in exchange for using the franchisor's trademark and method of doing business. (560)

franchising. A form of business organization in which a firm that already has a successful product or service (franchisor) licenses its trademark and method of doing business to other businesses (franchisees) in exchange for an initial franchise fee and an ongoing royalty. (560)

franchisor. A firm with a successful product or service that enters into a franchising agreement to license its trademark and method of doing business to other businesses in exchange for fee and royalty payments. (560)

freelancer. A person who is in business for themselves, works on their own time with their own tools and equipment, and performs services for a number of different clients. (348)

full business plan. A document that spells out a company's operations and plans in much more detail than a summary business plan; the format that is usually used to prepare a business plan for an investor. (229)

general partners. The venture capitalists who manage a venture capital fund. (383)

general partnership. A form of business organization in which two or more people pool their skills, abilities, and resources to run a business. (279)

geographic expansion. An internal growth strategy in which an entrepreneurial business grows by simply expanding from its original location to additional geographical sites. (527)

geographic roll-up strategy. When one firm starts acquiring similar firms that are located in different geographic areas. (203)

global industry. An industry that is experiencing significant international sales. (204)

global strategy. An international expansion strategy in which firms compete for market share by using the same basic approach in all foreign markets. (204)

guerilla marketing. A low budget approach to marketing that relies on ingenuity, cleverness, and surprise rather than traditional techniques. (432)

heterogeneous team. A team whose individual members are diverse in terms of their abilities and experiences. (341)

historical financial statements. Financial statements that reflect past performance and are usually prepared on a quarterly and annual basis. (306)

homogeneous team. A team whose individual members' experiences and areas of expertise are very similar to one another. (341)

idea. A thought, impression, or notion. (74)

idea–expression dichotomy. The legal principle describing the concept that although an idea is not able to be copyrighted, the specific expression of an idea can be. (472)

illiquid. Describes stock in both closely held and private corporations, meaning that it typically isn't easy to find a buyer for the stock. (282)

improving an existing product or service. Enhancing a product or service's quality by making it larger or smaller, making it easier to use, or making it more up-to-date, thereby increasing its value and price potential. (526)

income statement. A financial statement that reflects the results of the operations of a firm over a specified period of time: prepared on a monthly, quarterly, or annual basis. (308)

individual franchise agreement. The most common type of franchise agreement, which involves the sale of a single franchise for a specific location. (562)

industry. A group of firms producing a similar product or service, such as Pilates and Yoga studios, and solar panels. (118, 188)

industry analysis. Business research that focuses on the potential of an industry. (188)

industry/target market feasibility. An assessment of the overall appeal of the industry and target market for the product or service being proposed. (118)

initial public offering (IPO). The first sale of a company's stock to the public and an important milestone for a firm for four reasons: it is a way to raise equity capital; it raises a firm's public profile; it is a liquidity event; and it creates another form of currency (company stock) that can be used to grow the company. (384)

innovation. The process of creating something new, which is central to the entrepreneurial process. (50)

inside director. A person on a firm's board of directors who is also an officer of the firm. (350)

intellectual property. Any product of human intellect, imagination, creativity, or inventiveness that is intangible but has value in the marketplace and can be protected through tools such as patents, trademarks, copyrights, and trade secrets. (453)

intellectual property audit. A firm's assessment of the intellectual property it owns. (478)

intent-to-use trademark application. An application based on the applicant's intention to register and use a trademark. (469)

intern. A person who works for a business as an apprentice or trainee for the purpose of obtaining practical experience. (347)

internal growth strategies. Growth strategies that rely on efforts generated within the firm itself, such as new product development, other product related strategies, or international expansion. (522)

international new ventures. Businesses that, from inception, seek to derive significant competitive advantage by using their resources to sell products or services in multiple countries. (528)

inventory. A company's merchandise, raw materials, and products waiting to be sold. (304)

investing activities. Activities that include the purchase, sale, or investment in fixed assets, such as real estate and buildings. (313)

investment bank. A financial institution that acts as an underwriter or agent for a firm issuing securities. (386)

joint venture. An entity created when two or more firms pool a portion of their resources to create a separate, jointly owned organization. (539)

key assets. The assets a firm owns that enable its business model to work. (161)

landing page. A single web page that typically provides direct sales copy, like "click here to buy a Hawaiian vacation." (117)

