Business Entrepreneurship and Management

Contents

1.1 Introduction

Everyone have dreams of owning their own business. At one time or another, every body get ideas of their own business, but not able to make it into a reality. Most of the people get great ideas while in the shower, and forget about them after getting out of the shower. The entrepreneur is the person who gets out of the shower and acts on those ideas. However, chances of success will increase, if one thoroughly understands the motive of starting own business.

The main motives for starting a business are:

- Understanding the basic reason for starting a business
- Analyse the type of business in mind
- Understand the skills required for the business
- Personal qualities required to bring up the business
- Strengths and weaknesses as a business owner

1.2 Who are Entrepreneurs?

Entrepreneurs are those individuals who discover market needs and launch new business to meet those needs. They take risk and provide an impetus for change, innovation, and progress in economic life. If a salaried employee comes up with some business idea, they will be rewarded with a specified compensation and there is no ownership risks associated in such case.

Here, let us consider all active owner-managers to be entrepreneurs. The term entrepreneur is not only limited to founders of business firms; but can be applied to the operators of family-owned firms, franchisees, and owner-managers who have bought out the founders of existing firms. This definition excludes salaried managers of larger corporations, even though sometimes described as entrepreneurs, because of their flair for innovation and willingness to accept risk.

One of the examples of entrepreneurial ventures is Sergey Brin and Larry Page, the founders of Google. If success is having your firm's name outstanding, then these two individuals can without question claimed to be successful. Google has clearly been a phenomenal success, with a total stock value of over $140 billion at the end of 2006. But while few of us can relate to Brin and Page's level of success, as their experience teaches us that we will never know what is possible until we try.

1.3 What is Small Business?

A neighbourhood restaurant or bakery is clearly a small business, and Toyota is obviously not. But among small businesses also, there is great diversity in size. Small business may convey the impression that the business is unimportant; however, that impression would be totally incorrect.

The significance of small business in today's society is clearly expressed in this quote from Business Week: 'Small businesses produce 14 times as many patents per employee as large companies do, and they are twice as likely to turn those inventions into successes, according to a Congressional report. They account for half of the private gross domestic product, create more than 60% of net new jobs each year, and pay 44.3% of the private payroll.'

Small businesses are defined mainly using criteria as number of employees, sales volume, and value of assets. Size standards are basically arbitrary, adopted to serve a particular purpose.

In a small business, primary attention is given to businesses that are able to meet the following criteria:

- Financing for the business is provided by one individual or a group of individuals.
- Except for its marketing function, the business’s operations are geographically localised.
- Compared to the biggest firms in the industry, the business is small.
- The number of employees in the business is less than 100.

1.4 Rewards of Entrepreneurship

Different individuals have varied reasons and motivations to own their own business. In one study, researchers identified 38 different reasons for self-employment. However, the first goal of an entrepreneur should be to create a product or service that makes the world a better place. For the entrepreneur, the organisation should be important than anything else, so that the new venture will never be discouraging. Another reason for becoming an entrepreneur is to make meaning for all their ventures. Although any attempt to identify all the various attractions may be incomplete.

The figure given below summarises some reasons cited by individuals for becoming entrepreneurs. The reasons are later discussed each in turn.

