CHAPTER ONE
Entrepreneurship and Free Enterprise

After completing this unit, you will be able to:

- Define entrepreneur and entrepreneurship
- Identify the importance of entrepreneurship
- Relate among Entrepreneurship, Creativity and Innovation

1.1 Historical development of entrepreneurship

The concept of entrepreneurship varies from country to country as well as from period to period and the level of economic development thoughts and perceptions; a concise, universally accepted definition has not yet emerged. Not only different people have different views of what entrepreneurship is, but also the same people may use different definitions when researching entrepreneurship in different economic and social context. The development of the theory of entrepreneurship parallels to a great extent the development of the term itself. So, let us discuss the concept of entrepreneurship given at different times by different writers on the subject. The word entrepreneur is derived from the French verb entre prendre, which means to undertake.

Earliest period

At the earlier period an entrepreneur was viewed as a go-between, who attempted to establish contracts with trade routes and signed money persons/forerunners of today's venture capitalist, to sell goods. A common contract during this time provided a loan to the merchant-adventure at a relatively greater interest rate, including insurance. While the capitalist was a passive risk bearer, the merchant adventure took the active role in trading, bearing all the physical and emotional risks. When the merchant-adventure successfully sold the goods and completed the trip, the profits were divided with the capitalist taking most of them (up to 75 percent), while the merchant-adventure settled for the remaining 25 percent through passage of time.

Middle Ages

In the middle ages, the term entrepreneur was used to describe a person managing large production projects. In the case of large production projects, the person would not take any risks but would merely manage the project using the resources provided. A typical entrepreneur in the middle ages was the cleric - the person in charge of greater architectural works, such as castles and fortifications, public buildings, abbeys and cathedrals.

17th Century

The concept of risk in the notion of entrepreneurship had developed in the 17th century, with an entrepreneur being viewed as a person who entered into a contractual agreement with government to perform a service or supply stipulated products. Since the contract price to supply was fixed, any resulting profits or losses (since the price of raw materials and other cost of production are uncertain) reflected that the entrepreneur was risk taker.

18th Century

An 18th century Irishman named Richard Cantillon who was living in France at the time, is credited with being the first to use the term "entrepreneur" in a business context. He is also regarded as the founder/the father of the term entrepreneurship. Cantillon viewed the entrepreneur as a risk taker, seeing the merchants, farmers, crafts man and other sole proprietors buy products at certain price and sell at uncertain price-therefore, operating at a risk condition.

Furthermore, in the 18th century the entrepreneur role was distinguished from the capital-providing role. A venture capitalist is a professional money manager who invests in a risky investment from pool of equity capital to obtain a high rate of return on the investment. Whereas, an entrepreneur is one who creates and manages his own enterprise as well as one who assumes all risks related to running the venture.

In the late 19th and early 20th Centuries

In the late 19th and early 20th centuries, entrepreneurs were frequently not distinguished from managers and were viewed mostly from an economic perspective. Hess and Ely

defined the term entrepreneur as the one who organizes and operates an enterprise for personal gain. The entrepreneur contributes his/her own initiative, skill and integrity in planning, organizing and administering the enterprise. He/she pays prices for the materials consumed in the business, for the use of the land, for personal service he/ she employs, and for the capital he/ she requires. He/ she also assume the chance of loss and gain consequent to unforeseen and uncontrollable circumstances. Thus, an entrepreneur is both a risk taker and a manger.

In the Middle of 20th Century

According to Joseph Schumpeter, the function of an entrepreneur is to reform or revolutionize the pattern of production by exploiting an invention, or more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way, opening a new source of supply of materials or a new outlet for products, by organizing a new industry. The concept of innovation and newness are integral part of entrepreneurship in this definition. Briefly, an entrepreneur is one who innovates, raises money, assembles inputs, chooses managers and sets the organization going with his ability. But the entrepreneur differs from the mere innovator since he/she innovates something new and converts into business by investing his/her money and devoting time and& energy.

According to this definition, innovation can occur through:

i. Introduction of new quality in a product,
ii. Development of a new product,
iii. Discovery of a fresh demand and a fresh source of supply and,
iv. Changes in the organization and management

The concept of entrepreneurship is further refined when principles and terms from a business, managerial and personnel perspective are considered. In parti cular the concept of entrepreneurship has been explored in this century.

Relatively Recent Definitions:

❖ In almost all of the definitions of entrepreneurship, there is agreement that we are

talking about a kind of behavior that includes:

i. Initiative taking,
ii. The organizing and reorganizing of social/economic mechanisms to turn resources to practical account, and
iii. The acceptance of risk or failure. ... Albert Shapero

Karl Vesper has researched entrepreneurship and explained that its nature is a matter of individual perception as follows:

- To an economist, an entrepreneur is one who brings resources, labor, materials and other assets into combination that make their value greater than before and also one who introduces changes, innovations and a new order.
- To a psychologist, such a person is typically driven by certain forces like need to obtain, to attain, to experiment, to accomplish something or perhaps to escape authority of others.
- To capitalist philosophers, an entrepreneur is one who creates wealth for others as well, who finds better ways to utilize resources and reduce waste and who produce jobs that others are glad to get.

- The commonly held view of the entrepreneur as a calculated risk taker is also shared by Knight. For Knight, the entrepreneur is an individual who is prepared to undertake risk and receive the reward.
- "Entrepreneurship is the process of creating something different with value by devoting the necessary time and effort, assuming the accompanying financial, psychic and social risks, and receiving the resulting rewards of monetary and personal satisfaction." ... Hisrich, and Peters.

This definition stresses on four basic aspects of being an entrepreneur:

i. Entrepreneurship involves creating something new value.
ii. Entrepreneurship requires the devotion of the necessary time and effort though only those going through the entrepreneurial process appreciate the significant

amount of time and effort it takes to create something new and make it operational.

iii. Entrepreneurship assumes risk in the form of financial lose, psychological tension and social problems.

iv. Entrepreneurship also involves rewards of independence, followed by personal satisfaction and money.

Casson (1982), attempts to synthesize some of the attributes and concepts that have been discussed with the major writers above. He recognizes that the entrepreneur will have different skills from others. These skills enable the entrepreneur to make judgmental decisions that involve the allocation or organization of resources.

1.2. What is entrepreneur?

Like in many other terminologies that are coined by social scientists, we do not have one exact meaning for entrepreneurship and entrepreneur. Because various scholars define them differently depending on the reasons they address.

The Oxford English Dictionary defines an entrepreneur as 'a person who attempts to profit by risk and initiative

An entrepreneur is one who creates a new business in the face of risk and uncertainty for the purpose of achieving profit and growth by identifying opportunities and assembling the necessary resources to capitalize on those opportunities. Entrepreneurs usually start with nothing more than an idea—often a simple one—and then organize the resources necessary to transform that idea into a sustainable business.

Entrepreneurs shift economic resources from an area of lower productivity into an area of higher productivity and greater yield.

Karl Vesper (1980) stated that entrepreneur is seen differently by the fields of economists, psychologists, business persons and politician.

Economists explain entrepreneurs as those who bring resources together in unusual combinations to generate profit. Whereas, Psychologists explain entrepreneur in terms of behaviors as achievement oriented individuals who are driven to seek challenges and new accomplishment. Corporate managers define entrepreneur as persons who run small business lacking the potential needed for corporate management as it is explained by

Wickham (2003) and Hisrich and Peter (2005).

Druncker (1985) states 'entrepreneur' is someone who always searches for change, responds to it and exploits it as an opportunity. In addition to the above definitions of entrepreneur, you can see some more about it. Some of these are: Entrepreneurs are action – oriented and highly motivated individuals who take risk to achieve goals. Entrepreneurs are people who have:

- The ability to see and evaluate business opportunities
- The ability to gather the necessary resources to take advantage of them and
- The ability to initiate action to ensure success**.**

The entrepreneur is a combination of the thinker and the doer. This means entrepreneur sees an opportunity for a new product or services, a new approach, a new policy or a new way of solving historic problem. In almost all of the definitions of entrepreneurs, there is agreement that entrepreneurs are the instruments of change and innovators of new products, materials or markets. They take the existing resources and re-deploy them and accept the risks or failures.

1.3. Types of Entrepreneurs

The term "entrepreneurship" has traditionally been used to describe the activity of an economic agent whose function is to introduce innovative changes into the means and relations of production inherent in an economy. In this guise, the entrepreneur streamlines already existent production processes either through the innovative use of current technology, or streamlines production through the employment of new technologies. In addition to this, the entrepreneur may also create new services or products in response to market demand. If the products and services offered in an economy are seen to evolve, the entrepreneur is the agent that aids the evolution, perceiving and then addressing market inefficiencies and gaps by channeling investment capital away from underperforming entities into more productive organizations. In current popular usage, however, "entrepreneurship" has come to describe a particular mind-set that can be seen to denote any pioneering and innovative endeavor that addresses the inadequacies of current norms and practices. It is thus that the terms Social Entrepreneurship, Political Entrepreneurship

and Knowledge Entrepreneurship appear regularly in the press and media.

Sticking to the more traditional denotation of "entrepreneur", this section will briefly mention three theoretical types of entrepreneur (theoretical because any real-life entrepreneur might be a complex mix of these three types).

Social Entrepreneur

The social entrepreneur is primarily motivated by a deep desire to improve upon, or fundamentally change, prevailing and detrimental socio-economic, educational, environmental or health conditions. A social entrepreneur has a fierce ambition to alter the present reality of conditions s/he deems unacceptable or inhumane, and stubbornly refuses to accept the norm, or arguments that simply rationalize, if not justify, prevailing circumstances. The key trait of the social entrepreneur is, however, the fact that they are driven to engage in certain activities not by the promise of possible profit, but by an overwhelming sense of social conscience and social responsibility. The goal of this type of entrepreneur is to develop effective models that not only respond to a specific need, but can be propagated and implemented in a variety of settings.

Serial Entrepreneur

The serial entrepreneur consistently conceptualizes and executes business models that s/he intends, ultimately, to sell to shareholders, investors, or other businesses. Serial entrepreneurs can be seen to take on relatively high amounts of risk, display an ability to effectively handle the accompanying stress as they are usually very adaptable to changing conditions, and more often than not display a pattern of success (despite some failures) in the long run. Serial entrepreneurs display a definite propensity to recover both, economically as well as in confidence, from business and personal failures.

Lifestyle Entrepreneur

The central characteristic of the lifestyle entrepreneur is the attempt to create profit from personal passion. If, for example, an individual has a passion for the internet, they may start a site from which shoppers can buy online. This is to say that the "lifestyle" tries to discover innovative ways in which a personal passion can translate into enough profit from

which a living can be earned. More so than the above two entrepreneurial types, the lifestyle entrepreneur aims to be self-employed. S/he is not in the trade of building business models to sell, and is instead a practitioner of a specific trade or profession that attempts to break away from the mainstream in order to build a sustainable business from which a living allowance can be drawn over a long-period of time. It is thus that the lifestyle entrepreneur often invests heavily in his or her own business, rather than cede substantial control to an individual or group of investors. In this type of business model, the entrepreneur assumes personal risk, but is rewarded (if the business survives) with independence and autonomy from authority structures. If, for example, you have a passion for the internet and see yourself as a lifestyle entrepreneur you might want to start an e-commerce site. In this case you're quite fortunate as start-up costs will be relatively low: all you might have to do is buy a laptop and obtain a reliable, fast internet connection.

1.4. What is entrepreneurship?

Entrepreneurship is the dynamic process of creating incremental wealth. This wealth is created by individuals who assume the major risks in terms of equity, time or career commitments according to Hisrich and Peter (2005:10). Entrepreneurship is the process of creating and building something from practically nothing. It is the process of creating an opportunity and pursuing it regardless of the resource currently controlled. It is a human creative act. It involves finding personal energy by building an enterprise or organization. It requires willingness to take unclenched risks that are financial and personal as it is stated by Wickham (2003).

Entrepreneurship involves building a team of people with complimentary skills and talent. It is sensing an opportunity where others see contradiction and confusion. Entrepreneurship is the process of creating something new with values by devoting the necessary time and effort, assuming the financial, psychic, and social risks and personal satisfaction and independence.

1.5. Entrepreneurs and Owner-Managers

A comparison of traditional managers and entrepreneurs reveals several differences. Look at the table that shows the difference between managers and entrepreneurs and analyze the difference between them.

Owner-Manager	**Entrepreneur**
administers	innovators
a copier person	an original person
accepts the status quo	challenges the status quo
focuses on systems	focuses on people
relies on control	inspires trust
short range viewer	long range viewer
asks how and when	asks what and why
eye on the bottom line	eye on the horizon
imitates rules and principles	originates rules and working principles
obeys orders without question	obeys when appropriate but thinks
does things right	does the right things
is trained	learns more
Mangers operate within the culture	Entrepreneurs create the culture

Entrepreneurs are: agent of change, innovators of new products, less concerned with managing and what exists in the most effective manner. Owner - managers manage small/big enterprise, they may be conservative and have more intention survival than seeking innovative changes and growth.

1.6 The role of entrepreneurship in the economy

Prosperity of a nation depends on the development of its economy. Every nation has a responsibility to ensure economic development to improve the living standards of the people, eliminate poverty and backwardness. The process of economic development involves improvement in Gross National Product and depends on the utilization of physical natural resources by the human resources to realize the productive potential of the nation. It requires increase in production and level of consumption.

In a labor abundant but capital short economy like Ethiopia there is limitation to the government in directly involving itself in increasing productivity considering the severe budgetary constraint for funds and the pressing need for higher investment in the frontiers of social development. Hence, the people have to come forward to engage themselves in productive activities by starting their own industrial unit's livelihood. When more and more persons come forward to start their own enterprises, however small it may be, and run the enterprise, efficiently and effectively, the productivity of the nation will automatically improve. The government implements a number of programmes to induce self-employment and to develop entrepreneurship in the country. Hence, development of entrepreneurship and entrepreneur are sine-qua-non for the economic prosperity of the nation. Following are the reasons why entrepreneurship holds vital role in an economy:

1. ***Creates wealth for nation and for individuals as well***

Individuals who search business opportunities usually create wealth by entering into entrepreneurship. The wealth created by the same play a considerable role in the development of nation. The business as well as the entrepreneur contributes in some or other way to the economy, may be in the form of products or services or boosting the GDP rates or tax contributions. Their ideas, thoughts, and inventions are also a great help to the nation.

2. ***Provides employment to opportunity to citizens of a nation***

For example, in the United States small companies created by entrepreneurs employ 50.2 percent of the nation's private sector workforce, even though they possess less than one-fourth of total business assets. The Small companies also pay 45 percent of the total private payroll in the United States. Because they are primarily labor intensive, small businesses actually create more jobs than do big businesses. The Small Business Administration (SBA) estimates that small companies create 79 percent of the net new jobs each year in the United States. This data makes it clear that entrepreneurship heads nation towards better opportunities, which is a significant input to an economy.

3. ***Contributes towards research and development***

Almost 2-3% of all innovations are due to the entrepreneurs. Without the boom of inventions the world would have been a much dry place to live in. Inventions provide an easier way of getting things done through better and standardized technology.

4. ***It is a challenging opportunity for the people***

Although entrepreneurship is a challenging task but in most of the cases the rewards it gives are much more than what one anticipates. It does not only reward an entrepreneur at financial levels but also on individual level. It provides self-satisfaction to the entrepreneur.

5. Entrepreneurship provides self-sufficiency

The entrepreneur not only become self-sufficient but also provide great standards of living to its employees. It provides opportunity to a number of people working in the organization. The basic factors which become a cause of happiness may be liberty, monetary rewards, and the feeling of contentment that one gets after doing the job. Therefore the contribution of entrepreneurs makes the economy an improved place to live in.

6. Personal development opportunity

The individual gets maximum scope for growth and opportunity if he enters into entrepreneurship. He not only earns, the right term would be he learns while he earns. This is a real motivating factor for any entrepreneur as the knowledge and skills he develops while owning his enterprise are his assets for life time which usually, lacks when a person is under employment. The individual goes through a grooming process when he becomes an entrepreneur. In this way it not only benefits him but also the economy as a whole.

1.7 Entrepreneurship, Creativity and Innovation

The distinction between creativity and innovation has been elaborated by a number of management scholars. For instance: Stoner and Freeman (1989:408) defined creativity as the generation of a new idea where as innovation as the translation of such an idea into a new product, service or method of production. Lawrence B. Mohr (1969) describes creativity as "bringing something into being" and innovation as "bringing something new into us." According to Nutley and Osborne (1994), creativity is generating of new ideas or knowledge, whereas innovation is the application or implementation of these new ideas.

In general, the above definitions ascertain the fact that creativity is the process of bringing a new idea into being whereas innovation is the process of transforming (adopting) new idea into an organization, service, product, etc. It should also be borne in mind that creativity and innovation are not identical with change. To be more specific, it is true that all creativity and innovation do involve change, but change can occur without creativity and innovation. Furthermore, although the skills required for generating new ideas (creativity) are not the same, as those required for making these ideas a reality (innovation), the two of them are inseparable elements of organizations. Because creativity alone contributes little or nothing to organizational effectiveness unless the creative ideas can in some way be shared and be used or implemented by the organizational staff.

CHAPTER TWO

Small Business

After completing this unit, you will be able to:

- Explain the meaning and importance of small business
- List the failure factors for a small business
- Identify the elements while setting a small business

2.1 Meaning of small business

A literature review revealed that there is an inconsistency regarding both characteristics and definition of small business. There are varieties of definitions which are unable to set an agreeable format for small business definition.

A small business is a business that is privately owned and operated, with a small number of employees and relatively low volume of sales. Small businesses are normally privately owned corporations, partnerships, or sole proprietorships. The legal definition of 'small' varies by country and by industry. In the United States the small business administration establishes small business size standards on an industry-by-industry basis, but generally specifies a small business as having fewer than 500 employees for manufacturing businesses and less than $7 million in annual receipts for most non-manufacturing businesses.

In the European Union, a small business generally has fewer than 50 employees. However, in Australia, a small business has fewer than 15 employees. By comparison, a medium sized business or mid-sized business has fewer than 500 employees in the US, 250 in the European Union and fewer than 200 in Australia (Muotary, 2008).

In addition to number of employees, other methods are used to classify small companies which include annual sales (turnover), value of assets and net profit (balance sheet), alone or in a mixed definition. These criteria are followed by the European Union, for instance (headcount, turnover and balance sheet totals). Small businesses are usually not dominant in their field of operation.