Lanham Act. An act of Congress, passed in 1946, that spells out what is protected under trademark law. (466)

leadership strategy. A competitive strategy in which the firm tries to become the dominant player in the industry. (203)

lease. A written agreement in which the owner of a piece of property allows an individual or business to use the property for a specified period of time in exchange for regular payments. (391)

liability of newness. Situation that often causes new firms to falter because the people who start the firms can't adjust quickly enough to their new roles, and because the firm lacks a "track record" with customers and suppliers. (339)

licensee. A company that purchases the right to use another company's intellectual property. (536)

licensing. The granting of permission by one company to another company to use a specific form of its intellectual property under clearly defined conditions. (536)

licensing agreement. The formal contract between a licensor and licensee. (536)

licensor. The company that owns the intellectual property in a licensing agreement. (536)

lifestyle firms. Businesses that provide their owners the opportunity to pursue a particular lifestyle and earn a living while doing so (e.g., ski instructors, golf pros, and tour guides). (45)

limited liability company (LLC). A form of business organization that combines the limited liability advantage of the corporation with the tax advantages of the partnership. (283)

limited partners. Participants in a partnership, such as a venture capital fund, which have limited liability, meaning that they are only liable up to the amount of their investment and have no management authority. (383)

limited partnership. A modified form of a general partnership that includes two classes of owners: general partners and limited partners. The general partners are liable for the debts and obligations of the partnership, but the limited partners are liable only up to the amount of their investment. The limited partners may not exercise any significant control over the organization without jeopardizing their limited liability status. (280)

limited partnership agreement. Sets forth the rights and duties of the general and limited partners, along with the details of how the partnership will be managed and eventually dissolved. (280)

line of credit. A borrowing "cap" is established and borrowers can use the credit at their discretion; requires periodic interest payments. (387)

link joint venture. A joint venture in which the position of the parties is not symmetrical and the objectives of the partners may diverge. (541)

liquid market. A market in which stock can be bought and sold fairly easily through an organized exchange. (281)

liquidity. The ability to sell a business or other asset quickly at a price that is close to its market value; also, a company's ability to meet its short-term financial obligations. (277, 304)

liquidity event. An occurrence such as a new venture going public, finding a buyer, or being acquired by another company that converts some or all of a company's stock into cash. (378)

long-term liabilities. Notes or loans that are repayable beyond one year, including liabilities associated with purchasing real estate, buildings, and equipment. (311)

low-end market disruption. A type of disruption that is possible when the firms in an industry continue to improve products or services to the point where they are actually better than a sizable portion of their clientele needs or desires. (155)

managerial capacity problem. The problem that arises when the growth of a firm is limited by the managerial capacity (i.e., personnel, expertise, and intellectual resources) that a firm has available to investigate and implement new business ideas. (503)

managerial services. The routine functions of the firm that facilitate the profitable execution of new opportunities. (503)

market analysis. An analysis that breaks the industry into segments and zeros in on the specific segment (or target market) to which the firm will try to appeal. (234)

market leadership. The position of a firm when it is the number one or the number two firm in an industry or niche market in terms of sales volume. (497)

market penetration strategy. A strategy designed to increase the sales of a product or service through greater marketing efforts or through increased production capacity and efficiency. (526)

market segmentation. The process of studying the industry in which a firm intends to compete to determine the different potential target markets in that industry. (234, 413)

marketing alliances. Typically match a company with a distribution system with a company with a product to sell in order to increase sales of a product or service. (537)

marketing mix. The set of controllable, tactical marketing tools that a firm uses to produce the response it wants in the target market; typically organized around the four Ps—product, price, promotion, and place (or distribution). (421)

marketing strategy. A firm's overall approach for marketing its products and services. (238)

master franchise agreement. Similar to an area franchise agreement; but, in addition to having the right to operate a specific number of locations in a particular area, the franchisee also has the right to offer and sell the franchise to other people in the area. (562)

mature industry. An industry that is experiencing slow or no increase in demand, has numerous repeat (rather than new) customers, and has limited product innovation. (203)