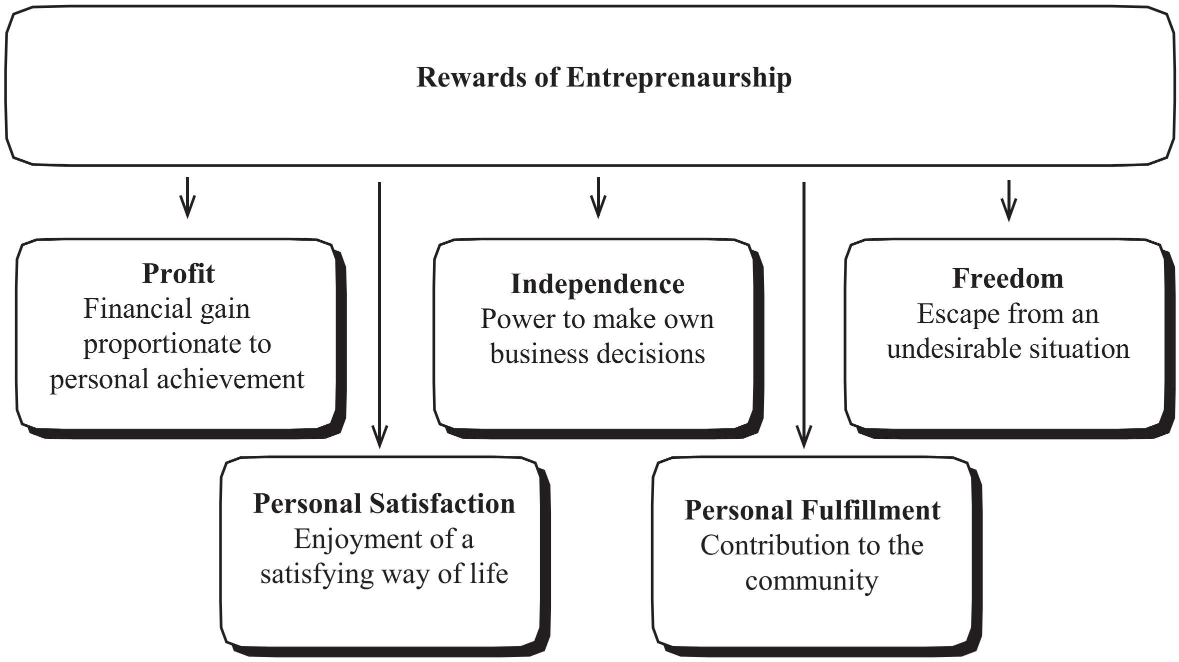

Fig. 1.1 Rewards of entrepreneurship

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

1.4.1 Make Money (Profit)

Like any other job or career, entrepreneurship provides for one's financial needs. Starting one's own business is a way to earn money. Indeed, some entrepreneurs earn lots of money. The self-employed people are generally considered as earning four times more, and are likely to be millionaires than those who work for others.

Some profit is necessary for a firm's survival and an entrepreneur expect in return for starting and running a business. Some entrepreneurs work hard just to have adequate profits to survive, while others receive a modest income for their time and investment. From an economic perspective, the financial return of a business should compensate its owner not only for the investment of personal time (in the form of a salary equivalent), but also for personal money invested in the business (in the form of dividends and increased value of the firm). That is, entrepreneurs should seek a financial return that will compensate them for the time and money they invest and also reward them well for the risks and initiative they take in operating their own businesses.

A significant number of entrepreneurs are highly motivated by the prospect of profits. They have heard the stories about young people who launched dot-com companies and quickly became multimillionaires. While some entrepreneurs do become rich quickly, the majority do not. Instead, the goal should be to get rich slowly. Wealth will come if the business is economically viable and the owner has enough patience and determination to make it happen.

1.4.2 Be Your Own Boss (Independence)

Freedom to operate independently is another reward of entrepreneurship. It's importance is evidenced by the results of one survey of small business owners, in which 38 percent of those who had left jobs at other companies said that their main reason for leaving was that they wanted to be their own boss. Like these entrepreneurs, many people have a strong desire to make their own decisions, take risks, and reap the rewards. Being one's own boss can be an attractive ideal.

The smallest businesses (i.e., part-time businesses and one-person firms), of which there are millions in the United States, probably offer the greatest flexibility to entrepreneurs.

Entrepreneurs always appreciate the independence inherent in their chosen careers. They can do things their own way, reap their own profits, and set their own schedules.

For instance, Karen Taylor started her own public relations firm, Southwest Ink, after working in advertising and public relations much of her career.

Independence does not guarantee an easy life. Most entrepreneurs work very hard for long hours. The basic thing to remember in a business is that the customer is ultimately the boss. But they do have the satisfaction of making their own decisions within the constraints imposed by economic and other environmental factors, including undesirable working conditions.

1.4.3 Escape a Bad Situation (Freedom)

People sometimes use entrepreneurship as an escape hatch, to free themselves from an undesirable situation. Some may wish to leave an unpleasant job situation, while others may seek change out of necessity. Diane D'Agostino-Smith provides one such an example. D'Agostino- Smith was putting in 15-hour days as an oil company executive's assistant. "My work had taken over my life," she said. "I felt like I couldn't even take the 30-minute exercise break my doctor had recommended." When her health began to slip, she knew she had to get out.