Small businesses are common in many countries depending on the economic system in operation. Typical examples include: convenience stores and other small shops (such as a bakery), hairdressers, tradesmen, lawyers, accountants, restaurants, guest houses, photographers, small-scale manufacturing etc.

The smallest businesses which are often located in private homes are called micro-businesses (term used by international organizations such as the World Bank). The term "mom and pop business" is a common colloquial expression for a single-family operated business with few (or no) employees other than the owners. When judged by the number

of employees, the American and the European definitions of a micro-business are the same which means small business with the size of fewer than 10 employees. There is a notable trend to further segment different-sized micro-businesses; for instance, the term very small business is now being used to refer to businesses that are the smallest of the smallest, such as those operated completely by one person or may be three employees (Muotary, 2008).

2.2 Definition of small business in Ethiopian context

The actual definition of Micro and Small enterprises adopted by Ethiopian Ministry of Trade and Industry are as follows:

- **Micro enterprises:** are business enterprises found in all sectors of the Ethiopian economy with a paid-up capital (fixed assets) of not more than Birr 20,000, but excluding high-tech consultancy firms and other high-tech establishments.
- **Small Enterprises:** are business enterprises with a paid-up capital of more than Birr 20,000 but not more than Birr 500,000 but excluding high-tech consultancy firms and other high-tech establishments.

The **Central Statistical Authority (CSA)**, for the purposes of its survey on "Urban Informal Sector Activity Operators and Small-scale Manufacturing Industries", attached various definitions to enterprises in different sectors, viz: the informal sector, cottage or handicrafts, small-scale manufacturing industries and medium-and large-scale manufacturing industries. The CSA based its definitions on the size of employment and extent of automation for small, medium and large-scale enterprises and used a combination of criteria for defining informal sector operators. CSA definition of enterprises:

- "Large and medium scale manufacturing enterprises have been classified as establishments with more than ten employees using automated machinery.
- Small and medium enterprises are establishments that engage less than 10 persons using power driven machinery.
- Cottage/handicrafts are household type enterprises located in households or workshops normally using own or family labor and mostly manual rather than automated/mechanical machinery.

2.3 Characteristics of small business enterprises

The following are some of the important characteristics of small-scale industrial sector/unit according to (Haily: 2007:76):-

- **Personal Character**: There is close personal contract/supervision of all activities, say purchase, production, labor, and sale of products. The owner himself is

generally the manager. Therefore, these firms are generally managed in a personalized manner.

- **Limited scale of operations**: A small scale industrial unit has a lesser gestation period. A small scale unit has a limited share of a given market. The size of the firm in the industry is small.
- **Indigenous resources:** Small-scale industries can be easily located anywhere subject to availability of raw materials, labor, finance, etc. Small scale units use local resources.
- **Labor intensive**: They are generally more labor oriented with comparatively smaller capital investment than the larger units.
- **Local area of operation:** The operations of a small scale unit are generally localized. However, market for its products need not be local. It may cater to local and regional demands or its products may even be exported.

2.4 Importance of Small Business

There are many contributions or uses of small businesses. Some of them are presented as follows:

Low cost: A small business can be started at a very low cost and on a part-time basis.

Adaption: Adapting to change is crucial in business and particularly small business; not being tied to any bureaucratic inertia, it is typically easier to respond to the marketplace quickly.

Intimacy: Small business proprietors tend to be intimate with their customers and clients which results in greater accountability and maturity.

Independence: Independence is another advantage of owning a small business. Freedom to operate independently is a reward for small business owners. In addition, many people desire to make their own decisions, take their own risks, and collect the rewards of their efforts. Small business owners have the satisfaction of making their own decisions within the constraints imposed by economic and other environmental factors.

However, entrepreneurs have to work very long hours and understand that ultimately their customers are their bosses.

Contribution to the Economy: Now a days, the contribution of small business for economic growth is increasing from time to time in many countries. In the US, small business (less than 500 employees) accounts for around half the GDP and more than half the employment.

Employment Creation: In many developing countries, unemployment and under employment are two of the major problems. This is due to many reasons such as land

tenure system, inefficient techniques of production, population problem and the use of inappropriate technology. The strongest argument in favor of small scale industries is that because of their labor intensive nature (Douglas, 1968:125).

Small scale industries have more advantages for developing countries not only because they demand more labor but also because they usually demand unskilled workers who are excessively available in developing countries. By increasing employment opportunities for the un-skilled labor, small scale industries can raise the income position of the country and contribute to the reduction of poverty (Little, 1987:205).

Capital Consideration: Capital is the main bottleneck in the development efforts of developing countries. Because of this, the development of large scale industries becomes very difficult. As a result of this it becomes important that these countries develop small scale industries (SSIs) which require a relatively smaller amount of capital. Another reason why small businesses are favored is their lower capital output ratio when compared to large scale unit. (Abraham: 1996:25)

Resource Utilization: Some writers argue that large scale industries require a highly developed infrastructure, market, skilled man power, higher technology to be profitable as a result of which there is exploitation of rural resources. Therefore, small businesses which require a much lesser market and infrastructure can be developed with less difficulty by developing countries. Secondly, the resource available might not be sufficient to justify the establishment of heavy industries in which case SSIs present an obvious alternative.

Rising of Technological Capacities: It is also believed that small businesses can serve as a means of disseminating new technological innovations. This capacity of diffusing new ideas has socio-economic impact on changing the life pattern of the society in general and the business community in particular (Abraham: 1996). The small businesses are the means of raising efficiency and productivity as they are the school of the participants through learning by doing.

2.5 Challenges in Small Businesses

Even if small business seems simple and low costly to start it, it is not without challenges. There are a lot of up and down to run this business. Some of them are:-

Marketing the Small Business

Finding new customers is the major challenge for small business owners. Small businesses typically find themselves strapped for time but in order to create a continual stream of new business, they must work on marketing activity every day.

Common marketing promotional techniques for small business include: networking, word of mouth, customer referrals, Yellow pages directories, outdoor (roadside and billboards) service, print, email marketing, and internet. Electronic media like TV can be quite expensive and is normally intended to create awareness of a product or service (Muotary, 2008).

Small Business Bankruptcy

When small business fails, the owner will have bankruptcy. In most cases, this can be handled through a personal bankruptcy filing. Corporations can file bankruptcy, but if it is out of business and valuable corporate assets are likely to be repossessed by secured creditors there is little advantage to going to the expense of a corporate bankruptcy. Many states offer exemptions for

small business assets so they can continue to operate during and after personal bankruptcy. However, corporate assets are normally not exempt; hence it may be more difficult to continue operating an incorporated business if the owner files bankruptcy.

Sales Fluctuations

The owner-manager often faces sales fluctuations. The individual must balance cash inflows with cash outflows so that the business will continue without fluctuations. Sometimes this will require the owner to take a short-term loan to help the business get through a slack period. This is great challenge for small business owners and entrepreneurs.

Competition

The other disadvantage of owning a small business is the risk of competition. In particular, an individual may start a business and propose for three or four years before meeting insurmountable competition. The changes in market demand may occur and the owner will find that this new demand is being satisfied by large competitors. For example, small restaurants may find that they have lost customers to fast food chains because of competition.

Increased Responsibility

Small businesses face many responsibilities when especially an operation gets larger and larger. For example, owners not only have to make more decisions on major matters but also have to become knowledgeable in many different areas. A successful owner is often a bookkeeper, accountant, salesperson, personnel manager, and janitor. This will be the challenge and great problems for entrepreneurs and small business owners.

Financial Losses

When the owner makes all major decisions, inevitably some of them will be wrong. On occasion, inventory will be too high (or low); a product line may be developed at great expense and there will not be sales; a price reduction will not increase product demand; this will create declining in total revenue; an advertising campaign will not pay for itself; or an increase in the sales force will prove to be a mistake, and excess personnel will have to be laid off. In all these cases the owner will face a financial loss.

Employee Relations

The small business owner also needs to be concerned with employee relations. If the workers are not content, sales will suffer. For example, in many retail stores employees are not allowed to talk or socialize on the job. Workers are expected to remain at their sales counters and stay alert for customers who need assistance. Management believes that if the employees begin talking to one another, they will lose potential sales. On the other hand, research reveals that if employees feel isolated or alone, their attitudes towards the job will decline. This, in turn, will affect their sales ability (Muotary,2008).

Generally, small businesses often face a variety of problems related to their size. A frequent cause of bankruptcy is under capitalization. This is often a result of poor planning rather than economic conditions.

2.5 Setting Small Business

2.5.1 Sources of business ideas

Business ideas are all around you. Some business ideas come from a careful analysis of market trends and consumer needs; others come from coincidence. If you are interested in starting a business, but don't know what product or service you might sell, exploring the ways of getting business ideas will help you choose. The following are some of the sources of business ideas:-

1) Examine your own skill

Do you have a talent or proven track record that could become the basis of a profitable business? To find a viable business idea, ask yourself, "What have I done? What can I do? Will people be willing to pay for my products or services?"

2) Keep up with current events and be ready to take advantage of business opportunities

If you read or watch the news regularly with the conscious intent of finding business ideas, you'll be amazed at how many business opportunities your brain generates. Keeping up with current events will help you identify market trends, new fads, industry news – and sometimes just new ideas that have business possibilities.

3) Invent a new product or service

The key to coming up with business ideas for a new product or service is to identify a market need that's not being met. Look around and ask yourself, "How this situation could be improved?" Ask people about additional services that they would like to see. Focus on a particular target market and brainstorm business ideas for services that that group would be interested in.

4) Add value to an existing product

The difference between raw wood and finished lumber is a good example of putting a product through an additional process which increases its value, but additional processes are not the only way value can be added. You might also add services, or combine the product with other products. For instance, a local farm which sells farm product also offers a vegetable delivery service; consumers can have a box of fresh vegetables delivered to their door each week.

5) Investigate other markets

Some business ideas are not suited to local consumption - but appeal greatly to a foreign market. Finding out about other cultures and investigating other market opportunities is an excellent way to find business ideas.

6) Improve an existing product or service

There are very few products (or services) that can't be improved. Start generating business ideas by looking at the products and services you use and brainstorming ideas as to how they could be better.

7) Get on the bandwagon

Sometimes markets surge for no apparent reason; masses of people suddenly "want" something, and the resulting demand can't be immediately met. For example, during the SARS epidemic, there was an insatiable demand for facial masks in several countries – and many entrepreneurs capitalized on this business idea.

A "bandwagon effect" is also created by larger social trends. There is much more of a demand for home-care services for the elderly than is currently being supplied. And the trend for pets to be treated as family members continues, creating demand for all kinds of pet-related services that didn't exist even ten years ago.

2.6 Steps in setting a small scale unit

"What do I need to do and what comes first?" That's the question most often asked by people considering starting a business. There is a logical sequence of actions and a process for starting a business. An explanation of each step follows:

2.6.1 Select a business idea

Step #1 is deciding on what type of business you want to start. Many people choose to start a business around something they know and are passionate about. The first question every would-be business owner needs to ask about his/her product or service idea: "What PROBLEM does it SOLVE or what NEED does it FILL?" There are many reasons why consumers make purchase decisions, but the primary one is need. Market research will help you answer this question.

2.6.2 Market Research (Feasibility)

Market research is the first and most important task you need to accomplish BEFORE you start your business, to determine if your idea is feasible, which according to Webster's Dictionary means "capable of being done; suitable." Market research is the gathering of facts and figures to make an informed decision about the market potential for your business, about the prospects for success and the direction your business will take.

A. **Type of Research Needed: Industry, market, customers, competition.** You'll be looking for answers to questions like: *How big is the industry my business fits into? What are the trends of that industry? How will my idea benefit customers? Who and how many potential customers are there? How many competitors are there? What is unique about my product or service? What will motivate customers to buy from me?*

The following describes the type of research needed using the example of a pizza parlor, which is part of the fast food industry:

- **Industry** is the BIG PICTURE of what's happening in the "total world" of your particular type of business. Look for answers to questions like: *What's happening in the fast food industry these days – how many pizzas get sold in Ethiopia or Addis*

Ababa each year, are there increased sales, specialty pizzas, healthier alternatives, changes in sizes or packaging, more or less pizza parlors in and out of business, etc? What's the BIG PICTURE in the pizza world?

- **Market** is population of consumers or businesses that buy your particular product or service – you can generally define them by a common set of characteristics. **Market segments** are groups within that population that you can define by even more specific set or sets of characteristics. Questions to answer could include: *Who and how many folks are buying fast food in the area or location I'm considering? How often do they buy? Can I group and identify them based on any common characteristics such as age or ethnicity?*

- **Customers** are the individual people or businesses that will buy your product or service. A good exercise is to define your ideal customer and work backwards – where there's one you can find another just like it, then another, and so on. *How many households exist in my geographic area? How many of these eat pizza, and how often? How much pizza are these prospective customers likely to purchase in a year?* (Customers x frequency x price = market potential.)

- **Competition** is any business that sells a product or service that is exactly like what you want to do (DIRECT) or that may be similar to or an alternative to your product or service (INDIRECT). *Where are other pizza shops? What are they like? What and where are other fast food, and/or grocery store food options? Why would these prospective customers buy your pizza (and not the other choices)? Is there an unmet need, am I offering something totally unique, are they dissatisfied with other choices?*

B. How and where to do research (secondary)

- **Local Library:** The best source of information is still the library. Many have business librarians and/or space dedicated to business reference materials. Look for information in sources and references related to your particular type of business, such as periodicals, trade journals, newspapers, industry association and other reference books.

- **Internet:** To get the most out of Internet searches and make the best use of your time, it is important to define your search fields as precisely as possible.

C. What information to collect: The following are sample of questions for which one might seek answers for market research.

Industry:

- What is the growth/decline of my industry?
- What are the associations relating to my industry?
- What are the trends in my industry?

Market/Customers:

- What are the spending habits of the consumers of my market?
- What are the demographics (characteristics) of my market?
- Who is the typical customer or target market for my business?

Competition:

- Who are my competitors?

D. Other forms of research (primary)

- Surveys: Build and conduct your own survey or focus group to gather information from businesses or persons who might be potential customers.
- Visit and "shop" the competition to observe and compare. "
- Study similar businesses' advertising and websites.
- Talk to non-competitors. Sometimes others in a business like the one you are interested in starting might be willing to share first-hand information, even become a mentor, if they are not in direct competition with you, perhaps they are outside your geographic service area.
- Hired research. There may be companies or individuals that conduct market research for a fee.
- College or university marketing students. Many schools offering business courses, specifically in marketing, are looking for "real world" projects in which to involve their students. Check around your area for schools that offer marketing courses. Identify the professors teaching those courses and contact them directly. Timing may be an issue as they would have to plan your project into their course and it might take a term or two before that could happen.

2.6.3 Startup Cost Analysis (Feasibility)

The business you have in mind may not be the business model you can afford. One of the most common reasons businesses fail is "hitting a financial wall" either before opening or soon thereafter, as a result of one or more contributing factors such as: An insufficient estimate of the true cost of starting what you have in mind and finding out you need to spend more than you have to get it open or keep it going; an unrealistic expectation about resources you might tap into because you find out too late that there aren't any grants and startup loans are difficult to obtain; or a misconception about how quickly you will start making money, meaning you might need sources of cash to keep a business afloat until it does start making money.

An in-depth startup cost analysis will provide you a more realistic, documented idea of the cost to start the business you have in mind, and will allow you then to match it to the reality of your available resources and/or your ability to get conventional financing. This may lead to refining your idea to make your startup possible, based on your personal situation.

On page 11 of this material, you will find a summary of categories of common startup costs. Some of these may apply to your business and some may not but chances are there are some on the list you hadn't thought of. For example: If you are relying on your business to pay your personal bills, you need to factor in living

expenses for a moderate period of time until the business can afford to "pay you a wage." Another example: One of the top reasons for business failures is not having enough cash to ride out the business ramp-up time. It's important to factor in cash to cover expenses until the business is projected to reach breakeven. In other words, if sales are not generating enough cash to cover all the bills and you have no other savings or loans to tap into, how will you pay the rent, or utilities, or.....?

2.6.4 Sources of Financing / Startup Resources

Once you know the cost to start your business, there are resource and finance issues to consider. How much do you need to start and where will it come from? Your savings? Selling your car? Asking your friends or family? Taking loan from microfinance, grants…? Or other alternatives should be found inadvance.

2.6.5 Decision Point – Is it Feasible?

Once you've gathered and reviewed your market research and financial information, you can make knowledge -based decisions – to go forward as you intended or to modify your plan.

- Weigh the facts and make decisions based on what you KNOW, not "think" or "feel".
- Is there a need in the marketplace for your product or service?
- Can you generate enough sales to achieve your personal and business goals?
- Can you justify the investment and risk?

Most entrepreneurs adjust their original concept in some way, and quite often a smaller scale startup is the option chosen. Always be prepared for the possibility that expenses will be more than you projected, or that sales will develop more slowly than you expected.

Chapter Three
Business Plan

After completing this chapter, you will be able to:

- Define business plan
- Explain feasibility analysis
- Recognize the three types of feasibility analysis
- Identify the elements of business plan

3.1 The concept of business planning

For many entrepreneurs, the easiest part of launching a business is coming up with an idea for a new business concept or approach. Business success, however, requires much more than just a great new idea. Once entrepreneurs develop an idea for a business, the next step is to subject it to a feasibility analysis to determine whether they can transform the idea into a viable business. A **feasibility analysis** is the process of determining whether an entrepreneur's idea is a viable foundation for creating a successful business. Its purpose is to determine whether a business idea is worth pursuing. If the idea passes the feasibility analysis, the entrepreneur's next step is to build a solid business plan for capitalizing on the idea. If the idea fails to pass muster, the entrepreneur drops it and moves on to the next opportunity. He or she has not wasted valuable time, money, energy, and other resources creating a full-blown business plan, or worse, launching a business that is destined to fail because it is based on a flawed concept. Although it is impossible for a feasibility study to guarantee an idea's success, conducting a study reduces the likelihood that entrepreneurs will waste their time pursuing fruitless business ventures.