mediation. A process in which an impartial third party (usually a professional mediator) helps those involved in a dispute reach an agreement. (272)

mentor. Someone who is more experienced than you and is willing to be your counselor, confidant, and go-to person for advice. (93)

merchandise and character licensing. The licensing of a recognized trademark or brand, which the licensor typically controls through a registered trademark or copyright. (537)

merger. The pooling of interests to combine two or more firms into one. (532)

milestone. In a business plan context, a noteworthy event in the past or future development of a business. (234)

mind map. A diagram used to visually organize information. (90)

mission or mission statement. A statement that describes why a firm exists and what its business model is supposed to accomplish. (157, 234)

moderate risk takers. Entrepreneurs who are often characterized as willing to assume a moderate amount of risk in business, being neither overly conservative nor likely to gamble. (43)

moral hazard. A problem a firm faces as it grows and adds personnel; the assumption is that new hires will not have the same ownership incentives or be as motivated to work as hard as the original founders. (503)

multidomestic strategy. An international expansion strategy in which firms compete for market share on a country by country basis and vary their product or service offerings to meet the demands of the local market. (204)

multiple-unit franchisee. An individual who owns and operates more than one outlet of the same franchisor, whether through an area or a master franchise agreement. (562)

net sales. Total sales minus allowances for returned goods and discounts. (308)

network entrepreneurs. Entrepreneurs who identified their idea through social contacts. (87)

networking. Building and maintaining relationships with people whose interests are similar or whose relationship could bring advantages to a firm. (344)

new market disruption. A market disruption that addresses a market that previously wasn't served. (153)

new product development. The creation and sale of new products (or services) as a means of increasing a firm's revenues. (523)

new-venture team. The group of founders, key employees, and advisors that move a new venture from an idea to a fully functioning firm. (122, 338)

niche market. A place within a large market segment that represents a narrow group of customers with similar interests. (414)

niche strategy. A marketing strategy that focuses on a narrow segment of the industry. (203)

noncompete agreement. An agreement that prevents an individual from competing against a former employer for a specific period of time. (272)

nondisclosure agreement. A promise made by an employee or another party (such as a supplier) to not disclose a company's trade secrets. (272)

one year after first use deadline. Requirement that a patent must be filed within one year of when a product or process was first offered for sale, put into public use, or was described in any printed publication. If this requirement is violated, the right to apply for a patent is forfeited. (458)

operating activities. Activities that affect net income (or loss), depreciation, and changes in current assets and current liabilities other than cash and short-term debt. (313)

operating expenses. Marketing, administrative costs, and other expenses not directly related to producing a product or service. (308)

operating leverage. An analysis of the firm's fixed costs versus its variable costs. (236)

operational business plan. A blueprint for a company's operations; primarily meant for an internal audience. (229)

operations. Activities that are both integral to a firm's overall business model and representative of the day-to-day heartbeat of a firm. (165)

opportunity. A favorable set of circumstances that creates a need for a new product, service, or business. (72)

opportunity gap. An entrepreneur recognizes a problem and creates a business to fill it. (73)

opportunity recognition. The process of perceiving the possibility of a profitable new business or a new product or service. (86)

organic growth. Internally generated growth within a firm that does not rely on outside intervention. (523)

organizational chart. A graphic representation of how authority and responsibility are distributed within a company. (241)

organizational feasibility analysis. A study conducted to determine whether a proposed business has sufficient management expertise, organizational competence, and resources to be successful. (122)

other assets. Miscellaneous assets including accumulated goodwill. (311)

outside director. Someone on a firm's board of directors who is not employed by the firm. (350)

outsourcing. Work that is done for a company by people other than the company's full-time employees. (527)

owners' equity. The equity invested in the business by its owner(s) plus the accumulated earnings retained by the business after paying dividends. (311)

pace of growth. The rate at which a firm is growing on an annual basis. (495)

partnership agreement. A document that details the responsibility and the ownership shares of the partners involved with an organization. (279)

passion for their business. An entrepreneur's belief that his or her business will positively influence people's lives; one of the characteristics of successful entrepreneurs. (36)

patent. A grant from the federal government conferring the rights to exclude others from making, selling, or using an invention for the term of the patent. (456)

patent infringement. The action of one party engaging in the unauthorized use of another's patent. (463)