After returning to school, she set up a life-coaching practice, to help others to choose new careers. She runs her business out of her home, and values working her own hours. "I took a difficult situation and changed it into something positive for myself and others," she said. "I'm proud of that."

Other individuals become entrepreneurs after being laid off by an employer. Unemployed personnel with experience in professional, managerial, technical, and even relatively unskilled positions often contemplate the possibility of venturing out on their own.

Individuals who have entered business ownership as a result of financial hardship or other severe negative conditions have been described as reluctant entrepreneurs.

Individuals may also flee the bureaucratic environment of a corporation that seems stifling or oppressive to them. Entrepreneurship often provides an attractive alternative for individuals fleeing from such undesirable situations (sometimes called refugees). Take Bob and Cathy Dammeyer, for example. Having become weary of all the travel and meetings associated with their corporate jobs, as well as the politics and bureaucracy, they went into business for themselves, selling Swirl frozen drink distributorships. Three years later, the Dammeyers' company, Culpepper Sales, does several million dollars in business annually. "It rejuvenated us," Cathy said. "We don't worry about corporate minutiae anymore. We only have to satisfy ourselves."

1.4.4 Enjoy a Satisfying Life (Personal Satisfaction)

Entrepreneurs frequently speak of the satisfaction they experience in their own businesses; some even refer to their work as fun. Rick Davis, founder and CEO of DAVACO, says, "There is nothing else I would rather do. I love the challenges, working with others to see our dreams come true, and making a difference in the community. It is fun."

Part of their enjoyment may derive from their independence, but it can also reflect an owner's personal gratification from working with the firm's products and services. Bill Thomas, who bought his first pair of khaki pants at an army surplus store in 1984, sensed a business opportunity when that pair of deep-pocketed World War II uniform pants wore out and he couldn't find another like it. In 1990, he founded Bill's Khakis, which by 2005 had sales of $9.5 million. Why did he start the business? In his words, 'I felt like I had such a great opportunity to start a business, and it was thanks in part to the generation I was trying to celebrate—my father's generation'.

Most small business owners report satisfaction in their careers. In a poll conducted by the National Federation of Independent Business, small employers rated the level of their personal satisfaction on average as 8 on a scale of 1 (extremely dissatisfied) to 10 (extremely satisfied).18 A majority (51 percent) also indicated that they spend most of their time doing what they like to do best. The reward can be a pleasurable activity, enjoyable associations, respect in the community, and other aspect of the business. For many entrepreneurs, the life satisfaction they receive is much more important than money or independence.

1.4.5 Contribution to Community (Personal Fulfilment)

Some people are drawn to entrepreneurship by their desire to do good things, to give some positive contribution to their communities. In many cases, this impulse is merely one element in a mix of motivations. In some endeavours, however, it is a particularly strong force behind the thinking of the entrepreneur.

Trey Moore and Cameron Powell (one of the "three success stories" described at the beginning of the chapter) provide a great example of entrepreneurs who want to make a difference in the lives of pregnant women and their babies. As you will recall, their product, Airstrip OB, allows obstetricians to track a mother's labour contractions and her baby's heart rate without having to be at the hospital. If proved effective, it will no doubt reduce the risk during a woman's labour.

1.4.6 Special Niche

If a small business can find a special niche of some type, it competes with great strength in that area. The niche consists of a uniquely specialised service or product, and focus on serving a particular geographical area. After finding a special niche, a small business may avoid intense competition from large corporations.

Lowe's Supermarkets of Littlefield, Texas, provides an example of a family business that followed this path to business success. In 1964, Roger Lowe, Sr., and his father purchased a small supermarket in Olton, Texas. The family business shifted to the next generation in 1973, when Roger Lowe, Jr., joined the firm as vice president and CEO following the death of his grandfather. The business gradually expanded to 58 stores by adding supermarkets, mostly in small rural towns of West Texas and New Mexico. In many towns, Lowe's faces no local competitor. In few locations where it competes with large chains like Wal-Mart, Lowe's Supermarket distinguishes itself by offering product selections to the unique local and ethnic tastes of the neighbourhood population.

1.5 Characteristics of Successful Entrepreneurs

There is no well defined entrepreneurial profile as individual entrepreneurs differ greatly from each other. Knowing this should encourage you if you wish to start your own business. You do not need to fit some prescribed stereotype.