A feasibility study is *not* the same as a business plan; both play important, but separate, roles in the start-up process. A feasibility study answers the question, "Should we proceed with this business idea?" Its role is to serve as a filter, screening out ideas that lack the potential for building a successful business, *before* an entrepreneur commits the necessary resources to building a business plan. A feasibility study primarily is an *investigative* tool. It is designed to give an entrepreneur a picture of the market, sales, and profit potential of a particular business idea. Will a ski resort located here attract enough customers to be successful? Will customers in this community support a sandwich shop with a retro rock-n-roll theme? Can we build the product at a reasonable cost and sell it at a price customers are willing and able to pay? Does this entrepreneurial team have the ability to implement the idea successfully?

A business plan, in contrast, is a planning tool for transforming an idea into reality. It builds on the foundation of the feasibility study but provides a more comprehensive analysis than a feasibility study. It functions primarily as a planning tool, taking an idea that has passed the feasibility analysis and describing how to turn it into a successful business. Its primary goals are to guide entrepreneurs as they launch and operate their businesses and to help them acquire the financing needed to launch.

Feasibility studies are particularly useful when entrepreneurs have generated multiple ideas for business concepts and must winnow their options down to the "best choice." They enable entrepreneurs to explore quickly the practicality of each of several potential paths for transforming an idea into a successful business venture. Sometimes the result of a feasibility study is the realization that an idea simply won't produce a viable business—no matter how it is organized. In other cases, a study shows an entrepreneur that the business idea is a sound one but it must be organized in a different fashion to be profitable.

Research suggests that, whatever their size, companies that engage in business planning outperform those that do not. A business plan offers:-

- A systematic, realistic evaluation of a venture's chances for success in the market
- A way to determine the principal risks facing the venture
- A "game plan" for managing the business successfully
- A tool for comparing actual results against targeted performance
- An important tool for attracting capital in the challenging hunt for money

The feasibility study and the business plan play important but separate roles in the start-up process. This chapter describes how to build and use these vital business documents, and it will help entrepreneurs create business plans that will guide them on their entrepreneurial journey and help them attract the capital they need to launch and grow their businesses.

3.2 Feasibility analysis

A feasibility analysis consists of three interrelated components: an industry and market feasibility analysis, a product or service feasibility analysis, and a financial feasibility analysis. "Making a critical evaluation of your business concept at an early stage will allow you to discover, address, and correct any fatal flaws before investing time in preparing your business plan," says Timothy Faley, managing director of the Samuel Zell & Robert H. Lurie Institute for Entrepreneurial Studies at the University of Michigan.

3.2.1 Industry and Market Feasibility Analysis

When evaluating the feasibility of a business idea, entrepreneurs find a basic analysis of the industry and targeted market segments a good starting point. The focus in this phase is twofold: (1) to determine how attractive an industry is overall as a "home" for a new business and (2) to identify possible niches a small business can occupy profitably.

The first step in assessing industry attractiveness is to paint a picture of the industry with broad strokes, assessing it from a "macro" level. Answering the following questions will help establish this perspective:-

- How large is the industry?
- How fast is it growing?
- Is the industry as a whole profitable?

- Is the industry characterized by high profit margins or razor-thin margins?
- How essential are its products or services to customers?
- What trends are shaping the industry's future?
- What threats does the industry face?
- What opportunities does the industry face?
- How crowded is the industry?
- How intense is the level of competition in the industry?
- Is the industry young, mature, or somewhere in between?

Addressing these questions helps entrepreneurs determine whether the potential for sufficient demand for their products and services exists.

A useful tool for analyzing an industry's attractiveness is Porter's Five Forces model developed by Michael E. Porter of the Harvard Business School. Five forces interact with one another to determine the setting in which companies compete and hence the attractiveness of the industry: (1) the rivalry among competing firms, (2) the bargaining power of suppliers, (3) the bargaining power of buyers, (4) the threat of new entrants, and (5) the threat of substitute ®°-¢³¡²±÷-°÷±£°´§¡£±Ｋ ÷

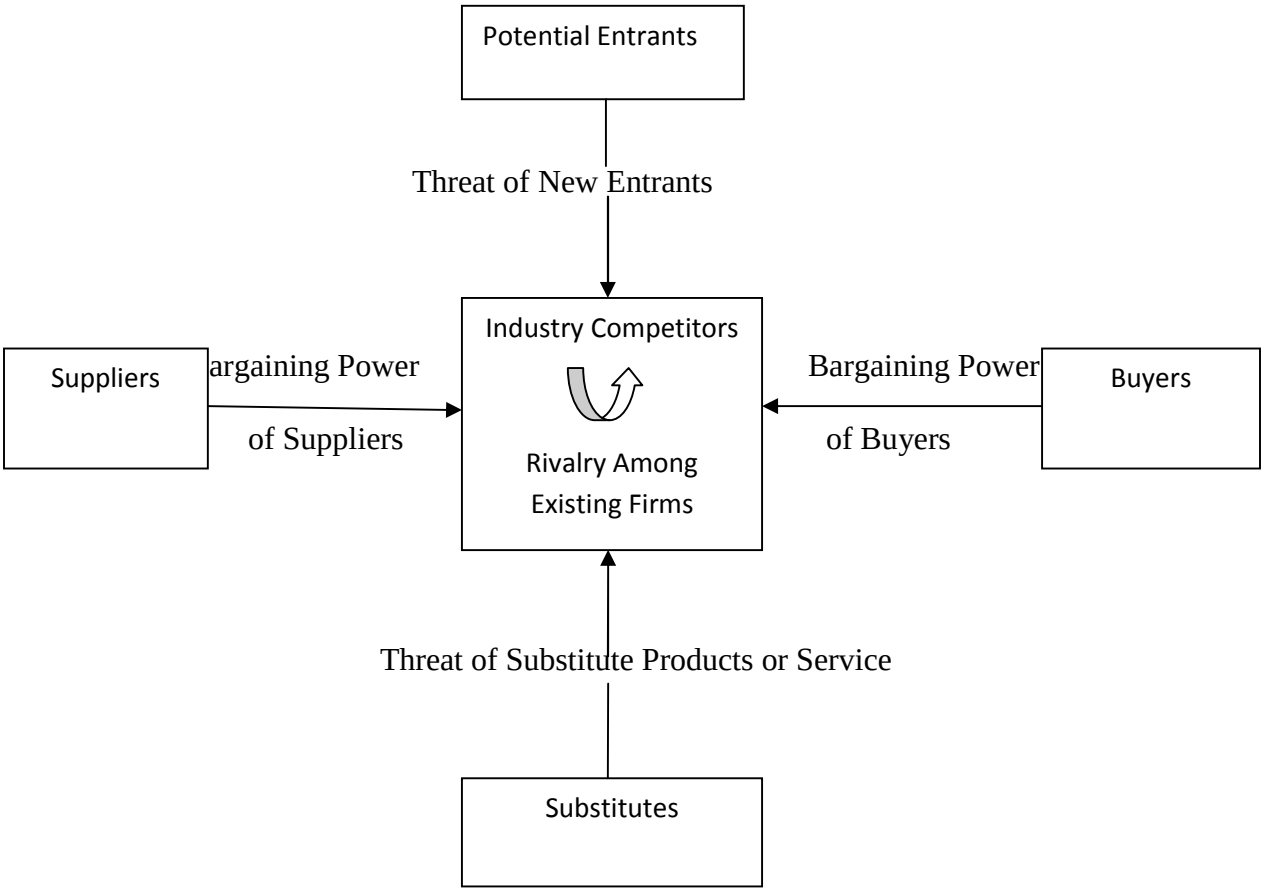

FIGURE 1: Porter's Five Forces Model

Source: Adapted from Michael E. Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review*, Volume 57, No. 2, March–April 1979, pp. 137–145.

RIVALRY AMONG COMPANIES COMPETING IN THE INDUSTRY

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THREAT OF SUBSTITUTE PRODUCTS OR SERVICES

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TABLE 1: Five Forces Matrix

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Minimum Score _ 5 (Very attractive)
Maximum Score _ 125 (Very unattractive)

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3.2.2 Product or Service Feasibility Analysis

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CUSTOMER SURVEYS AND QUESTIONNAIRES

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PROTOTYPES

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IN-HOME TRIALS

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3.2.3 Financial Feasibility Analysis

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RETURN ON INVESTMENT

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3.4 The Elements of a Business Plan

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3.4.1 Title Page and Table of Contents

A business plan should contain a title page with the company's name, logo, and address as well as the names and contact information of the company's founders. Many entrepreneurs also include the copy number of the plan and the date on which it was issued on the title page. Business plan readers appreciate a table of contents that includes page numbers so that they can locate the particular sections of the plan in which they are most interested.

3.4.2 The Executive Summary

To summarize the presentation for each potential financial institution or for investors, the entrepreneur should write an executive summary. It should be concise—a maximum of two pages—and should summarize all of the relevant points of the proposed business. After reading the executive summary, anyone should be able to understand the entire business concept and what differentiates the company from the competition. The executive summary is a synopsis of the entire plan, capturing its essence in a condensed form. It should explain the basic business model and the problem the business will solve for customers, briefly describing the owners and key employees, target market(s), financial highlights (e.g., sales and earnings projections, the loan or investment requested, how the funds will be used, and how and when any loans will be repaid or investments cashed out), and the company's competitive advantage. Much like Abraham Lincoln's Gettysburg Address, which at 256 words lasted just 2 minutes and is hailed as one of the greatest speeches in history, a good executive summary provides a meaningful framework for potential lenders and investors of the essence of a company.

The executive summary is a written version of what is known as "the elevator pitch." Imagine yourself on an elevator with a potential lender or investor. Only the two of you are on the elevator, and you have that person's undivided attention for the duration of the ride, but the building is not very tall! To convince the investor that your business idea is a great investment, you must condense your message down to its essential elements—key points that you can communicate in no more than 2 minutes. In the Babcock Elevator Competition at Wake Forest University, students actually ride an elevator 27 floors with a judge, where they have the opportunity to make their elevator pitches in just 2 minutes. "The competition was designed to simulate reality," says Stan Mandel, creator of the event and director of the Angell Center for Entrepreneurship. Winners receive the chance to make 20-minute presentations of their business plans to a panel of venture capitalists, who judge the competition using criteria that range from the attractiveness of the business idea and the value proposition it offers to the quality of the plan's marketing and financial elements.

Like a good movie trailer, an executive summary is designed to capture readers' attention and draw them into the plan. If it misses, the chances of the remainder of the plan being read are minimal. A coherent, well-developed summary introducing the rest of the plan establishes a favorable first impression of the business and the entrepreneur behind it and can go a long way

toward obtaining financing. A good executive summary should allow the reader to understand the business concept and how it will make money as well as answering the ultimate question from investors or lenders: "What's in it for me?" Although the executive summary is the first part of the business plan, it should be the last section you write.

3.4.3 Mission and Vision Statement

A mission statement expresses an entrepreneur's vision for what his or her company is and what it is to become. It is the broadest expression of a company's purpose and defines the direction in which it will move. It anchors a company in reality and serves as the thesis statement for the entire business plan by answering the question, "What business are we in?" Every good plan captures an entrepreneur's passion and vision for the business, and the mission statement is the ideal place to express them.

3.4.4 Company History

The owner of an existing small business should prepare a brief history of the operation, highlighting the significant financial and operational events in the company's life. This section Should describe when and why the company was formed, how it has evolved over time, and what the owner envisions for the future. It should highlight the successful accomplishment of past objectives and should convey the company's image in the marketplace.

3.4.5 Business and Industry Profile

To acquaint lenders and investors with the industry in which a company competes, an entrepreneur should describe it in the business plan. This section should provide the reader with an overview of the industry or market segment in which the new venture will operate. Industry data such as market size, growth trends, and the relative economic and competitive strength of the major firms in the industry set the stage for a better understanding of the viability of a new business. Strategic issues such as ease of market entry and exit, the ability to achieve economies of scale or scope, and the existence of cyclical or seasonal economic trends further help readers to evaluate the new venture. This part of the plan also should describe significant industry trends and key success factors as well as an overall outlook for its future. Information about the evolution of the industry helps the reader comprehend its competitive dynamics.

This section should contain a statement of the company's general business goals and then work down to a narrower definition of its immediate objectives. Together they should spell out what the business plans to accomplish, how, and when. **Goals** are broad, long-range statements of what a company plans to achieve in the future that guide its overall direction. In other words, they address the question, "Where do I want my company to be in 3 to 5 years?"

Objectives are short-term, specific performance targets that are specific, measurable, and assignable. Every objective should reflect some general business goal and include a technique for measuring progress toward its accomplishment. To be meaningful, an objective must have a time frame for achievement. Both goals and objectives should relate to the company's basic mission. In other words, accomplishing each objective should move a business closer to achieving its goals, which, in turn, should move it closer to its mission.

3.4.6 Business Strategy

An even more important part of the business plan is the owner's view of the strategy needed to meet—and beat—the competition. In the previous section, an entrepreneur defined where he or she wants to take the business by establishing goals and objectives. This section addresses the question of how to get there—business strategy. Here an entrepreneur explains how he or she plans to gain a competitive edge in the market and what sets his or her business apart from the competition. A key component of this section is defining what makes the company unique in the eyes of its customers. One of the quickest routes to business failure is trying to sell "me-too" products or services that offer customers nothing newer, better, bigger, faster, or different.

This section of the business plan should outline the methods the company will use to meet the key success factors cited earlier. If, for example, making sales to repeat customers is critical to success, an entrepreneur must devise a plan of action for achieving a customer retention rate that exceeds that of existing companies in the market.

3.4.7 Description of Firm's Product or Service

An entrepreneur should describe the company's overall product line, giving an overview of how customers use its goods or services. Drawings, diagrams, and illustrations may be required if the product is highly technical. It is best to write product and service descriptions so that laypeople can understand them. A statement of a product's position in the product life cycle might also be helpful. An entrepreneur should include a summary of any patents, trademarks, or copyrights that protect the product or service from infringement by competitors. Finally, the plan should include an honest comparison of the company's product or service with those of competitors, citing specific advantages or improvements that make its goods or services unique and indicating plans for creating the next generation of goods and services that will evolve from the present product line. Ideally, a product or service offers high-value benefits to customers and is difficult for competitors to duplicate.

TABLE 2: **Transforming Features into Meaningful Benefits**

For many entrepreneurs, there's a big gap between what a business is selling and what its customers are buying. The following exercise is designed to eliminate that gap.

First, develop a list of the features your company's product or service offers. List as many as you can think of, which may be 25 or more. Consider features that relate to price, performance, convenience, location, customer service, delivery, reputation, reliability, quality, features, and other aspects.

The next step is to group features that have similar themes together by circling them in the same color ink. Then translate those groups of features into specific benefits to your customers by addressing the question "What's in it for me?" from the customer's perspective. (Note: It usually is a good idea to ask actual customers why they buy from you. They usually give reasons that you never thought of.) As many as six or eight product or service (or even company) features may translate into a single customer benefit, such as saving money or time or making life safer. Don't ignore intangible benefits, such as increased status; they can be more important than tangible benefits.

Finally, combine all of the benefits you identify into a single benefit statement. Use this statement as a key point in your business plan and to guide your company's marketing strategy.

Product or Service *Features*	**Product or Service *Benefits***

Benefit Statement:	

Source: Based on Kim T. Gordon, "Position for Profits," *Business Start-Ups*, February 1998, pp. 18–20.

One danger entrepreneurs must avoid in this part of the plan is the tendency to dwell on the features of their products or services. This problem is the result of the "fall-in-love-with-your-product" syndrome, which often afflicts inventors. Customers, lenders, and investors care less about how much work, genius, and creativity went into a product or service than about what it will do for them. The emphasis of this section should be on defining the benefits customers get by purchasing the company's products or services, rather than on just a "nuts and bolts" description of the features of those products or services. A **feature** is a descriptive fact about a product or service (e.g., "an ergonomically designed, more comfortable handle"). A **benefit** is what the customer gains from the product or service feature (e.g., "fewer problems with carpal tunnel syndrome and increased productivity"). Advertising legend Leo Burnett once said, "Don't tell the people how good you make the goods; tell them how good your goods make them." This part of the plan must describe how a business will transform tangible product or service features into important but often intangible customer benefits—for example, lower energy bills, faster access to the Internet, less time writing checks to pay monthly bills, greater flexibility in building floating structures, shorter time required to learn a foreign language, or others. Remember: *Customers buy benefits, not product or service features*. Table 2 offers an easy exercise designed to help entrepreneurs translate their products' or services' features into meaningful customer benefits.

3.4.8 Marketing Strategy

One of the most important tasks a business plan must fulfill is proving that a viable market exists for a company's goods or services. A business plan must identify and describe a company's target customers and their characteristics and habits. Defining the target audience and its potential is one of the most important—and most challenging—parts of building a business plan. Narrowing its target market enables a small company to focus its limited resources on serving the needs of a specific group of customers rather than attempting to satisfy the desires of the mass market. Creating a successful business depends on an entrepreneur's ability to attract real customers who are willing and able to spend real money to buy its products or services. Perhaps the worst marketing error an entrepreneur can commit is failing to define his target market and trying to make the business "everything to everybody." Small companies usually are much more successful focusing on a specific market niche or niches where they can excel at meeting customers' special needs or wants.

Proving that a profitable market exists involves two steps: showing customer interest and documenting market claims.

SHOWING CUSTOMER INTEREST

An important element of any business plan is showing how a company's product or service provides a customer benefit or solves a customer problem. Entrepreneurs must be able to prove

that their target customers actually need or want their goods or services and are willing to pay for them. Venture capitalist Kathryn Gould, who has reviewed thousands of business plans, says that she looks for plans that focus on "target customers with a compelling reason to buy. The product must be a 'must-have.'"

Proving that a viable market exists for a product or service is relatively straightforward for a company already in business but can be quite difficult for an entrepreneur with only an idea. In this case, the key is to find a way to get primary customer data. For instance, an entrepreneur might build a prototype of the product and offer it to several potential customers to get written testimonials and evaluations to show to investors. The entrepreneur also could sell the product to several customers, perhaps at a discount, on the condition that they provide evaluations of it.
Doing so proves that there are potential customers for the product and allows customers to experience the product in operation. Getting a product into customers' hands is also an excellent way to get valuable feedback that can lead to significant design improvements and increased sales down the road.