peer-to-peer lenders. A category of financial transactions which occur directly between individuals or "peers." (389)

percent-of-sales-method. A method for expressing each expense item as a percent of sales. (317)

piercing the corporate veil. The chain of events that occurs if the owners of a corporation don't file their yearly payments, neglect to pay their annual fees, or commit fraud, which may result in the court ignoring the fact that a corporation has been established, and the owners could be held personally liable for actions of the corporation. (281)

place. The marketing mix category that encompasses all of the activities that move a firm's product from its place of origin to the consumer (also known as distribution). (433)

plant patents. Patents that protect new varieties of plants that can be reproduced asexually by grafting or cross-breeding rather than by planting seeds. (459)

position. How the entire company is situated relative to its competitors. (189, 234)

preferred stock. Stock that is typically issued to conservative investors, who have preferential rights over common stockholders in regard to dividends and to the assets of the corporation in the event of liquidation. (281)

preliminary prospectus. A document issued by an investment bank that describes the potential offering to the general public while the SEC is conducting an investigation of the offering (also red-herring). (386)

press kit. A folder typically distributed to journalists and made available online that contains background information about a company and includes a list of the company's most recent accomplishments. (430)

price. The amount of money consumers pay to buy a product; one of the four Ps in a company's marketing mix. (423)

price-to-earnings (P/E) ratio. A simple ratio that measures the price of a company's stock against its earnings. (309)

price-quality attribution. The assumption consumers naturally make that the higher priced product is also the better quality product. (424)

primary research. Research that is original and is collected firsthand by the entrepreneur by, for example, talking to potential customers and key industry participants. (110)

prior entrepreneurial experience. Prior start up experience; this experience has been found to be one of the most consistent predictors of future entrepreneurial performance. (343)

private corporation. A corporation in which all of the shares are held by a few shareholders, such as management or family members, and the stock is not publicly traded. (281)

private placement. A variation of the IPO in which there is a direct sale of an issue of securities to a large institutional investor. (387)

product. The element of the marketing mix that is the good or service a company offers to its target market; often thought of as something having physical form. (422)

product and trademark franchise. An arrangement under which the franchisor grants to the franchisee the right to buy its product and use its trade name. (561)

product attribute map. A map that illustrates a firm's positioning strategy relative to its major rivals. (415)

product/customer focus. A defining characteristic of successful entrepreneurs that emphasizes producing good products with the capability to satisfy customers. (38)

product line extension strategy. A strategy that involves making additional versions of a product so they will appeal to different clientele. (527)

product/market fit. The benefits your product or service offers and what your prospective customers need and require. (112)

product/market scope. A range that defines the products and markets on which a firm will concentrate. (159)

product prototype. The first physical manifestation of a new product, often in a crude or preliminary form. (238)

product/service feasibility analysis. An assessment of the overall appeal of the product or service being proposed. (110)

productive opportunity set. The set of opportunities the firm feels it is capable of pursuing. (503)

pro forma balance sheet. Provides a firm a sense of how its activities will affect its ability to meet its short-term liabilities and how its finances will evolve over time. (321)

pro forma financial statements. Projections for future periods, based on a firm's forecasts, and typically completed for two to three years in the future. (307)

pro forma income statement. A financial statement that shows the projected results of the operations of a firm over a specific period. (320)

pro forma (or projected) financial statements. Statements that are at the heart of the financial section of a business plan. (241)

pro forma statement of cash flows. A financial statement that shows the projected flow of cash into and out of a company for a specific period. (323)

profit margin. A measure of a firm's return on sales that is computed by dividing net income by average net sales. (309)

profitability. The ability to earn a profit. (304)

promissory note. A document that details the terms of a loan agreement. (377)

promotion. The marketing mix category that includes the activities planned by a company to communicate the merits of its product to its target market with the goal of persuading people to buy the product. (426)

prototype. An early sample, model, or release of a product that is built to test a concept or a process. (119)

provisional patent application. A part of patent law that grants "provisional rights" to an inventor for up to one year, pending the filing of a complete and final application. (461)

public corporation. A corporation that is listed on a major stock exchange, such as the New York Stock Exchange or the NASDAQ, in which owners can sell their shares at almost a moment's notice. (281)