Some qualities, however, are common among entrepreneurs and probably contribute to their success. One of these characteristics is a strong commitment or passion for the business. It is an attitude that results in tenacity in the face of difficulty and a willingness to work hard. Entrepreneurs do not give up easily.

Such individuals are typically confident of their ability to meet the challenges confronting them. This factor of self-confidence was described by psychologist J. B. Rotter as an internal locus of control, and a feeling that success depends on one's own efforts. In contrast, an external locus of control reflects an attitude of dependence on luck or fate for success.

Entrepreneurs are often risk takers. By investing their own money, they assume financial risk. If they leave secure jobs, they risk their careers. The stress and time required to start and run a business may place their families at risk. Even though entrepreneurs assume risk, they are moderate risk takers who accept risks over which they have some control, rather than extreme risk takers, who accept outcomes depending purely on chance.

Timmons and Spinelli have summarised research on entrepreneurial characteristics. They group what they describe as “desirable and acquirable attitudes and behaviours” into the following six categories:

- **Commitment and determination:** Tenacious, decisive, and persistent in problem solving.
- **Leadership:** Self-starters and team builders and focus on honesty in their business relationships.
- **Opportunity obsession:** They are aware of market and customer needs.
- **Tolerance of risk, ambiguity, and uncertainty:** They are risk takers, risk minimisers, and uncertainty tolerators.
- **Creativity, self-reliance, and adaptability:** Open-minded, flexible, uncomfortable with the status quo, and quick learners.
- **Motivation to exceed:** Goal oriented and aware of their weaknesses and strengths.

1.6 Varieties of Entrepreneurship

Entrepreneurship is marked by diversity, as there is great variety both in the people and in the firms termed entrepreneurial. As a potential entrepreneur, one can be encouraged by this diversity; and do not need to fit some narrow stereotype.

1.6.1 Founder Entrepreneurs versus Other Business Owners and Franchisees

They are considered to be “pure” entrepreneurs, as founders may be inventors who initiate businesses on the basis of new or improved products or services. They can be artisans who develop skills and then start their own firm. They can also be enterprising individuals, often with marketing backgrounds, who draw on the ideas of others in starting new firms. Whether acting as individuals or as part of a group, founders bring firms into existence by surveying the market, raising funds, and arranging for the necessary facilities.

After a new firm is established, it may be purchased or taken over by a second-generation family member or another entrepreneur who acts as administrator of the business. These “second-stage” entrepreneurs do not differ greatly from founding entrepreneurs in the way they manage their businesses. Sometimes, their well-established small firms grow rapidly, and their orientation may be more similar to that of a founder than of a manager. Nevertheless, it is helpful to distinguish between entrepreneurs who found or substantially change firms (the “movers and shakers”) and those who direct the continuing operations of established firms.

Another category of entrepreneurs comprises franchisees. Franchisees differ from other business owners in the degree of their independence. Because of the constraints and guidance provided by contractual relationships with franchising organisations, franchisees function as limited entrepreneurs.

1.6.2 High-potential Ventures versus Attractive Small Firms and Micro-businesses

Small businesses differ drastically in their growth potential. According to the researcher Bhide, promising start-ups are those with the potential for attaining significant size and profitability, where marginal start-ups lack such prospects. The few businesses that have glowing prospects for growth are high potential ventures, or gazelles. Within this group, there is variation in styles of operation and approaches to growth. Some are high-tech start-ups: the kind that once made Silicon Valley in California famous. The success stories often feature a technology wizard with a bright idea, backed by venture capitalists eager to underwrite the next Microsoft.

When such companies prosper, they usually grow at blinding speed and make their founders wealthy by being sold or going public. In contrast to such high-potential ventures, attractive small firms offer substantial financial rewards for their owners. They represent a strong segment of small businesses, which is solid, healthy and which can provide rewarding careers.

The least profitable types of firms, including many service firms such as dry cleaners, beauty shops, and appliance repair shops, which provide only very modest returns to their owners. These micro-businesses and their distinguishing feature is their limited ability to generate significant profits. Entrepreneurs, who devote personal effort to such ventures, receive a profit more than what is expected. Many businesses of this type are also called lifestyle businesses because they permit an owner to follow a desired pattern of living, even though they provide only modest returns. Businesses of this type do not attract investors.