DOCUMENTING MARKET CLAIMS

Too many business plans rely on vague generalizations such as, "This market is so huge that if we get just 1 percent of it, we will break even in 8 months." Statements such as these usually reflect nothing more than an entrepreneur's unbridled optimism, and, in most cases, are quite unrealistic! In *The Art of the Start*, entrepreneur and venture capitalist Guy Kawasaki calls this the Chinese Soda Lie: "If just 1 percent of the people in China drink our soda, we will be more successful than any company in the history of mankind." The problems with this reasoning are (1) few markets, especially the niche markets that small businesses often pursue, are as large as that, and (2) capturing 1 percent of a big market is extremely difficult to do, especially for a small company. Capturing a large share of a small, well-defined niche market is much more realistic for a small company than is winning a small share of a huge market.

Entrepreneurs must support claims of market size and growth rates with *facts*, and that requires market research. Results of market surveys, customer questionnaires, and demographic studies lend credibility to an entrepreneur's frequently optimistic sales projections. Quantitative market data are important because they form the basis for all of the company's financial projections in the business plan.

As you learned earlier in the section on conducting a feasibility analysis, one effective documentation technique involves business prototyping, in which entrepreneurs test their business models on a small scale before committing serious resources to a business that might not work. Business prototyping recognizes that every business idea is a hypothesis that should be tested before an entrepreneur takes it to full scale. If the test supports the hypothesis and its accompanying assumptions, it is time to launch a company. If the prototype flops, the entrepreneur scraps the business idea with only minimal losses and turns to the next idea.

One of the main purposes of the marketing section of the plan is to lay the foundation for financial forecasts that follow. Sales, profit, and cash forecasts must be founded on more than wishful thinking. An effective market analysis should address the following items:-

Target Market: Who are the company's target customers? How many of them are in the company's trading area? What are their characteristics (age, gender, educational level, income, and others)? What do they buy? Why do they buy? When do they buy? What expectations do they have about the product or service? Will the business focus on a niche? How does the company seek to position itself in the market(s) it will pursue? Knowing customers' needs, wants, and habits, what should be the basis for differentiating the business in their minds?

Advertising and Promotion: Only after entrepreneurs understand their companies' target markets can they design a promotion and advertising campaign to reach those customers most effectively and efficiently. Which media are most effective in reaching the target market? How will they be used? How much will the promotional campaign cost? How will the promotional campaign position the company's products or services? How can the company benefit from publicity? How large is the company's promotional budget?

Market Size and Trends: Assessing the size of the market is a critical step. How large is the potential market? Is it growing or shrinking? Why? Are customers' needs changing? Are sales seasonal? Is demand tied to another product or service?

Location: For many businesses, choosing the right location is a key success factor. For retailers, wholesalers, and service companies, the best location usually is one that is most convenient to their target customers. Using census data and other market research, entrepreneurs can determine the sites with the greatest concentrations of their customers and locate there. Which sites put the company in the path of its target customers? Maps that show customer concentrations, traffic counts, the number of customers using a particular train station and when, and other similar types of information provide evidence that a solid and sizable customer base exists. Do zoning regulations restrict the use of a site? For manufacturers, the location issue often centers on finding a site near their key raw materials or near their primary customers. Using demographic reports and market research to screen potential sites takes the guesswork out of choosing the "right" location for a business.

Pricing: What does the product or service cost to produce or deliver? Before opening a restaurant, for example, an entrepreneur should know *exactly* what it will cost to produce each item on the menu. Failing to know the total cost (including the cost of the food as well as labor, rent, advertising, and other indirect costs) of putting a plate in front of a customer is a recipe for failure. Cost is just one part of the pricing equation. Another significant factor to consider is the image a company is trying to create in the market. "Price really is more of a marketing tool than it is a vehicle for cost recovery," says Peter Meyer, author of *Creating and Dominating New Markets*. "People will pay more for a high value product or solution, so be sure to research your [product's or service's] total value."

Other pricing issues that a plan should address include: What is the company's overall pricing strategy? Will the planned price support the company's strategy and desired image? Given the company's cost structure, will the price produce a profit? How does the planned price compare to those of similar products or services? Are customers willing to pay it? What price tiers exist in the market? How sensitive are customers to price changes? Will the business sell to customers on credit? Will it accept credit cards? Will the company offer discounts?

Distribution: This portion of the plan should describe the channels of distribution that the business will use (the Internet, direct mail, in-house sales force, sales agents, retailers, or others) to distribute its products and services. Will distribution be extensive, selective, or exclusive? What is the average sale? How large will the sales staff be? How will the company compensate its sales force? What are the incentives for salespeople? How many sales calls does it take to close a sale? What can the company do to make it as easy as possible for customers to buy?

3.4.9 Competitor Analysis

An entrepreneur should describe the new venture's competition. Failing to assess competitors realistically makes entrepreneurs appear to be poorly prepared, naive, or dishonest, especially to potential lenders and investors. The plan should include an analysis of each significant competitor. Entrepreneurs who believe they have no competitors are only fooling themselves and are raising a huge red flag to potential lenders and investors. Gathering information on competitors' market shares, products, and strategies is usually not difficult. Trade associations, customers, industry journals, marketing representatives, and sales literature are valuable sources of data. This section of the plan should focus on demonstrating that the entrepreneur's company has an advantage over its competitors and address these questions:-

- Who are the company's key competitors?
- What are their strengths and weaknesses?
- What are their strategies?
- What images do they have in the marketplace?
- How successful are they?
- What distinguishes the entrepreneur's product or service from others already on the market, and how will these differences produce a competitive edge?

Firsthand competitor research is particularly valuable.

3.4.10 Owners' and Managers' Résumés

The most important factor in the success of a business venture is its management, and financial officers and investors weight heavily the ability and experience of a company's managers in financing decisions. A plan should include the résumés of business officers, key directors, and any person with at least 20 percent ownership in the company. This is the section of the plan in which entrepreneurs have the chance to sell the qualifications and the experience of their management team. Remember: *Lenders and investors prefer experienced managers.* Ideally, they look for managers with at least 2 years of operating experience in the industry they are targeting.

A résumé should summarize each individual's education, work history (emphasizing managerial responsibilities and duties), and relevant business experience. Lenders and investors look for the experience, talent, and integrity of the people who will breathe life into the plan. This portion of the plan should show that the company has the right people organized in the right fashion for success. One experienced private investor advises entrepreneurs to remember the following:-

- Ideas and products don't succeed; people do. Show the strength of your management team. A top-notch management team with a variety of proven skills is crucial. Arthur Rock, a legend in the venture capital industry, says, "I invest in people, not ideas."
- Show the strength of key employees and how you will retain them. Most small companies cannot pay salaries that match those at large businesses, but stock options and other incentives can improve employee retention.
- Enhance the strength of the management team with a capable, qualified board of advisors. A board of directors or advisors consisting of industry experts lends credibility and can complement the skills of the management team.

3.4.11 Plan of Operation

To complete the description of the business, an entrepreneur should construct an organization chart identifying the business's key positions and the people who occupy them. Assembling a management team with the right stuff is difficult, but keeping it together until the company is established can be even harder. Thus, entrepreneurs should describe briefly the steps taken to encourage important officers to remain with the company. Employment contracts, shares of ownership, and perks are commonly used to keep and motivate key employees.

Finally, a description of the form of ownership (sole proprietorship, partnership, joint venture, corporation, or LLC, for example) and of any leases, contracts, and other relevant agreements pertaining to the operation is helpful.

3.4.12 Pro Forma (Projected) Financial Statements

One of the most important sections of the business plan is an outline of the proposed company's financial statements—the "dollars and cents" of the proposed venture. In fact, one survey found that 74 per cent of bankers say that financial documentation is the most important aspect of a business plan for entrepreneurs who are seeking loans. For an existing business, lenders and investors use past financial statements to judge the health of the company and its ability to repay loans or generate adequate returns; therefore, an owner should supply copies of the firm's financial statements from the past 3 years. Ideally, these statements should be audited by a certified public accountant because most financial institutions prefer that extra reliability although a financial review of the statements by an accountant sometimes may be acceptable.

Whether assembling a plan for an existing business or for a start-up, an entrepreneur should carefully prepare projected (pro forma) financial statements for the operation for the next year using past operating data, published statistics, and research to derive forecasts of the income statement, balance sheet, cash forecast (always!), and a schedule of planned capital expenditures. Although including only most likely forecasts in the business plan is acceptable, entrepreneurs also should develop forecasts for pessimistic and optimistic conditions that reflect the uncertainty of the future in case potential lenders and investors ask for them.

It is essential for financial forecasts to be realistic. Entrepreneurs must avoid the tendency to "fudge the numbers" just to make their businesses look good. Experienced lenders and investors can detect unrealistic forecasts easily. In fact, some venture capitalists automatically discount an entrepreneur's financial projections by as much as 50 percent. After completing these forecasts,

an entrepreneur should perform a break-even analysis for the business.

It is also important to include a statement of the *assumptions* on which these financial projections are based. Potential lenders and investors want to know how an entrepreneur derived forecasts for sales, cost of goods sold, operating expenses, accounts receivable, collections, accounts payable, inventory, taxes, and other items. Spelling out realistic assumptions gives a plan more credibility and reduces the tendency to include overly optimistic estimates of sales growth and profit margins. Greg Martin, a partner in the venture capital company Redpoint Ventures, says, "I have problems with start-ups making unrealistic assumptions—how much money they need or how quickly they can ramp up revenue. Those can really kill a deal for me."

3.4.13 The Loan or Investment Proposal

The loan or investment proposal section of the business plan should state the purpose of the financing, the amount requested, and the plans for repayment or, in the case of investors, an attractive exit strategy. When describing the purpose of the loan or investment, an entrepreneur must specify the planned use of the funds. Entrepreneurs should state the precise amount requested and include relevant backup data, such as vendor estimates of costs or past production levels.

Another important element of the loan or investment proposal is the repayment schedule or exit strategy. A lender's main consideration when granting a loan is the reassurance that the applicant will repay, whereas an investor's major concern is earning a satisfactory rate of return. Financial projections must reflect a company's ability to repay loans and produce adequate returns. Without this proof, a request for funding stands little chance of being approved. It is necessary for the entrepreneur to produce tangible evidence that shows the ability to repay loans or to generate attractive returns. Developing an exit strategy, such as the option to cash out through an acquisition or a public offering, is important.

Finally, an entrepreneur should include a realistic timetable for implementing the proposed plan. This should include a schedule showing the estimated start-up date for the project and noting all significant milestones along the way.

A business plan must present an honest assessment of the risks facing the new venture. Evaluating risk in a business plan requires an entrepreneur to walk a fine line, however. Dwelling too much on everything that can go wrong discourages potential lenders and investors from financing the venture. Ignoring the project's risks makes those who evaluate the plan see the entrepreneur as either naive, dishonest, or unprepared. The best strategy is to identify the most significant risks the venture faces and then to describe the plans the entrepreneur has developed to avoid them altogether or to overcome the negative outcome if the event does occur.

There is a difference between a *working* business plan—the one the entrepreneur is using to guide her business—and the *presentation* business plan—the one he or she is using to attract capital. Although coffee rings and penciled-in changes in a working plan don't matter (in fact, they're a *good* sign that the entrepreneur is actually using the plan), they have no place on a plan going to someone outside the company. A plan is usually the tool that an entrepreneur uses to

make a first impression on potential lenders and investors. To make sure that impression is a favorable one, an entrepreneur should follow these tips:-

- Realize that first impressions are crucial. Make sure the plan has an attractive (but not an expensive) cover.
- Make sure the plan is free of spelling and grammatical errors and “typos.” It is a professional document and should look like one.
- Make it visually appealing. Use color charts, figures, and diagrams to illustrate key points. Don’t get carried away, however, and end up with a “comic book” plan.
- Include a table of contents with page numbers to allow readers to navigate the plan easily. Reviewers should be able to look through a plan and quickly locate the sections they want to see.
- Make it interesting. Boring plans seldom get read; a good plan tells an interesting story.
- A plan must prove that the business will make money. In one survey of lenders, investors, and financial advisors, 81 percent said that, first and foremost, a plan should prove that a venture will earn a profit. Start-ups do not necessarily have to be profitable immediately, but sooner or later (preferably sooner), they must make money.
- Use computer spreadsheets to generate a set of realistic financial forecasts. They allow entrepreneurs to perform valuable “what if” (sensitivity) analysis in just seconds.
- *Always* include cash flow projections. Entrepreneurs sometimes focus excessively on their proposed venture’s profit forecasts and ignore cash flow projections. Although profitability is important, lenders and investors are much more interested in cash flow because they know that’s where the money to pay them back or to cash them out comes from.
- The ideal plan is “crisp,” long enough to say what it should but not so long that it is a chore to read. Entrepreneur and venture capitalist Guy Kawasaki says that for him the ideal business plan is just 20 pages long, including 2 pages of financial projections.
- Tell the truth. Absolute honesty is always critical when preparing a business plan.

Business plans are forecasts about the future that an entrepreneur plans to create, something that one expert compares to “taking a picture of the unknown,” which is a challenging feat!

As uncertain and difficult to predict as the future may be, an entrepreneur who launches a business without a plan arguing that “trying to forecast the future is pointless” is misguided. In the *Harvard Business Review*, William Sahlman says that “the best business plans...are like movies of the future. They show the people, the opportunity, and the context from multiple angles. They offer a plausible, coherent story of what lies ahead. They unfold the possibilities of action and reaction.” That’s the kind of “movie” an entrepreneur should strive to create in a plan.

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Chapter Four

Product and Service Concept

At the end of this chapter, you will be able to:

- Explain the various concepts of Product
- Identify the steps of Product development process
- Differentiate the types of product protection mechanisms

4.1 INTRODUCTION

This chapter begins our discussion of the functional areas of marketing. Why do we begin our discussion with product rather than with promotion, distribution, or pricing? The answer is quite obvious. None of those other functions serve any useful purpose without a company product that provides consumer satisfaction. Without a product, there is nothing to promote, nothing to distribute, nothing to price. This does not suggest that product is more important, rather, it is the impetus for the other marketing functions. Logically, we should start at the beginning, and the beginning of a market place is a set of correct decisions about the product offerings of the firm.

4.1.1 DEFININGTHE PRODUCT

In essence, the term "product" refers to anything offered by a firm to provide customer satisfaction, be it tangible or intangible. It can be a single product, a combination of products, a product-service combination, or several related products and services. It normally has at least a generic name and usually a brand name. Although a product is normally defined from the perspective of the manufacturer, it is also important to note two other points-of-view-those of the consumer and other relevant publics.

We define product as follows: Anything, either tangible or intangible, offered by the firm; as a solution to the needs and wants of the consumer; is profitable or potentially profitable; and meets the requirements of the various publics governing or influencing society.

There are four levels of a product: core, tangible, augmented, and promised. We begin with the notion of the *core product*, which identifies what the consumers feel they are *getting* when they purchase the product. Because the core product is so individualized, and oftentimes vague, a full-time task of the entrepreneur is to accurately identify the core product for a particular target market.

Once the core product has been indicated, the *tangible product* becomes important. This tangibility is reflected primarily in its quality level, features, brand name, styling, and packaging. Literally every product contains these components to a greater or lesser degree. In addition, the importance of each will vary across products, situations, and individuals. For example, for Mr. Smith at age 25, the selection of a particular brand of new automobile (core product

=transportation) was based on tangible elements such as styling and brand name (choice =Corvette); at age 45, the core product remains the same, while the tangible components such as quality level and features become important (choice = Mercedes).

At the next level lies the *augmented product.* Every product is backed up by a host of supporting services. Often, the buyer expects these services and would reject the core-tangible product if they were not available. Examples would be restrooms and escalators/elevators in the case of a department store, and warranties and return policies in the case of a lawn mower. Dow Chemical has earned a reputation as a company that will bend over backwards in order to service an account. It means that a Dow sales representative will visit a troubled farmer after-hours in order to solve a serious problem. This extra service is an integral part of the augmented product and a key to their success. In a world with many strong competitors and few unique products, the role of the augmented product is clearly increasing.

The outer ring of the product is referred to as the *promised product.* Every product has an implied promise. An implied promise is a characteristic that is attached to the product over time. The car industry rates brands by their trade-in value. There is no definite promise that a Mercedes-Benz holds its value better than a BMW. There will always be exceptions. How many parents have installed a swimming pool based on the implied promise that their two teenagers will stay home more, or that they will entertain friends more often.

Having discussed the components of a product, it is now relevant to examine ways of classifying products in order to facilitate the design of appropriate product strategies.

4.1.2 CLASSIFICATION OF PRODUCTS

It should be apparent that the process of developing successful marketing programs for individual products is extremely difficult. In response to this difficulty, a variety of classification systems have evolved that, hopefully, suggest appropriate strategies. The two most common classifications are: (I) consumer goods versus industrial goods, and (2) goods products (i.e. durables and nondurables) versus service products.

Consumer Goods and Industrial Goods

The traditional classification of products is to dichotomize all products as being either *consumer goods* or *industrial goods.* When we purchase products for our own consumption or that of our family with no intention of selling these products to others, we are referring to *consumer goods.* Conversely, industrial goods are purchased by an individual or organization in order to modify them or simply distribute them to the ultimate consumer in order to make a profit or meet some other objective.

Classification of Consumer Goods

A classification used in marketing separates products targeted at consumers into three groups: convenience, shopping, and specialty. A *convenience good* is one that requires a minimum amount of effort on the part of the consumer. Extensive distribution is the primary marketing strategy. The product must be available in every conceivable outlet and must be easily accessible in these outlets. Vending machines typically dispense convenience goods, as do automatic teller

machines. These products are usually of low unit value, they are highly standardized, and frequently they are nationally advertised. Yet, the key is to convince resellers, i.e., wholesalers and retailers, to carry the product. If the product is not available when, where, and in a form desirable by the consumer, the convenience product will fail.

From the consumer's perspective, little time, planning, or effort is required to go into buying convenience goods. Consequently, entrepreneurs must establish a high level of brand awareness and recognition. This is accomplished through extensive mass advertising, sales promotion devices such as coupons and point-of-purchase displays, and effective packaging. The fact that many of our product purchases are often on impulse is evidence that these strategies work. Availability is also important. Consumers have come to expect a wide spectrum of products to be conveniently located at their local supermarkets, ranging from packaged goods used daily, e.g., bread and soft drinks, to products purchased rarely or in an emergency such as snow shovels, carpet cleaners, and flowers.