public relations. The efforts a company makes to establish and maintain a certain image with the public through networking with journalists and others to try to interest them in saying or writing good things about the company and its products. (428)

ratio analysis. Ratios showing the relationships between items on a firm's financial statements that are used to discern whether a firm is meeting its financial objectives and how it stacks up against industry peers. (241)

reference account. An early user of a firm's product who is willing to give a testimonial regarding his or her experience with the product. (423)

regression analysis. A statistical technique used to find relationships between variables for the purpose of predicting future values. (317)

relevant industry experience. Experience in the same industry as an entrepreneur's current venture that includes a network of industry contacts and an understanding of the subtleties of the industry. (343)

resources. The inputs a firm uses to produce, sell, distribute, and service a product or service. (160)

revenue streams. A description of how a firm makes money. (162)

rewards-based crowdfunding. This type of funding allows entrepreneurs to raise money in exchange for some type of amenity or reward. (390)

road show. A whirlwind tour taken by the top management team of a firm wanting to go public; consists of meetings in key cities where the firm presents its business plan to groups of investors. (386)

rounds. Stages of subsequent investments made in a firm by investors. (383)

salary-substitute firms. Small firms that yield a level of income for their owner or owners that is similar to what they would earn when working for an employer (e.g., dry cleaners, convenience stores, restaurants, accounting firms, retail stores, and hairstyling salons). (45)

sales forecast. A projection of a firm's sales for a specified period (such as a year); most firms, though, forecast their sales for two to five years into the future. (316)

sales process. The systematic process a business engages in to identify prospects and close sales. (434)

Sarbanes-Oxley Act. A federal law that was passed in response to corporate accounting scandals involving prominent corporations, like Enron and WorldCom. (386)

SBA Guaranteed Loan Program. An important source of funding for small businesses in general in which approximately 50 percent of the 9,000 banks in the United States participate. (388)

SBIR Program. Small Business Innovation Research (SBIR) competitive grant program that provides over $1 billion per year to small businesses for early stage and development projects. (391)

scale joint venture. A joint venture in which the partners collaborate at a single point in the value chain to gain economies of scale in production or distribution. (541)

secondary market offering. Any later public issuance of shares after the initial public offering. (384)

secondary meaning. This arises when, over time, consumers start to identify a trademark with a specific product. For example, the name CHAP STICK for lip balm was originally considered to be descriptive, and thus not afforded trademark protection. (468)

secondary research. Data collected previously by someone else for a different purpose. (110)

service. An activity or benefit that is intangible and does not take on a physical form, such as an airplane trip or advice from an attorney. (422)

service marks. Similar to ordinary trademarks but used to identify the services or intangible activities of a business rather than a business' physical product. (465)

shareholders. Owners of a corporation who are shielded from personal liability for the debts and obligations of the corporation. (281)

signaling. The act of a high-quality individual agreeing to serve on a company's board of directors, indicating that the individual believes that the company has the potential to be successful. (351)

single-purpose loan. One common type of loan in which a specific amount of money is borrowed that must be repaid in a fixed amount of time with interest. (387)

skills profile. A chart that depicts the most important skills that are needed and where skills gaps exist. (346)

social plug-ins. Tools that websites use to provide users with personalized and social experiences. (431)

sole proprietorship. The simplest form of business organization involving one person, in which the owner maintains complete control over the business and business losses can be deducted against the owner's personal tax return. (277)

solo entrepreneurs. Entrepreneurs who identified their business idea on their own. (87)

sources and uses of funds statement. A document, usually included in the financial section of a business plan, that lays out specifically how much money a firm needs, where the money will come from, and what the money will be used for. (241)

spin-ins. A transaction that takes place when a large firm that has a small equity stake in a small firm, decides to acquire a 100% interest in the firm. (541)

spin-out. The opposite of a spin-in that occurs when a larger company divests itself of one of its smaller divisions. (541)

stability. The strength and vigor of the firm's overall financial posture. (304)

standard business models. Models that depict existing plans or recipes firms can use to determine how they will create, deliver, and capture value for their stakeholders. (151)

statement of cash flows. A financial statement summarizing the changes in a firm's cash position for a specified period of time and detailing why the changes occurred. Similar to a month end bank statement, it reveals how much cash is on hand at the end of the month as well as how the cash was acquired and spent during the month. (313)

stock options. Special form of incentive compensation providing employees the option or right to buy a certain number of shares of their company's stock at a stated price over a certain period of time. (282)

strategic alliance. A partnership between two or more firms that is developed to achieve a specific goal. (537)

strong-tie relationships. Relationships, characterized by frequent interaction, that form between like-minded individuals such as coworkers, friends, and spouses; these relationships tend to reinforce insights and ideas the individuals already have and, therefore, are not likely to introduce new ideas. (87)