In contrast, consumers want to be able to compare products categorized as *shopping goods.* Automobiles, appliances, furniture, and homes are in this group. Shoppers are willing to go to some lengths to compare values, and therefore these goods need not be distributed so widely. Although many shopping goods are nationally advertised, often it is the ability of the retailer to differentiate itself that creates the sale. The differentiation could be equated with a strong brand name, such as Sears Roebuck or Marshall Field; effective merchandising; aggressive personal selling; or the availability of credit. Discounting, or promotional price-cutting, is a characteristic of many shopping goods because of retailers' desire to provide attractive shopping values. In the end, product turn-over is slower and retailers have a great deal of their capital tied-up in inventory. This combined with the necessity to price discount and provide exceptional service means that retailers expect strong support from manufacturers with shopping goods.

Specialty goods represent the third product classification. From the consumer's perspective, these products are so unique that they will go to any lengths to seek out and purchase them. Almost without exception, price is not a principle factor affecting the sales of specialty goods. Although these products may be custom-made (e.g., a hairpiece) or one- ofa-kind (e.g. , a statue), it is also possible that the marketer has been very successful in differentiating the product in the mind of the consumer. Crisco shortening, for instance, may be considered to be a unique product in the mind of a consumer and the consumer would pay any price for it. Such a consumer would not accept a substitute and would be willing to go to another store or put off their pie baking until the product arrives. Another example might be the strong attachment some people feel toward a particular hair stylist or barber. A person may wait a long time for that individual and might even move with that person to another hair salon. It is generally desirable for an entrepreneur to lift her product from the shopping to the specialty class (and keep it there). With the exception of price-cutting, the entire range of marketing activities are required to accomplish this goal.

Classification of *Industrial Goods*

Consumer goods are characterized as products that are aimed at and purchased by the ultimate consumer. Although consumer products are more familiar, industrial goods represent a very important product category, and in the case of some manufacturers, they are the only product sold.

Industrial products can either be categorized from the perspective of the producer and how they shop for the product, or the perspective of the manufacturer and how they are produced and how much they cost. The latter criteria offers a more insightful classification for industrial products.

Farms, forests, mines, and quarries provide ***extractive products*** to producers. Although there are some farm products that are ready for consumption when they leave the farm, most farm and other extractive products require some processing before purchased by the consumer. A useful way to divide extractive products is into *farm products* and *natural products*, since they are marketed in slightly different ways.

Manufactured products are those that have undergone some processing. The demands for manufactured industrial goods are usually derived from the demands for ultimate consumer goods. There are a number of specific types of manufactured industrial goods.

Semi-manufactured goods are raw materials that have received some processing but require some more before they are useful to the purchaser. Lumber and crude oil are examples of these types of products. Since these products tend to be standardized, there is a strong emphasis on price and vendor reliability.

Parts are manufactured items that are ready to be incorporated into other products. For instance, the motors that go into lawn mowers and steering wheels on new cars are carefully assembled when they arrive at the manufacturing plant. Since products such as these are usually ordered well in advance and in large quantities, price and service are the two most important marketing considerations.

Process machinery (sometimes called "installations") refers to major pieces of equipment used in the manufacture of other goods. This category would include the physical plant (boilers, lathes, blast furnaces, elevators, and conveyor systems). The marketing process would incorporate the efforts of a professional sales force, supported by engineers and technicians, and a tremendous amount of personalized service.

Equipment is made up of portable factory equipment (e.g., forklift trucks, fire extinguisher) and office equipment (e.g ., computers, copier machines). Although these products do not contribute directly to the physical product, they do aid in the production process. These products may be sold directly from the manufacturer to the user, or a middleman can be used in geographically dispersed markets. The marketing strategy employs a wide range of activities, including product quality and features, price, service, vendor deals, and promotion.

Supplies and service do not enter the finished product at all, but are nevertheless consumed in conjunction with making the product. Supplies would include paper, pencils, fuel oil, brooms, soap, and so forth. These products are normally purchased as convenience products with a minimum of effort and evaluation. Business services include maintenance (e,g., office cleaning), repairs (e.g. plumbing), and advisory (e.g. legal). Because the need for services tends to be unpredictable, they are often contracted for a relatively long period of time.

Goods Versus Services

Suggesting that there are substantial differences between goods products and service products has been the source of great debate in marketing. Opponents of the division propose that "products are products" and just because there are some characteristics associated with service products and not goods products and vice-versa, does not mean customized strategies are generally necessary for each. Advocates provide evidence that these differences are significant. It is the position in this course that service products are different than goods products, and that service products represent an immense market sector.

Service products are reflected by a wide variety of industries: utilities, barbers, travel agencies, health spas, consulting firms, medical care and banking, to name but a few, and they account for nearly 50% of the average consumer's total expenditures, 70% of the jobs, and two-thirds of the G.N.P. Clearly, the service sector is large and is growing. While all products share certain common facets, service products tend to differ from goods products in a number of ways.

Characteristics of Service Products

Like goods products, service products are quite heterogeneous. Nevertheless, there are several characteristics that are generalized to service products.

Intangible: As noted by Berry, "a good is an object, a device, a thing; a service is a deed, a performance, an effort." With the purchase of a good you have something that can be seen, touched, tasted, worn or displayed; this is not true with a service. Although you pay your money and consume the service, there is nothing tangible to show for it. For example, if you attend a professional football game, you spend $19.50 for a ticket and spend nearly three hours taking in the entertainment.

Simultaneous Production and Consumption: Service products are characterized as those that are being consumed at the same time they are being produced. The tourist attraction is producing entertainment or pleasure at the same time it is being consumed. In contrast, goods products are produced, stored, and then consumed. A result of this characteristic is that the provider of the service is often present when consumption takes place. Dentists, doctors, hair stylists, and ballet dancers are all present when the product is used.

Little Standardization: Because service products are so closely related to the people providing the service, ensuring the same level of satisfaction from time to time is quite difficult. Dentists have their bad days, not every baseball game is exciting, and the second vacation to Disney World may not be as wonderful as the first.

High Buyer Involvement: With many service products, the purchaser may provide a great deal of input into the final form of the product. For example, if you wanted to take a Caribbean cruise, a good travel agent would give you a large selection of brochures and pamphlets describing the various cruise locations, options provided in terms of cabin location and size, islands visited, food, entertainment, prices, and whether they are set up for children. Although the task may be quite arduous, an individual can literally design every moment of the vacation.

It should be noted that these four characteristics associated with service products vary in intensity from product to product. In fact, service products are best viewed as being on a continuum in respect to these four characteristics.

While this discussion implies that service products are marketed differently than goods products, it is important to remember that all products, whether they are goods, services, blankets, diapers, or plate glass, possess peculiarities that require adjustments in the marketing effort. However, "pure" goods products and "pure" service products (i.e., those on the extreme ends of the continuum) tend to reflect characteristics and responses from customers that suggest opposite marketing strategies. Admittedly, offering an exceptional product at the right price, through the most accessible channels, promoted extensively and accurately, should work for any type of product. The goods/services classification provides the same useful insights provided by the consumer/industrial classification discussed earlier.

4.2 PRODUCT DEVELOPMENT PROCESSS

Evidence suggests that there may be as many varieties of new product development systems as there are kinds of companies. For the most part, most companies do have a formal comprehensive new product development system, and the evolution of such systems were not necessarily the result of systematic planning. Because of the complexity of the process, it is important that the general guidelines of effective management be applied to new product development.

Before starting our discussion of the eight-step process of new product development, a necessary caveat should be considered: a great many new products fail. Depending on definitions used for products actually introduced, failure rates range between 20 percent and 30 percent, but have been as high as 80 percent. Of more concern than the level of failure are the reasons for failure. Possibilities include: technical problems, bad timing, mis- understanding the consumer, actions by competitors, and misunderstanding the environment.

Step 1: Generating New Product Ideas

Generating new product ideas is a creative task that requires a specific way of thinking. Gathering ideas is easy, but generating good ideas is another story. Examples of internal sources are:-

1. *Basic research:* many companies, such as DuPont, have several scientists who are assigned the task of developing new product ideas and related technology.
2. *Manufacturing:* people who manufacture products often have ideas about modifications and improvements, as well as completely new concepts.
3. *Salesperson:* company salespeople and representatives can be a most helpful source of ideas, since they not only know the customer best, but they also know the competition and the relative strengths and weaknesses of existing products.
4. *Top management:* the good top executive knows the company' s needs and resources, and is a keen observer of technological trends and of competitive activity.

External sources of new product ideas are almost too numerous to mention. A few of the more useful are:

1. *Secondary sources of information:* there are published lists of new products, available licenses, and ideas for new product ventures.
2. *Competitors:* good inferences about competitive product development can be made on the basis of indirect evidence gained from salespeople and from other external sources, including suppliers, resellers, and customers.
3. *Customers:* frequently customers generate new product ideas, or at least relay information regarding their problems that new and improved products would help to solve.
4. *Resellers:* a number of firms use "councils" or committees made up of representative resellers to assist in solving various problems, including product development.
5. *Foreign markets:* many companies look toward foreign markets, especially Western Europe and other developed countries, because they have been so active in product development.

There are probably as many approaches to collecting new product ideas as there are sources.
For most companies, taking a number of approaches is preferable to a single approach. Still, coming up with viable new product ideas is rare.

Step 2: Screening Product Development Ideas

The second step in the product development process is *screening*. It is a critical part of the development activity. Product ideas that do not meet the organization's objectives should be rejected. If a poor product idea is allowed to pass the screening state, it wastes effort and money in subsequent stages until it is later abandoned. Even more serious is the possibility of screening out a worthwhile idea.

There are two common techniques for screening new product ideas; both involve the comparison of a potential product idea against criteria of acceptable new products. The first technique is a simple checklist. For example, new product ideas can be rated on a scale ranging from very good to poor, in respect to criteria such as: value added, sales volume, patent protection, affect on present products, and so forth. Unfortunately, it is quite difficult for raters to define what is fair or poor. Also, it does not address the issue of the time and expense associated with each idea, nor does it instruct with regard to the scores. A second technique goes beyond the first: the criteria are assigned importance weights and then the products are rated on a point scale measuring product compatibility. These scores are then multiplied by their respective weights and added to yield a total score for the new product idea.

Step 3: Business Analysis

After the various product ideas survive their initial screen, very few viable proposals will remain. Before the development of prototypes can be decided upon, however, a further evaluation will be conducted to gather additional information on these remaining ideas in order to justify the

enormous costs required. The focus of the business analysis is primarily on profits, but other considerations such as social responsibilities may also be involved.

The first step in the business analysis is to examine the projected demand. This would include two major sources of revenue: the sales of the product and the sales or license of the technology developed for or generated as a by-product of the given product.

A complete cost appraisal is also necessary as part of the business analysis. It is difficult to anticipate all the costs that will be involved in product development, but the following cost items are typical:-

- Expected development costs, including both technical and marketing R&D
- Expected set-up costs (production, equipment, distribution)
- Operating costs that account for possible economies of scale and learning curves
- Marketing costs, especia1ly promotion and distribution
- Management cost.

Step 4: Technical and Marketing Development

A product that has passed the screen and business analysis stages is ready for technical and marketing development. Technical development involves two steps. The first is the applied laboratory research required to develop exact product specifications. The goal of this research is to construct a prototype model of the product that can be subjected to further study. Once the prototype has been created, manufacturing-methods research can be undertaken to plan the best way of making the product in commercial quantities under normal manufacturing conditions. This is an extremely important step, because there is a significant distinction between what an engineer can assemble in a laboratory and what a factory worker can produce.

While the laboratory technicians are working on the prototype, the marketing department is responsible for testing the new product with its intended consumers and developing the other elements of the marketing mix. The testing process usually begins with the concept test. The *product concept* is a synthesis or a description of a product idea that reflects the core element of the proposed product. For example, a consumer group might be assembled and the interview session might begin with the question: "How about something that would do this?."

The second aspect of market development involves consumer testing of the product idea. This activity must usually await the construction of tile prototype or, preferably, limited-ran production models. Various kinds of consumer preference can be conducted. The product itself can be exposed to consumer taste or use tests. Packaging, labeling, and other elements in the mix can be similarly studied. Comparison tests are also used.

Step 5: Manufacturing Planning

Assuming that the product has cleared the technical and marketing development stage, the manufacturing department is asked to prepare plans for producing it. The plan begins with an appraisal of the existing production plant and the necessary tooling required to achieve the most economical production. Fancy designs and material might be hard if not impossible to

accommodate on existing production equipment; new machinery is often time-consuming and costly to obtain. Compromise between attractiveness and economy is often necessary.

Finally, manufacturing planning must consider the other areas of the organization and what is required of each. More specifically, they should determine how to secure the availability of required funds, facilities, and personnel at the intended time, as well as the methods of coordinating this effort.

Step 6: Marketing Planning

It is at this point that the marketing department moves into action again. The product planner must prepare a complete marketing plan-one that starts with a statement of objectives and ends with the fusion of product, distribution, promotion, and pricing into an integrated program of marketing action.

Step 7: Test Marketing

Test marketing is the final step before commercialization; the objective is to test all the variability's in the marketing plan including elements of the product. Test marketing represents an actual launching of the total marketing program. But it is done on a limited basis.

Three general questions can be answered through test marketing. First, the overall workability of the marketing plan can be assessed. Second, alternative allocations of the budget can be evaluated. Third, determining whether a new product introduction is inspiring users to switch from their previous brands to the new one and holding them there through subsequent repeat purchases is determined. In the end, the test market should include an estimate of sales, market share, and financial performance over the life of the product.

Initial product testing and test marketing are not the same. *Product testing* is totally initiated by the producer: he selects the sample of people, provides the consumer with the test product, and offers the consumer some sort of incentive to participate.

Test marketing, on the other hand, is distinguished by the fact that the test cities are to represent the national market, the consumer must make the decision herself, must pay her money, and the test product must compete with the existing products in the actual marketing environment. For these and other reasons a market test is an accurate simulation of the national market and serves as a method for reducing risk. It should enhance the new product's probability of success and allow for final adjustment in the marketing mix before the product *is* introduced on a large scale.

However, running a test marketing is not without inherent risks. First, there are substantial costs in buying the necessary plant and machinery needed to manufacture the product or locating manufacturers willing to make limited runs. There are also promotional costs, particularly advertising and personal selling. Although not always easy to identify, there are indirect costs as well. For example, the money used to test market could be used for other activities. The risk of losing consumer goodwill through the testing of an inferior product is also very real. Finally, engaging in a test-market might allow competitors to become aware of the new product and quickly copy it.

Because of the special expertise needed to conduct test markets and the associated expenses, most manufacturers employ independent marketing research agencies with highly trained project directors, statisticians, psychologists, and field supervisors. Such a firm would assist the product manager in making the remaining test market decisions.

1. *Duration of testing:* the product should be tested long enough to account for market factors to even out, allow for repeat purchases, and account for deficiencies in any other elements in the new product (three to six months of testing may be sufficient for a frequently purchased and rapidly consumed convenience item).
2. *Selection of test market cities:* the test market cities should reflect the norms for the new product in such areas as advertising, competition, distribution system, and product usage.
3. *Number of test cities:* should be based on the number of variations considered (i.e., vary price, package, or promotion), representativeness, and cost.
4. *Sample size determination:* the number of stores used should be adequate to represent the total market.

Even after all the test results are in, adjustments in the product are still made. Additional testing may be required, or the product may be deleted.

Step 8: Commercialization

At last the product is ready to go. It has survived the development process and it is now on the way to commercial success. How can it be guided to that marketing success? It is the purpose of the lifecycle marketing plan to answer this question. Such a complete marketing program will, of course, involve additional decisions about distribution, promotion, and pricing.

4.3 PRODUCT PROTECTION

Entrepreneurs excel at coming up with innovative ideas for creative products and services. Many entrepreneurs build businesses around intellectual property, products and services that are the result of the creative process and have commercial value. New methods that are capable of teaching foreign languages at an accelerated pace, hit songs with which we can sing along, books that bring a smile, and new drugs that fight diseases are just some of the ways intellectual property makes our lives better or more enjoyable.

Unfortunately, thieves are escalating their efforts to steal intellectual property by selling counterfeit merchandise. The problem extends far beyond pirated software, fake shoes and handbags, and knockoffs of expensive watches or the latest styles of designer clothing. Authorities have discovered pirates selling counterfeit helicopter, airplane, and auto parts; prescription medications; and many other products. The U.S. Justice Department recently seized 82 Web sites, 70 of them located in China, for selling counterfeit goods supposedly from companies such as Coach, Disney, Oakley, Louis Vuitton, Nike, and others to unsuspecting consumers.

Entrepreneurs can protect their intellectual property from unauthorized use with the help of three important tools: patents, trademarks, and copyrights.

Patents

A **patent** is a grant from the responsible government office to the inventor of a product, giving the exclusive right to make, use, or sell the invention. For example, the US government issues a patent to an inventor with right to make, use, or sell the invention in the country for 20 years from the date of filing the patent application. The purpose of giving an inventor a 20-year monopoly over a product is to stimulate creativity and innovation. After 20 years, the patent expires and cannot be renewed. Most patents are granted for new product inventions, but **design patents**, issued for 3.5, 7, or 14 years beyond the date the patent is issued, are given to inventors who make new, original, and ornamental changes in the design of existing products that enhance their sales. Inventors who develop a new plant can obtain a **plant patent** (issued for 7 years), provided they can reproduce the plant asexually (e.g., by grafting or cross-breeding rather than planting seeds). To be patented, a device must be new (but not necessarily better), not obvious to a person of ordinary skill or knowledge in the related field, and useful. An inventor cannot patent a device if it has been publicized in print anywhere in the world or if it has been used or offered for sale in the country prior to the date of the patent application. A patent is granted only to the true inventor, not to a person who discovers another's invention. No one can copy or sell a patented invention without getting a license from its creator. A patent does not give one the right to make, use, or sell an invention, but rather the right to exclude others from making, using, or selling it.

To receive a patent, an inventor must follow these steps:

Establish the invention's novelty. An invention is not patentable if it is known or has been used or has been described in a printed publication in a country or a foreign country.

Document the device. To protect a patent claim, inventors should be able to verify the date on which they first conceived the idea for their invention. Inventors can document a device by keeping dated records (including drawings) of their progress on the invention and by having knowledgeable friends witness these records.

Search existing patents. To verify that the invention truly is new, non obvious, and useful, inventors must conduct a search of existing patents on similar products. The purpose of the search is to determine whether the inventor has a chance of getting a patent. Most inventors hire professionals trained in conducting patent searches to perform the research. Inventors themselves can also conduct an online search of all patents granted by the respective government body.

Study search results. Once the patent search is finished, inventors must study the results of the search to determine their chances of getting a patent. To be patentable, a device must be sufficiently different from what has been used or described before and must not be obvious to a person having ordinary skill in the area of technology related to the invention.

Submit the patent application. An inventor must file an application describing the invention. This description, called the patent's claims, should be broad enough so that others cannot easily engineer around the patent, rendering it useless. However, they cannot be so narrow as to infringe on patents that other inventors already hold. The typical patent application runs 20 to 40

pages, although some, especially those for biotech or high-tech products, are tens of thousands of pages long.

Prosecute the patent application. Before the issuance of a patent, examiners study the application to determine whether the invention warrants a patent. If the application rejected, the inventor can amend the application and resubmit it. For example, in the US the average time for a patent to be issued is 35 months, and as the backlog of patent applications grows ever larger the average time will double within 5 years.

Defending a patent against "copycat producers" can be expensive and time-consuming, but it often is necessary to protect an entrepreneur's idea. Patent lawsuits are on the rise; the number filed annually has more than tripled since the early 1980s. Unfortunately, the cost of defending a patent has increased as well; the average cost of a patent infringement case is about $2 million for each side. However, the odds of winning are in the patent holder's favor; more than 60 percent of those holding patents win their infringement suits.

Trademarks

A **trademark** is any distinctive word, phrase, symbol, design, name, logo, slogan, or trade dress that a company uses to identify the origin of a product or to distinguish it from other goods on the market. (A **service mark** is the same as a trademark except that it identifies and distinguishes the source of a service rather than a product.) A trademark serves as a company's "signature" in the marketplace. A trademark can be more than just a company's logo, slogan, or brand name; it can also include symbols, shapes, colors, smells, or sounds. For instance, Coca-Cola holds a trademark on the shape of its bottle, and NBC owns a trademark on its three-toned chime. Components of a product's identity such as these are part of its **trade dress**, the unique combination of elements that a company uses to create a product's image and to promote it. For instance, a company's particular décor, color schemes, design, and overall "look and feel" comprise its trade dress. To be eligible for trademark protection, trade dress must be inherently unique and distinctive to a company, and another company's use of that trade dress must be likely to confuse customers.

Before 1989, a business could not reserve a trademark in advance of use. Today, the first party that either uses a trademark in commerce or files an application with the responsible government office has the ultimate right to register that trademark. In the US, it takes approximately 11 months to process a trademark application. Unlike patents and copyrights, which are issued for limited amounts of time, trademarks last indefinitely as long as the holder continues to use it. However, a trademark cannot keep competitors from producing the same product and selling it under a different name. It merely prevents others from using the same or confusingly similar trademark for the same or similar products.

Many business owners are confused by the use of the symbols ™ and ®. Anyone who claims the right to a particular trademark (or servicemark) can use the ™ (or ^{SM}) symbols without having to register the mark with the responsible government office. The claim to that trademark or servicemark may or may not be valid, however. Only those businesses that have registered their marks can use the ® symbol. Entrepreneurs do not have to register trademarks or servicemarks to establish their rights to those marks; however, registering a mark with does give entrepreneurs

greater power to protect their marks. Filing an application to register a trademark or servicemark is relatively easy, but it does require a search of existing names.

An entrepreneur may lose the exclusive right to a trademark if it loses its unique character and becomes a generic name or if the company abandons its trademark by failing to market the brand adequately. *Aspirin, escalator, thermos, brassiere, superglue, yo-yo,* and *cellophane* all were once enforceable trademarks that have become common words in the English language. These generic terms can no longer be licensed as a company's trademark.

Copyrights

A **copyright** is an exclusive right that protects the creators of original works of authorship, such as literary, dramatic, musical, and artistic works (e.g., art, sculptures, literature, software, music, videos, video games, choreography, motion pictures, recordings, and others). The internationally recognized symbol © denotes a copyrighted work. A copyright protects only the form in which an idea is expressed, not the idea itself. A copyright on a creative work comes into existence the moment its creator puts that work into a tangible form. Just as with a trademark, obtaining basic copyright protection does not require registering the creative work; doing so, however, gives creators greater protection over their work. A valid copyright on a work lasts for the life of the creator plus 70 years after his or her death. (A copyright lasts 75 to 100 years if the copyright holder is a business.) When a copyright expires, the work becomes public property and can be used by anyone free of charge.

Because they are easy to duplicate, computer software, CDs, and DVDs are among the most often-pirated items by copyright infringers. Copyright piracy, for example, costs U.S. companies an estimated $58 billion a year in lost sales. The software and music industries alone lose $15.4 billion annually to pirates.

Chapter Five

Marketing and New Venture Development

At the end of this unit, you will be able to:

- Describe the concept of marketing research
- Define the term marketing intelligence
- Explain the concept of competitive analysis
- Describe the concept of marketing strategies
- Differentiate international markets from domestic markets

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5.2 MARKETING RESEARCH

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5.3 MARKETING INTELLIGENCE

Marketing intelligence is the systematic collection and analysis of publicly available information about competitors and developments in the marketing environment. A company then uses this everyday information about developments in the marketing environment to help managers prepare and adjust marketing plans. The marketing intelligence system determines what intelligence is needed, collects it by searching the environment, and delivers it to marketing managers.

5.4 COMPETITIVE ANALYSIS

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TABLE 2: **Sample Competitive Profile Matrix**

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5.5 MARKETING STRATEGIES

Small Businesses can gain a competitive advantage over larger competitors by tailoring their products or services to meet the demands of the individual customer. This tailoring can be done through the means of the product/service offered, price, promotion, and placement (distribution). The above are known as the marketing mix. Another advantage is that small businesses offer a more personalized interaction with the customer.

First of all, a marketing strategy that you should take advantage of both offline and online is networking. This is probably the single most important strategy you can look into. As a small business, you will find that one of your first and most important hurdles is simply getting people to know that you exist. If people don't know you've started a small business and that you have amazing widgets or services to sell, they're not going to ask to buy those widgets or hire you for those services, regardless of how wonderful and amazing they might be. So your first job as a small business entrepreneur will be to get the word out. Beyond online and offline networking, another avenue for marketing in both venues is promoting your business through ads. In the real world, this can be done through print and flyer ads, vehicle tags, and window displays.

A set of strategies found quite commonly in smaller businesses are growth strategies. One way to look at strategies to grow your business is through the way you will use products and markets or customers:

- ***Current product/current market:*** Market penetration is a strategy of increasing your share of existing markets. You might achieve this by raising customers' awareness of your products and services or finding new customers.

- ***Current product/new market:*** Market development is a strategy of finding and entering new markets with your current product or service range. The new market could be a new region, a new country or a new segment of the market.

- ***New product/current market:*** Product development is a strategy for enhancing benefits you deliver to customers by improving your existing products and services or developing new ones.

- ***New product/new market:*** Diversification is a strategy that usually carries high costs and high risks. It often requires firms to adopt new ways of doing business and so has consequences far beyond simply offering new products/services in a new market. It is therefore usually a strategy to be adopted when other options are not feasible.

5.6 INTERNATIONAL MARKETS

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Chapter Six

Organizing and Financing New Venture

At the end of this unit, you will be able to:

- Explain the concept of Entrepreneurial team and business formation
- List out the various sources of finance

6.1 Entrepreneurial Team

Nearly half of all new business ventures are started by teams of people. As one business writer observes, “Launching a company isn’t just a full-time job; in many cases, it’s three full-time jobs.” Perhaps that is why a study of 2,000 businesses by researchers at Marquette University found that companies started by teams of entrepreneurs are nearly 16 times more likely to become high-growth ventures than those started by solo entrepreneurs. Indeed, launching a company is a demanding task that requires a diverse blend of skills, abilities, and experience that not every individual possesses. If that is the case, the best alternative is to launch your company with others whose skills, abilities, and experience *complement* rather than *mirror* yours. Picking the right entrepreneurial players is as essential to business success as picking the best kids to be on your kickball team was in grammar school! However many people it may require, ideally a start-up team includes a “big picture” strategic thinker, a top-notch networker with marketing and sales know-how, and a hands-on technical person who understands the business opportunity at the “nuts-and-bolts” level.

6.2 Forms of Business Ownership

Have you ever seen the most common types of business ownership in your area? Have you tried to see the difference between the ownership of the shop that is found in your area and the ownership of businesses like Banks? I am now going to discuss the forms of business ownership in the following topics.

The form of business ownership describes how a business is legally set up. In other words, the form of business ownership is the business' legal structure. The most common forms of business ownership, as has been discussed in chapter two, are the sole proprietorship, partnership, and corporation.

There are other forms of business ownership available in many countries such as the limited partnership, cooperatives, and limited liability company (LLC) but the three listed above are the main choices for anyone starting a business. These three basic legal forms are compared with regard to: ownership, liability, start up costs, continuity, transferability of interest, capital requirement, management control, distribution of profit and attractiveness for raising capital.

Don't confuse the form of business ownership with the type of business, such as retail, service, etc. Most types of business can have any form of business ownership.

The form of business ownership you choose is one of the most important decisions that you will make when you are starting a business. Each form of business ownership has its own cons and pros. The decision must be made before the submission of a business plan and request for venture capital.

6.2.1 Sole Proprietorship

A sole proprietorship is the simplest form of business and the easiest to register. It is owned by an individual who has full control/authority of his/hers, owns all assets as well as answers all liabilities or losses. The fact that it is run by the individual means that it is highly flexible and the owner retains absolute control over it.

Because of this relationship, a sole proprietorship is known as a pass-through entity. This means that all income and expenses pass-through to, and are filed as, part of the owner's personal return. If there is a business loss, the owner will enjoy a deduction to offset personal (paycheck) income. However, if the business makes a profit, the owner is responsible for any taxes due.

Since they have few legal requirements, sole proprietorships are easy to form and operate. They can also be more affordable since no legal documents need to be filed in most cases.

While doing business as a sole proprietor may seem fairly simple, there is one very serious adverse consequence, especially if the business involves products which could cause harm or injury to other persons. As a sole proprietor, you are also personally liable for any and all debts and liabilities of the business. Whether a claim is made against your business by a customer, an employee, a competitor, or a trade creditor, you will be personally "on the catch" for any such claim. As a result, all of your personal assets, home, motor vehicles, savings accounts, jewelry, household goods, etc; will be subject to the claims of all such creditors.

While certain jointly owned property of a husband and wife may be exempt from liability to the creditors of only one of the spouses, even these joint assets may be jeopardized if both the husband and wife are involved in the operation of the business. Obviously, these are risks which many persons engaged in business would like to avoid.

Generally, the following are the characteristics of Sole Proprietorship:-

- Easy and inexpensive to create and operate business.
- Decision-making is entirely in the hands of the owner.
- Hard to raise funds. Sources of funds limited to the owner’s personal funds and the funds that outsiders are willing to provide.
- You may be co-sole proprietor with a spouse. Co-sole proprietors can split profits and file separate tax returns.
- Unlimited personal liability if something bad would happen. You could lose your car, home, etc. if someone sued your business. Creditors can take personal and business assets.
- You have no job security and are completely responsible for the success of your business. You don’t have worker’s compensation or unemployment insurance.
- The business terminates with the death, disability, or retirement of the owner.

6.2.2 Partnership

A partnership consists of two or more persons who bind themselves to contribute money or industry to a common fund, with the intention of dividing the profits among themselves. The most common example of partnerships is professional partnerships, like in the case of law firms and accounting firms.

A partnership may be general or limited. **In a general partnership**, the partners have unlimited liability for the debts and obligation of the partnership, pretty much like a sole proprietorship. **In a limited partnership**, one or more general partners have unlimited liability and the limited partners have liability only up to the amount of their capital contributions. Unlike a corporation, which survives even when a member/stockholder dies or gets out, a partnership is dissolved upon the death of a partner or whenever a partner bolts out.

A partnership occurs when two or more persons combine to operate a business. Normally, the allocation of profits and losses, management and operation of the partnership is set forth in a written **'partnership agreement'** which is signed by all of the partners. Also, the partners of a partnership do have some very limited protection from the claims.

Unlike the corporation, the earnings of the partnership are not exposed to 'double taxation'. All of the earnings of the partnership are allocated and taxed directly to the individual partners. This is one of the principal reasons why many individuals choose to operate in the partnership form, rather than as a corporation.

In general, the advantages and disadvantages of partnership are the same as the sole proprietorship. However, the partnership has an additional drawback. A partner can be held liable for the acts of the other partners, increasing personal liability. For example you and your friend are partners. You have formed your own business together as forms of partnership. The business may get loan from micro-finance institutes. But you could not give back the loan to the institute; you are bankrupted. The micro finance institute will definitely claim the loan. And unfortunately you may have car and your partner does not have tangible asset but s/he may have intangible asset. Thus your car will be liable for the loan.

Advantages of Partnership:

- Easy to establish
- Complimentary skills
- Division of profits and losses
- Larger pool of capital and the ability to attract limited partners
- Little government regulation
- Flexibility and taxation

Disadvantages of partnership:

- Unlimited liability of at least one partner
- Difficult to dispose of partnership interest without dissolving the partnership
- Lack of continuity unless there are correct provisions in the agreement.
- Potential for personality and authority conflicts

Dissolution of Partnership

Dissolution is when a partner ceases to associate with the business and termination is the final act of winding up the partnership as a business. Dissolution occurs as a result of one or more of the following events:-

- Expiration per the agreement
- Expressed wish of any general partner to cease operation
- Expulsion of a partner under the provisions of the agreement
- Withdrawal, retirement, insanity, or death of a general partner
- Bankruptcy of the partnership or any general partner
- Admission of a new partner
- Any event that makes it unlawful for the partnership to continue operation
- A judicial decree that a general partner is permanently incapacitated
- Mounting losses that make it impractical
- Impropriety or improper behavior that reflects negatively on the business.

6.2.3 Corporation

A corporation is the third most common forms of business ownership. It is a juridical entity established under the Corporation Code and registered with ministry of trade in Ethiopia context. It must be created by or composed of at least five natural persons and unlimited maximum number, technically called ‘incorporators’. Juridical persons, like other corporations or partnerships, cannot be incorporators, although they may subsequently purchase shares and become corporate shareholders/stockholders.

The corporation was conceived to solve the typical problems of the partnership. Incorporating allows a group of entrepreneurs to act as one, much the way a partnership does, with one important advantage. Since the corporation is a separate legal entity capable of being sued, it can protect its owners by absorbing the liability if something goes wrong.

A corporation is essentially an ‘artificial person’ created and operated with the permission of the state where it is incorporated. It's a person like you, but only "on paper." A corporation is brought to life when a person, the incorporator, files a form with a state known as the articles of incorporation. The owner of a corporation is known as a shareholder.

Since a corporation is a separate legal entity, the corporation actually owns and operates the business on behalf of the shareholder, under the shareholder's total control. This separation provides a legal distinction between the owner and the business and provides the following important benefits:

- It allows you, the owner, to hire yourself as an employee and then participate in company-funded employee benefit plans.
- Since you and your company are now two separate legal entities, law suits can be brought against your company instead of you personally.
- Transferability of ownership.
- When debt is incurred in the company name, you are not personally liable and your assets cannot be taken to settle company obligations.

The liability of the shareholders of a corporation is limited to the amount of their capital contribution. In other words, personal assets of stockholders cannot generally be attached to satisfy the corporation's liabilities, although the responsible members may be held personally liable in certain cases.

Disadvantages of Corporation:-

- Cost and time involved in the incorporation process
- Double taxation
- Potential for diminished managerial incentives
- Legal requirements and regulatory red tape
- Potential loss of control by the founders.

The articles of incorporation must set forth:-

- A corporate name for the corporation.
- The number of shares the corporation is authorized to issue and any information concerning the authorized shares.
- The name and address of each incorporator.
- The names and addresses of the individuals who are to serve as the initial directors;
- The purpose or purposes for which the corporation is organized;
- Managing the business and regulating the affairs of the corporation;
- Defining, limiting and regulating the powers of the corporation, its board of directors and shareholders; and
- A per value for authorized shares or classes of shares;

The Articles must be signed by at least one incorporator regardless of the number of shareholders of the corporation.

6.3 Sources of Financing

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Fixed Capital

Fixed capital is needed to purchase a business's permanent or fixed assets, such as buildings, land, computers, and equipment. Money invested in these fixed assets tends to be frozen because it cannot be used for any other purpose. Typically, large sums of money are involved in purchasing fixed assets, and credit terms usually are lengthy. Lenders of fixed capital expect the assets purchased to improve the efficiency, and thus the profitability, of the business and to create improved cash flows that ensure repayment.

Working Capital

Working capital represents a business's temporary funds; it is the capital used to support a company's normal short-term operations. Accountants define working capital as current assets minus current liabilities. The need for working capital arises because of the uneven flow of cash into and out of the business due to normal seasonal fluctuations. Credit sales, seasonal sales swings, or unforeseeable changes in demand create fluctuations in *any* small company's cash flow. Working capital normally is used to buy inventory, pay bills, finance credit sales, pay wages and salaries, and take care of any unexpected emergencies. Lenders of working capital expect it to produce higher cash flows to ensure repayment at the end of the production/sales cycle.

Growth Capital

Growth capital, unlike working capital, is not related to the seasonal fluctuations of a small business. Instead, growth capital requirements surface when an existing business is expanding or changing its primary direction. For example, a small manufacturer of silicon microchips for computers saw his business skyrocket in a short time period. With orders for chips rushing in, the growing business needed a sizable cash infusion to increase plant size, expand its sales and production workforce, and buy more equipment. During times of such rapid expansion, a growing company's capital requirements are similar to those of a business start-up. Like lenders of fixed capital, growth capital lenders expect the funds to improve a company's profitability and cash flow position, thus ensuring repayment.

Although these three types of capital are interdependent, each has certain sources, characteristics, and effects on the business and its long-term growth that entrepreneurs must recognize.

6.3.1 Sources of Equity Financing

Equity capital represents the personal investment of the owner (or owners) in a business and is sometimes called *risk* capital because the investor assumes the primary risk of losing his or her funds if the business fails.