STTR Program. A government grant program, similar to the SBIR program, which requires the participation of a research organization, such as a research university or a federal laboratory. (392)

subchapter S corporation. A form of business organization that combines the advantages of a partnership and C corporation; similar to a partnership, in that the profits and losses of the business are not subject to double taxation, and similar to a corporation, in that the owners are not subject to personal liability for the behavior of the business. (282)

subfranchisees. The people who buy franchises from master franchisees. (562)

summary business plan. A business plan, 10 to 15 pages long, that works best for companies very early in their development that are not prepared to write a full plan. (228)

supplier. A company that provides parts or services to another company. (167)

sustained growth. Growth in both revenues and profits over an extended period of time. (490)

sweat equity. The value of the time and effort that a founder puts into a new firm. (376)

tagline. A phrase that is used consistently in a company's literature, advertisements, promotions, stationery, and even invoices to develop and to reinforce the position the company has staked out in its market. (234, 416)

target. In an acquisition, the firm that is acquired. (534)

target market. The limited group of individuals or businesses that a firm goes after or tries to appeal to at a certain point in time. (118, 158)

technological alliances. Business alliances that cooperate in R&D, engineering, and manufacturing. (537)

technology licensing. The licensing of proprietary technology, which the licensor typically controls by virtue of a utility patent. (536)

trade secret. Any formula, pattern, physical device, idea, process, or other information that provides the owner of the information with a competitive advantage in the marketplace. (475)

trade show. An event at which the goods or services in a specific industry are exhibited and demonstrated. (430)

trademark. Any work, name, symbol, or device used to identify the sources or origin of products or services and to distinguish those products and services from others. (463)

triggering event. The event that prompts an individual to become an entrepreneur (e.g., losing a job, inheriting money, accommodating a certain lifestyle). (52)

Uniform Trade Secrets Act. An act drafted in 1979 by a special commission in an attempt to set nationwide standards for trade secret legislation; although the majority of states have adopted the act, most revised it, resulting in a wide disparity among states in regard to trade secret legislation and enforcement. (475)

utility patents. The most common type of patent covering what we generally think of as new inventions that must be useful, must be novel in relation to prior arts in the field, and must not be obvious to a person of ordinary skill in the field. (457)

value. Relative worth, importance, or utility. (45)

value-based pricing. A pricing method in which the list price is determined by estimating what consumers are willing to pay for a product and then backing off a bit to provide a cushion. (424)

variable costs. The costs that are not fixed that a company incurs as it generates sales. (164, 236, 495)

vendor credit. A form of credit in which a vendor extends credit to a business in order to allow the business to buy its products and/or services up front but defer payment until later. (389)

venture capital. The money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential. (383)

venture-leasing firms. Firms that act as brokers, bringing the parties involved in a lease together (e.g., firms acquainted with the producers of specialized equipment match these producers with new ventures that are in need of the equipment). (391)

viral marketing. A new marketing technique that facilitates and encourages people to pass along a marketing message about a particular product or service. (432)

virtual assistant. A freelancer who provides administrative, technical, or creative assistance to clients remotely from a home office. (348)

virtual prototype. A computer generated 3-D image of an idea. (239)

weak-tie relationships. Relationships, characterized by infrequent interaction, that form between casual acquaintances who do not have a lot in common and, therefore, may be the source of completely new ideas. (87)

window of opportunity. The time period in which a firm or an entrepreneur can realistically enter a new market. (73)

working capital. A firm's current assets minus its current liabilities. (311)

yield rate. The percentage of investment opportunities that are brought to the attention of angel investors that result in an investment. (382)

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