If a venture succeeds, however, founders and investors share in the benefits, which can be quite substantial. The founders of and early investors in Yahoo!, Sun Microsystems, FedEx, Intel, and Microsoft became multimillionaires when the companies went public and their equity

investments finally paid off. To entrepreneurs, the primary advantage of equity capital is that it does not have to be repaid like a loan does. Equity investors are entitled to share in the company's earnings (if there are any) and usually to have a voice in the company's future direction.

The primary disadvantage of equity capital is that the entrepreneur must give up some—perhaps *most*—of the ownership in the business to outsiders. Although 50 percent of something is better than 100 percent of nothing, giving up control of your company can be disconcerting and dangerous. Many entrepreneurs who give up majority ownership in their companies in exchange for equity capital find themselves forced out of the businesses they started! Entrepreneurs are most likely to give up more equity in their businesses in the start-up phase than in any other.

We now turn our attention to describe some of the common sources of equity capital available to entrepreneurs, including personal savings, friends and relatives, angels, partners, corporations, venture capital, and public stock offerings.

Personal Savings

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Because they are not able to attract capital from outside sources, entrepreneurs often must bootstrap their companies, launching them with little or no money. It takes creativity, boldness, and a certain degree of brashness and moxie, but it works.

Friends and Family Members

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Investments (or loans) from family and friends are an excellent source of seed capital and can get a start-up far enough along to attract money from private investors or venture capital companies. Inherent dangers lurk in family business investments and loans, however. A recent study reports a default rate of 14 percent on business loans from family and friends, compared to a default rate of 1 percent for bank loans. Unrealistic expectations or misunderstood risks have destroyed many friendships and have ruined many family reunions. To avoid problems, an entrepreneur must honestly present the investment opportunity and the nature of the risks involved to avoid alienating friends and family members if the business fails. Smart entrepreneurs treat family members and friends who invest in their companies in the same way they would treat business

partners. Some investments in startup companies return more than friends and family members ever could have imagined. In 1995, Mike and Jackie Bezos invested $300,000 into their son Jeff's start-up business, Amazon.com. Today, Mike and Jackie own 6 percent of Amazon.com's stock, and their shares are worth billions of dollars!

Angels

After dipping into their own pockets and convincing friends and relatives to invest in their business ventures, many entrepreneurs still find themselves short of the seed capital they need.
Frequently, the next stop on the road to business financing is private investors. These **private investors** (or **angels**) are wealthy individuals, often entrepreneurs themselves, who invest in business start-ups in exchange for equity stakes in the companies. Alexander Graham Bell, inventor of the telephone, used angel capital to start Bell Telephone in 1877. More recently, companies such as Google, Facebook, Apple, Starbucks, Amazon.com, and Costco relied on angel financing in their early years to finance growth.

Partners

Entrepreneurs can take on partners to expand the capital base of a business. Before entering into any partnership arrangement, however, entrepreneurs must consider the impact of giving up some personal control over operations and of sharing profits with others. Whenever entrepreneurs give up equity in their businesses (through whatever mechanism), they run the risk of losing control over it. As the founder's ownership in a company becomes increasingly diluted, the probability of losing control of its future direction and the entire decision-making process increases.

Corporate Venture Capital

Large corporations are in the business of financing small companies. Today, about 13 percent of all venture capital deals involve corporate venture capital. The average investment that large corporations make in small companies is $3.52 million, an amount that represents 7.4 percent of total venture capital investments. Approximately 300 large corporations across the globe, including Intel, Motorola, Cisco Systems, Chevron, Comcast, Nokia, UPS, Best Buy, and General Electric, have venture capital divisions that invest on average a total of $2.1 billion a year in young companies, most often those in the product development and sales growth stages.
The large companies are looking not only for financial returns from the small companies in which they invest, but also for innovative products that can benefit them. Young companies get a boost from the capital injections large companies give them, but they also stand to gain many other benefits from the relationship. The right corporate partner may share technical expertise, distribution channels, marketing know-how, and provide introductions to important customers and suppliers. Another intangible yet highly important advantage that an investment from a large corporate partner gives a start-up is credibility, often referred to as "market validation." Doors that otherwise would be closed to a small company magically open when the right corporation becomes a strategic partner.

Venture Capital Companies

Venture capital companies (VCs) are private, for-profit organizations that raise money from investors to purchase equity positions in young businesses they believe have high-growth and

high-profit potential, producing annual returns of 300 to 500 percent over 5 to 7 years. More than 700 venture capital firms operate across the United States today, investing in promising small companies in a variety of industries. Companies in California's Silicon Valley and Boston's high-tech corridor attract about half of all venture capital investments. Some colleges and universities have created venture funds designated to invest in promising businesses started by their students, alumni, faculty, and others. Business schools at the University of Michigan, the University of Maryland, the University of North Dakota, Cornell University, and, in a joint venture called the University Venture Fund, the University of Pennsylvania, Brigham Young University, the University of Utah, and Westminster College operate venture capital funds that are comanaged by students, faculty, and sometimes professional venture capitalists.

Venture capital firms, which provide about 7 percent of all funding for private companies, have invested billions of dollars in high-potential small companies over the years, including notable businesses such as Apple, Microsoft, Intel, and Outback Steakhouse. Clearwire, the wireless communications company, tops the list of companies backed by venture capital with a record $1.3 billion of equity capital raised. Although companies in high-tech industries such as communications, computer software, energy, medical care, and biotechnology are the most popular targets of venture capital, a company with extraordinary growth prospects has the potential to attract venture capital, whatever its industry.

Public Stock Sale ("Going Public")

In some cases, small companies can "go public" by selling shares of stock to outside investors. In an **initial public offering (IPO)**, a company raises capital by selling shares of its stock to the general public for the first time. A public offering is an effective method of raising large amounts of capital, but it can be an expensive and time-consuming process filled with regulatory nightmares. "An IPO can be a wonderful thing," says one investment banker, "but it's not all sweetness and light." Once a company makes an initial public offering, *nothing* will ever be the same again. Managers must consider the impact of their decisions not only on the company and its employees but also on shareholders and the value of their stock. In addition, entrepreneur should know that "Going Public" isn't for every business. In fact, most small companies do not meet the criteria for making a successful public stock offering.

6.3.2 Sources of Debt Financing

Debt financing involves the funds that a small business owner borrows and must repay with interest. Although entrepreneurs who borrow capital maintain complete ownership of their businesses, they must carry it as a liability on the balance sheet as well as repay it with interest at some point in the future. In addition, because lenders consider small businesses to be greater risks than bigger corporate customers, small companies must pay higher interest rates because of the risk–return trade-off—the higher the risk, the greater the return demanded. Most small firms pay the **prime rate**, the interest rate banks charge their most creditworthy customers, *plus* two or more percentage points. Still, the cost of debt financing often is lower than that of equity financing because debt financing does not require entrepreneurs to dilute their ownership interest in the company.

Entrepreneurs seeking debt capital face an astounding range of credit options varying greatly in complexity, availability, and flexibility. Not all of these sources of debt capital are equally

favorable, however. By understanding the various sources of capital—both commercial and government lenders—and their characteristics, entrepreneurs can greatly increase the chances of obtaining a loan.

We now turn to explain some of the sources of debt capital.

Commercial Banks

Commercial banks are the very heart of the financial market, providing the greatest number and variety of loans to small businesses. Commercial banks provide 50 percent of the dollar value of all loans to small businesses. For small business owners, banks are lenders of *first* resort, especially as their companies grow. The typical loan amount is small; more than 88 percent of all small business bank loans are for less than $100,000. The average micro business loan (those less than $100,000) is $6,820, and the average small business loan (those between $100,000 and $1 million) is $245,775.

Short-term loans, extended for less than 1 year, are the most common type of commercial loan banks make to small companies. These funds typically are used to replenish the working-capital account to finance the purchase of inventory, boost output, finance credit sales to customers, or take advantage of cash discounts. As a result, an owner repays the loan after converting inventory and receivables into cash. There are several types of short-term loans.

Banks primarily are lenders of short-term capital to small businesses, although they will make certain intermediate and long-term loans. Intermediate and long-term loans are extended for 1 year or longer and are normally used to increase fixed- and growth-capital balances. Commercial banks grant these loans for starting a business, constructing a plant, purchasing real estate and equipment, and other long-term investments. Loan repayments are normally made monthly or quarterly.

Although they are usually the first stop for entrepreneurs in search of debt capital, banks are not the only lending game in town. We now turn our attention to other sources of debt capital that entrepreneurs can tap to feed their cash-hungry companies.

Asset-Based Lenders

Asset-based lenders, which are usually smaller commercial banks, commercial finance companies, or specialty lenders, allow small businesses to borrow money by pledging otherwise idle assets such as accounts receivable, inventory, or purchase orders as collateral. This form of financing works especially well for manufacturers, wholesalers, distributors, and other companies with significant stocks of inventory, accounts receivable, equipment, real estate, or other assets. Even unprofitable companies whose income statements could not convince loan officers to make traditional loans can get asset-based loans. Because asset-based lenders focus more on collateral than on a company's credit rating, these cash-poor but asset-rich companies can use normally unproductive assets—accounts receivable, inventory, equipment, and purchase orders—to finance rapid growth and the cash crises that often accompany it. Even large companies such as Levi Strauss, Goodyear, and Rite Aid rely on asset-based loans.

Trade Credit

Because of its ready availability, trade credit is an extremely important source of financing to most entrepreneurs. In fact, 60 percent of small businesses use trade credit as a source of financing. Trade credit involves convincing vendors and suppliers to sell goods and services without requiring payment up front. When banks refuse to lend money to a small business because they see it as a poor credit risk, an entrepreneur may be able to turn to trade credit for capital. Getting vendors to extend credit in the form of delayed payments usually is much easier for small businesses than obtaining bank financing. Essentially, a company receiving trade credit from a supplier is getting a short-term, interest-free loan for the amount of the goods purchased.

Vendors and suppliers usually are willing to finance a small business owner's purchase of goods from 30 to 90 days, interest free. The key to maintaining trade credit as a source of funds is establishing a consistent and reliable payment history with every vendor.

Equipment Suppliers

Most equipment suppliers encourage business owners to purchase their equipment by offering to finance the purchase over time. This method of financing is similar to trade credit but with slightly different terms. Usually, equipment vendors offer reasonable credit terms with only a modest down payment and the balance financed over the life of the equipment (often several years). In some cases, the vendor repurchases equipment for salvage value at the end of its useful life and offers the business owner another credit agreement on new equipment. Start-up companies often use trade credit from equipment suppliers to purchase equipment and fixtures such as counters, display cases, refrigeration units, machinery, and the like. It pays to scrutinize vendors' credit terms, however; they may be less attractive than those of other lenders.

Commercial Finance Companies

When denied bank loans, small business owners often look to commercial finance companies for the same types of loan. Commercial finance companies are second only to banks in making loans to small businesses and, unlike their conservative counterparts, are willing to tolerate more risk in their loan portfolios. For instance, Chris Lehnes, a top manager at CIT Small Business Lending, says that his company regularly makes loans to small businesses with debt to equity ratios of 10:1 (10 times as much debt as equity), a situation that would send most bankers scurrying back to their vaults. Of course, like banks, finance companies' primary consideration is collecting their loans, but finance companies tend to rely more on obtaining a security interest in some type of collateral, given the higher risk loans that make up their portfolios. Because commercial finance companies depend on collateral to recover most of their losses, they do not always require a complete set of financial projections of future operations as most banks do. However, this does *not* mean that they neglect to evaluate carefully a company's financial position, especially its cash balance, before making a loan. "We're looking at the projected cash flow—the ability of the business to repay us," says CIT's Lehnes. "We put a lot of weight on what the business has done in the past couple of years."

Savings and Loan Associations

Savings and loan associations (S&Ls) specialize in loans for real property. In addition to their traditional role of providing mortgages for personal residences, S&Ls offer financing on commercial and industrial property. In the typical commercial or industrial loan, the S&L will lend up to 80 percent of the property's value with a repayment schedule of up to 30 years. Minimum loan amounts are typically $50,000, but most S&Ls hesitate to lend money for buildings specially designed for a particular customer's needs. S&Ls expect the mortgage to be repaid from the company's future profits.

Stock Brokerage Houses

Stockbrokers also make loans, and many of them offer loans to their customers at lower interest rates than banks. These **margin loans** carry lower rates because the collateral supporting them—the stocks and bonds in the customer's portfolio—is of high quality and is highly liquid. Moreover, brokerage firms make it easy to borrow. Usually, brokers set up a line of credit for their customers when they open a brokerage account. To tap that line of credit, a customer simply writes a check or uses a debit card. Typically, a margin loan does not have a fixed repayment schedule; the debt can remain outstanding indefinitely, as long as the market value of the borrower's portfolio of collateral meets minimum requirements. Aspiring entrepreneurs can borrow up to 50 percent of the value of their stock portfolios, up to 70 percent of their bond portfolios, and up to 90 percent of the value of their government securities.

Using stocks and bonds as collateral on a loan can be risky. Brokers typically require a 30 percent cushion on margin loans. If the value of the borrower's portfolio drops, the broker can make a **margin call**; that is, the broker can call the loan and require the borrower to provide more cash and securities as collateral. Recent swings in the stock market have translated into margin calls for many entrepreneurs, requiring them to repay a significant portion of their loan balances within a matter of days—or hours. If an account lacks adequate collateral, the broker can sell some of the customer's portfolio to pay off the loan.

Insurance Companies

For many small businesses, life insurance companies can be an important source of business capital. Insurance companies offer two basic types of loans: policy loans and mortgage loans. **Policy loans** are extended on the basis of the amount of money paid through premiums into the insurance policy; with a policy loan, a business owner serves as his or her own bank, borrowing against the money accumulated in the investment portion of an insurance policy. It usually takes about 2 years for an insurance policy to accumulate enough cash surrender value to justify a loan against it. Once the cash value accumulates in a policy, an entrepreneur may borrow up to 95 percent of that value for any length of time. Interest is levied annually, but the entrepreneur determines the repayment rate, or repayment may be deferred indefinitely. However, the amount of insurance coverage is reduced by the amount of the loan. Policy loans typically offer very favorable interest rates, sometimes below the prime rate. Only insurance policies that build cash value—those that combine a savings plan with insurance coverage—offer the option of borrowing. These include whole life (permanent insurance), variable life, universal life, and many corporate-owned life insurance policies. Term life insurance, which offers only pure insurance coverage, has no borrowing capacity.

Insurance companies make **mortgage loans** on a long-term basis on real property worth a minimum of $500,000. They are based primarily on the value of the real property being purchased. The insurance company will extend a loan of up to 75 or 80 percent of the real estate's value and will allow a lengthy repayment schedule over 25 or 30 years so that payments do not strain the firm's cash flows excessively. Many large real estate developments such as shopping malls, office buildings, and theme parks rely on mortgage loans from insurance companies.

Credit Unions

Credit unions, nonprofit financial cooperatives that promote saving and provide loans to their members, are best known for making consumer and car loans. However, many are also willing to lend money to their members to launch businesses, especially since many banks have restricted loans to higher-risk start-ups. Increasingly, entrepreneurs are turning to credit unions to finance their businesses' capital needs.

Bonds

Bonds have always been a popular source of debt financing for large companies, but few small business owners realize that they can also tap this valuable source of capital. Although the smallest businesses are not viable candidates for issuing bonds, a growing number of small companies are finding the funding they need through bonds when banks and other lenders say no. Because of the costs involved, issuing bonds usually is best suited for companies generating annual sales between $5 million and $30 million and have capital requirements between $1.5 million and $10 million. Although they can help small companies raise much needed capital, bonds have certain disadvantages. The issuing company must follow the same regulations that govern businesses selling stock to public investors. Even if the bond issue is private, the company must register the offering and file periodic reports with the responsible government body.

In addition to the above explained sources of debt financing, there are various government sponsored lending programs available for entrepreneurs, though it varies from country to country.

Chapter Seven

Managing Growth and Transaction

At the end of this chapter, you will be able to:

- Identify the ways of managing venture growth
- Explain new venture expansion strategies

7.1 Introduction

Categorizing the problems and growth patterns of small businesses in a systematic way that is useful to entrepreneurs seems at first glance a hopeless task. Small businesses vary widely in size and capacity for growth. They are characterized by independence of action, differing organizational structures, and varied management styles.

Yet on closer scrutiny, it becomes apparent that they experience common problems arising at similar stages in their development. These points of similarity can be organized into a framework that increases our understanding of the nature, characteristics, and problems of businesses ranging from a corner dry cleaning establishment with two or three minimum wage employees to a $20-million-a-year computer software company experiencing a 40% annual rate of growth.

For owners and managers of small businesses, such an understanding can aid in assessing current challenges; for example, the need to upgrade an existing computer system or to hire and train second-level managers to maintain planned growth.

It can help in anticipating the key requirements at various points—e.g., the inordinate time commitment for owners during the start-up period and the need for delegation and changes in their managerial roles when companies become larger and more complex.

The framework also provides a basis for evaluating the impact of present and proposed governmental regulations and policies on one's business. A case in point is the exclusion of dividends from double taxation, which could be of great help to a profitable, mature, and stable business like a funeral home but of no help at all to a new, rapidly growing, high-technology enterprise.

Finally, the frame work aids accountants and consultants in diagnosing problems and matching solutions to smaller enterprises. The problems of a 6-month-old, 20-person business are rarely addressed by advice based on a 30-year-old, 100-person manufacturing company. For the former, cash-flow planning is paramount; for the latter, strategic planning and budgeting to achieve coordination and operating control are most important.

7.2 Managing Growth of Venture

Dictionary.com, defines the word 'growth' in several ways:

- to increase by natural development as any living organism;
- to form and increase in size by an inorganic process;
- to arise or issue as a natural development from an original happening, circumstance, or source.

There have been several attempts to conceptualize the manner in which firms grow and some of the challenges that will be encountered along the way. The best known of these include Greiner (1972) and Churchill and Lewis (1983). Scott and Bruce (1987) and Burns (1996) used the Churchill and Lewis construct as a basis for their adaptations and additions.

Greiner's model essentially maps five stages of growth each characterized by a period of crisis which must be managed by shifting leadership style and practices and procedures in order to progress to the next stage of the model.

The Churchill and Lewis' (1983) model similarly follows the five-stage lifecycle pattern of Greiner (1972) but is more general and has no crises which precipitate the movement from one stage to the next. The stages are:-

i. Existence;
ii. Survival;
iii. Success;
iv. Take-off; and
v. Maturity.

Stage I: Existence

In this stage the main problems of the business are obtaining customers and delivering the product or service contracted for. Among the key questions are the following:-

- Can we get enough customers, deliver our products, and provide services well enough to become a viable business?
- Can we expand from that one key customer or pilot production process to a much broader sales base?
- Do we have enough money to cover the considerable cash demands of this start-up phase?

The organization is a simple one—the owner does everything and directly supervises subordinates, who should be of at least average competence. Systems and formal planning are minimal to nonexistent. The company's strategy is simply to remain alive. The owner *is* the business, performs all the important tasks, and is the major supplier of energy, direction, and capital.

Companies in the Existence Stage range from newly started restaurants and retail stores to high-technology manufacturers that have yet to stabilize either production or product quality. Many such companies never gain sufficient customer acceptance or product capability to become viable. In these cases, the owners close the business when the start-up capital runs out and, if they're lucky, sell the business for its asset value. In some cases, the owners cannot accept the demands the business places on their time, finances, and energy, and they quit. Those companies that remain in business become Stage II enterprises.

Stage II: Survival

In reaching this stage, the business has demonstrated that it is a workable business entity. It has enough customers and satisfies them sufficiently with its products or services to keep them. The key problem thus shifts from mere existence to the relationship between revenues and expenses. The main issues are as follows:-

- In the short run, can we generate enough cash to break even and to cover the repair or replacement of our capital assets as they wear out?
- Can we, at a minimum, generate enough cash flow to stay in business and to finance growth to a size that is sufficiently large, given our industry and market niche, to earn an economic return on our assets and labor?

The organization is still simple. The company may have a limited number of employees supervised by a sales manager or a general foreman. Neither of them makes major decisions independently, but instead carries out the rather well-defined orders of the owner.

Systems development is minimal. Formal planning is, at best, cash forecasting. The major goal is still survival, and the owner is still synonymous with the business.

In the Survival Stage, the enterprise may grow in size and profitability and move on to Stage III. Or it may, as many companies do, remain at the Survival Stage for some time, earning marginal returns on invested time and capital, and eventually go out of business when the owner gives up or retires. The "mom and pop" stores are in this category, as are manufacturing businesses that cannot get their product or process sold as planned. Some of these marginal businesses have developed enough economic viability to ultimately be sold, usually at a slight loss. Or they may fail completely and drop from sight.

Stage III: Success

The decision facing owners at this stage is whether to exploit the company's accomplishments and expand or keep the company stable and profitable, providing a base for alternative owner activities. Thus, a key issue is whether to use the company as a platform for growth—a sub-stage III-G company—or as a means of support for the owners as they completely or partially disengage from the company—making it a sub-stage III-D company. Behind the disengagement might be a wish to start up new enterprises, run for political office, or simply to pursue hobbies and other outside interests while maintaining the business more or less in the status quo.

Sub-stage III-D.

In the Success-Disengagement sub-stage, the company has attained true economic health, has sufficient size and product-market penetration to ensure economic success, and earns average or above-average profits. The company can stay at this stage indefinitely, provided environmental change does not destroy its market niche or ineffective management reduce its competitive abilities.

Organizationally, the company has grown large enough to, in many cases, require functional managers to take over certain duties performed by the owner. The managers should be competent but need not be of the highest caliber, since their upward potential is limited by the corporate goals. Cash is plentiful and the main concern is to avoid a cash drain in prosperous periods to the detriment of the company's ability to withstand the inevitable rough times.

In addition, the first professional staff members come on board, usually a controller in the office and perhaps a production scheduler in the plant. Basic financial, marketing, and production systems are in place. Planning in the form of operational budgets supports functional delegation. The owner and, to a lesser extent, the company's managers, should be monitoring a strategy to, essentially, maintain the status quo.

As the business matures, it and the owner increasingly move apart, to some extent because of the owner's activities elsewhere and to some extent because of the presence of other managers. Many companies continue for long periods in the Success-Disengagement substage. The product-market niche of some does not permit growth; this is the case for many service businesses in small or medium-sized, slowly growing communities and for franchise holders with limited territories.

Other owners actually choose this route; if the company can continue to adapt to environmental changes, it can continue as is, be sold or merged at a profit, or subsequently be stimulated into growth. For franchise holders, this last option would necessitate the purchase of other franchises.

If the company cannot adapt to changing circumstances, as was the case with many automobile dealers in the late 1970s and early 1980s, it will either fold or drop back to a marginally surviving company.

Sub-stage III-G.

In the Success-Growth substage, the owner consolidates the company and marshals resources for growth. The owner takes the cash and the established borrowing power of the company and risks it all in financing growth.

Among the important tasks are to make sure the basic business stays profitable so that it will not outrun its source of cash and to develop managers to meet the needs of the growing business. This second task requires hiring managers with an eye to the company's future rather than its current condition.

Systems should also be installed with attention to forthcoming needs. Operational planning is, as in substage III-D, in the form of budgets, but strategic planning is extensive and deeply involves

the owner. The owner is thus far more active in all phases of the company's affairs than in the disengagement aspect of this phase.

If it is successful, the III-G company proceeds into Stage IV. Indeed, III-G is often the first attempt at growing before commitment to a growth strategy. If the III-G company is unsuccessful, the causes may be detected in time for the company to shift to III-D. If not, retrenchment to the Survival Stage may be possible prior to bankruptcy or a distress sale.

Stage IV: Take-off

In this stage the key problems are how to grow rapidly and how to finance that growth. The most important questions, then, are in the following areas:-

- **Delegation**

Can the owner delegate responsibility to others to improve the managerial effectiveness of a fast growing and increasingly complex enterprise? Further, will the action be true delegation with controls on performance and a willingness to see mistakes made, or will it be abdication, as is so often the case?

- **Cash**

Will there be enough to satisfy the great demands growth brings (often requiring a willingness on the owner's part to tolerate a high debt-equity ratio) and a cash flow that is not eroded by inadequate expense controls or ill-advised investments brought about by owner impatience?

The organization is decentralized and, at least in part, divisionalized—usually in either sales or production. The key managers must be very competent to handle a growing and complex business environment. The systems, strained by growth, are becoming more refined and extensive. Both *operational* and *strategic* planning are being done and involve specific managers. The owner and the business have become reasonably separate, yet the company is still dominated by both the owner's presence and stock control.

This is a pivotal period in a company's life. If the owner rises to the challenges of a growing company, both financially and managerially, it can become a big business. If not, it can usually be sold—at a profit—provided the owner recognizes his or her limitations soon enough. Too often, those who bring the business to the Success Stage are unsuccessful in Stage IV, either because they try to grow too fast and run out of cash (the owner falls victim to the omnipotence syndrome), or are unable to delegate effectively enough to make the company work (the omniscience syndrome).

It is, of course, possible for the company to traverse this high-growth stage without the original management. Often the entrepreneur who founded the company and brought it to the Success Stage is replaced either voluntarily or involuntarily by the company's investors or creditors.

If the company fails to make the big time, it may be able to retrench and continue as a successful and substantial company at a state of equilibrium. Or it may drop back to Stage III or, if the problems are too extensive, it may drop all the way back to the Survival Stage or even fail. (High

interest rates and uneven economic conditions have made the latter two possibilities all too real in the early 1980s.)

Stage V: Resource Maturity

The greatest concerns of a company entering this stage are, first, to consolidate and control the financial gains brought on by rapid growth and, second, to retain the advantages of small size, including flexibility of response and the entrepreneurial spirit. The corporation must expand the management force fast enough to eliminate the inefficiencies that growth can produce and professionalize the company by use of such tools as budgets, strategic planning, management by objectives, and standard cost systems—and do this without stifling its entrepreneurial qualities.

A company in Stage V has the staff and financial resources to engage in detailed operational and strategic planning. The management is decentralized, adequately staffed, and experienced. And systems are extensive and well developed. The owner and the business are quite separate, both financially and operationally.

The company has now arrived. It has the advantages of size, financial resources, and managerial talent. If it can preserve its entrepreneurial spirit, it will be a formidable force in the market. If not, it may enter a sixth stage of sorts: ossification.

Ossification is characterized by a lack of innovative decision making and the avoidance of risks. It seems most common in large corporations whose sizable market share, buying power, and financial resources keep them viable until there is a major change in the environment. Unfortunately for these businesses, it is usually their rapidly growing competitors that notice the environmental change first.

7.3 New Venture Expansion Strategies and Issues

There are many ways in which a business can structure growth. Some examples include: (a) adding additional company-owned outlets; (b) mergers and acquisitions; (c) appointing distributors or dealers; (d) licensing; (e) partnerships and joint ventures; and (f) franchising. Each growth strategy has its own advantages and disadvantages, and each has its own legal ramifications. This article will explore different growth strategies with a particular emphasis on franchising, which is the most highly regulated of the growth strategies analyzed. The broad scope of the franchise laws may apply to a distributorship or license relationship resulting in an unwitting breach by a business owner of Federal or state franchise and business opportunity laws. The purpose of this article is to make the business owner and their advisors aware of the scope of the franchise and business opportunity laws and how they may affect the growth strategy sought to be employed by the business owner.

The following is a general description of the various growth strategies, including the advantages and disadvantages to each:-

1. Company-Owned Outlets. A business may increase growth by building additional outlets regionally, nationally, or internationally. Depending upon the nature of the business, this could mean adding additional retail locations, additional manufacturing facilities, additional sales offices, additional distribution facilities, etc. The advantages to this method of expansion are:

(a) the company retains complete control and flexibility over the expansion process, including timing, management decisions, employment decisions, policies and procedures, resale prices, and customers; and (b) the company retains all profits from such expansion. The disadvantages are: (a) such expansion may require significant capital expense; (b) the company assumes all risks of loss if any one or more of the additional outlets are not successful; (c) the company's managers may not have the same incentive or motivation as a distributor, licensee or franchisee; (d) potential liability for the actions of the company's managers and other employees; (e) the company has additional employment related expenses and liability exposure (payroll taxes, benefits programs, labor problems, employment law issues); and (f) multiple state tax and business license expenses.

2. Mergers and Acquisitions. Companies in the same or similar business are combined under common ownership. Generally categorized as either upstream, downstream or lateral. Upstream merger – smaller company seeks out larger company and is acquired by it; Downstream merger – larger company seeks out and acquires smaller company; and Lateral mergers are the combination of equals. The primary advantages to this method of expansion are the control and flexibility on the timing, and the ability to increase growth exponentially in a very short period of time. However, there are some serious disadvantages to this type of growth, including: (a) the high cost of acquiring companies, often at a premium price; (b) the legal and accounting expense in the due diligence process; (c) the potential liabilities of the acquired company; (d) the potential difficulty in merging the cultures and personnel of two different companies; and (e) the potentially adverse effect the acquisition may have on the customers of the acquired company.

Mergers & Acquisitions generally fall under two categories:-

1. Vertical Integration
2. Horizontal Integration

Vertical Integration: Most common type of integration. It allows a firm to gain control over its suppliers or distributors in order to increase power in the marketplace, reduce transaction costs and secure supplies or distribution channels.

Horizontal Integration: Strategy where company acquires or merges with another company in the same industry. Pursued by a company in order to strengthen its position in the industry.

3. Distributorships/Dealerships. A business may increase growth by appointing distributors or dealers to sell or distribute its goods or services. Distributors typically purchase product directly from a manufacturer, take title to the merchandise, and re-sell the products at such prices as the distributor determines. Distributors may or may not be granted exclusive territories within which to distribute the manufacturer's products. Dealerships are similar to distributorships, but a Dealer typically purchases products from a Distributor, rather than directly from the manufacturer, and Dealers typically sell products at retail to the end user, as opposed to Distributors who typically sell product at wholesale to Dealers. In practice, the terms Distributor and Dealer are sometimes used interchangeably. Some of the advantages of a distributorship or dealership include: (a) lower capital expense by the manufacturer than adding company-owned outlets; (b) the Distributor/Dealer assumes the risk of loss upon purchase of the product from the

Manufacturer; (c) the Distributor/Dealer becomes the responsible employer for its own employees; (d) the Distributor/Dealer pays its own state and local business taxes; (e) advertising expenses are incurred by the Distributor/Dealer, or at least shared with the manufacturer; and (f) risk of failure is shifted primarily to the Distributor/Dealer. Some of the disadvantages of a distributorship or dealership include: (a) loss of control over the sales process; (b) lower margins; (c) potential dilution of trademark if products are sold in conjunction with Distributor/Dealer's trademark; and (d) the Distributor/Dealer may be selling a competitor's product.

There are very subtle differences between a Distributor/Dealer relationship and a franchise relationship, and there are numerous instances where a purported Distributor/Dealer has been deemed to be a franchise. This often results in significant liability to the company if they have not complied with the franchise disclosure laws. Each Distributor/Dealer relationship should be carefully reviewed to confirm that it is not deemed to be a franchise. Laws regulating Distributorships and Dealerships (where they exist), are generally more lenient than laws regulating franchising or independent sales representatives.

4. Independent Sales Representatives. Independent Sales Representative relationships are closely related to distributorships and dealerships. But, unlike a distributor or dealer, an Independent Sales Representative does not purchase products for resale at a profit. Rather, an Independent Sales Representative solicits orders for products or services on behalf of the company and is usually compensated in the form of a commission. The advantages of Independent Sales Representative are similar to those associated with distributorships and dealerships, but with greater control over pricing and less risk of competition (Independent Sales Representatives are usually prohibited from selling competing products, whereas Distributors and Dealers are usually not so prohibited). The Independent Sales Representative relationship has greater financial and legal risk than the distributorship or dealership relationship. Finally, one must be careful to structure the Independent Sales Representative relationship to avoid liability as an employer (including withholding tax liability, unemployment compensation and workers compensation insurance). Many states now have laws regulating the relationship between independent sales representatives and the suppliers of the products and services for which orders are solicited.

5. Technology and Know-how Licensing. In a traditional technology or knowhow license relationship, the licensor possesses technology that is the subject of one or more patents or technology or know-how that includes one or more trade secrets (Intellectual Property). The licensor permits the licensee to manufacture, use and/or sell products or use processes that are within the scope of its Intellectual Property. Provided the licensee is not permitted to use any trademark or other advertising symbol of the licensor, the arrangement will fall outside the definition of a franchise. The licensee in these arrangements are typically already actively engaged in business at the time of creation of the relationship, and the licensor does not significantly control or assist the licensee in the conduct of its business. An example of a technology or know-how license would be a relationship between an independent product designer and a manufacturer wherein the designer permits the manufacturer to manufacture and sell a new product created by the designer. The primary advantage of this type of arrangement to the owner of the Intellectual Property is the opportunity for the owner of the technology to receive income without significant effort, investment or risk. The primary disadvantages to this

type of relationship include little or no control, and the inability of the owner of the technology to obtain the benefit of the goodwill created by the licensee's business activities. Where the licensee is expressly prohibited from using any trademark or other identifying symbol associated with the licensor, no franchise law issues arise. However, if the relationship includes the use of any such trademark or other identifying symbol, the elements of a franchise should be considered.

6. Trademark License. In a "pure" trademark license, a licensor grants a single license to one licensee to enable the licensee to manufacture a product according to the licensor's specifications, and to sell such product under the licensor's trademark. Another form of trademark license is a "collateral product" license, where a licensee is granted the right to use a trademark that is well known in one context in an entirely different context. This is also known as "merchandising". The primary advantages to the licensor of these "pure" licenses include: (a) the opportunity for the licensor to receive income without significant investment or financial risk; and (b) the creation of substantial goodwill in the trademark. The disadvantages include loss of control, including the risk that the licensee's poor quality or sales performance may tarnish the reputation of the licensor. While a pure trademark license is not usually covered by franchise and business opportunity laws, since every franchise relationship includes a trademark license, it would be prudent to consider the elements of franchise and business opportunity laws when structuring or terminating any trademark license relationship.

7. Partnerships and Joint Ventures. A partnership exists when two or more persons or entities associate to carry on a business for profit as co-owners. Partnerships may be structured as general partnerships or limited partnerships depending on the participation and liability of the parties. The advantages of a partnership or joint venture include: (a) greater control than a Distributorship/Dealership, licensing arrangement or franchise; (b) sharing of profits in accordance with the partnership agreement; (c) flexibility in structuring the relationship and growing the business; and (d) few regulatory issues. The primary disadvantages include all of those associated with Company-Owned Outlets, as well as the potential for partnership disputes. A general partnership is not covered by the Federal franchise law. However, a limited partnership may be covered by the Federal franchise law, and the elements of a franchise and business opportunity under both Federal and state law should be considered when structuring or terminating limited partnership relationships.

8. Franchising. A business may also grow through franchising. There are two distinct types of franchises – package franchises and product franchises. A package franchise exists when a franchisor licenses a franchisee to do business under a pre-packaged business format established by the franchisor and identified with the franchisor's trademark. The franchisor usually provides the franchisee with initial training and assistance in the establishment of the franchised business as well as some ongoing assistance. The franchisor usually exerts significant control over the method in which the franchisee operates its business. McDonalds® and Burger King® are good examples of package franchises. Product franchises, on the other hand, exist where the franchisor has already produced goods and the franchisee merely provides an outlet for the goods. The franchisor will usually exercise significant control over the franchisee's operation to ensure proper marketing of the product. Gas stations and car dealerships are examples of product franchises. The primary advantages of a franchise relationship include: (a) lower capital expense

than company-owned outlets; (b) most of the risk is absorbed by the franchisee; (c) the franchisee becomes the responsible employer; (d) the franchisee is responsible for state and local taxes and business licenses; and (e) the franchisee will generally have a greater interest in the success of the business than a manager of a company-owned outlet. Since franchisors generally exert a significant degree of control on the franchisee's method of operation, there is more control in a franchise relationship than in a distributorship/dealership or license. Furthermore, since the franchisee operates its business under the franchisor's trademark, most of the goodwill of the franchisee's business inures to the benefit of the franchisor. The primary disadvantages of a franchise relationship are the additional regulatory (and legal) expense, and the additional level of administration to manage the franchise process (including sales, training, operations, etc.).

As you can see, there are many ways in which a business can structure its growth. No one method is better than another. A prudent business owner will analyze each of the options listed above to determine which method of expansion is appropriate for the type of business and business structure desired by the business owner.