1.6.3 Artisan versus Opportunistic Entrepreneurs

Because of the different backgrounds, entrepreneurs display differences in the degrees of professionalism and in the management styles in their businesses. The ways in which they analyse problems and approach decision making may differ radically. Norman R. Smith has suggested two basic entrepreneurial patterns, exemplified by artisan (or craftsman) entrepreneurs and opportunistic entrepreneurs.

According to Smith, the education of the artisan entrepreneur is limited to technical training. Such entrepreneurs have technical job experience, but lack good communication skills and managerial training. Artisan entrepreneurs' approach to business decision making characterised by the following features:

- They are paternalistic as they guide their businesses much as they might guide their own families.
- They are reluctant to delegate authority.
- They use few (usually only one or two) capital sources to create their firm.
- They define marketing strategy in terms of the traditional components of price, quality, and company reputation.
- Their sales efforts are primarily personal.

Their time orientation may be short, with little planning for future growth or change.

A mechanic who starts an independent garage, a beautician who operates a beauty shop or a painter who opens a studio is an example of an artisan entrepreneur.

In contrast to the artisan entrepreneur, an opportunistic entrepreneur is one who has supplemented his or her technical education by studying such nontechnical subjects as economics, law, or history. Opportunistic entrepreneurs avoid paternalism, delegate authority as necessary for growth, employ various marketing strategies and types of sales efforts, obtain original capitalisation from more sources, and plan for future growth. An example of an opportunistic entrepreneur is a small building contractor and developer who adopt a relatively sophisticated approach to management, which includes careful record keeping and budgeting, precise bidding, and systematic marketing research.

Smith's description of entrepreneurial styles illustrates two extremes:

- At one end is a craftsperson in an entrepreneurial position
- Next is a well-educate and experienced manager.

1.6.4 Women Entrepreneurs

Although entrepreneurship and business in general have been male dominated for decades, the scene is changing rapidly. Between 1997 and 2006, growth in the number of women owned firms was nearly twice that of all U.S. firms (42.3 percent vs. 23.3 percent). As of 2006, there were an estimated 7.7 million women-owned firm, accounting for 30 percent of all businesses in the United States. In 2006, women-owned firm in the United States generated $1.1 trillion in annual sales and employed 7.2 million people nationwide.21 while revenues generated by companies owned by women are still small relative to those of businesses owned by men, women-owned businesses make a significant contribution to the U.S. economy.

The largest share of women-owned firm is in the service sector. More than two-thirds of women-owned firm provide services. An additional 14 percent are in retail trade, and 8 percent are in real estate sales, rental, and leasing. From 1997 to 2006, the greatest growth among women-owned firm was found in the following sectors:

- Wholesale trade (283 percent growth)
- Healthcare and social assistance services (130 percent growth)
- Arts, entertainment, and recreation services (116 percent growth)
- Professional, scientific, and technical services (83 percent growth)

Women who starts firm in non-traditional industries are with ambitious plans for growth and profit. Faced with losing the family farm, Elaine J. Martin started her Nampa, Idaho-based highway construction project company, MarCon Inc., in 1985.To help her get started, Martin's mother put up a $25,000 certificate of deposit as collateral so that she could borrow $25,000. At the time, Martin had no construction background. While looking for construction work, she heard about the Idaho Department of Transportation's highway fencing needs. Since she had been raised on a farm and knew how to build fence, she started bidding for highway work. To she went to the state library to study fencing and highway management and, thus, improved her chances. She eventually modified the business by getting into guardrail construction. Today, Martin runs a $6-million business in a male-dominated industry. In 2002, she was named the Idaho Small Business Person of the Year.

Female entrepreneurs often face problems that are common to all entrepreneurs. However, they must also contend with difficulties associated with their newness in entrepreneurial roles. Lack of access to credit has been a common problem for women who enter business. This is a troublesome area for most small business owners, but women often carry the added burden of discrimination.

Another barrier for some women is the limited opportunity for business relationships with others in similar positions. It takes time and effort to gain full acceptance and to develop informal relationships with others in local, male-dominated business and professional groups.

These conditions have improved in recent years, as women have assumed strong entrepreneurial roles. In a panel discussion of the issue, some women entrepreneurs emphasised the improved business climate, as Cristi Cristich, founder of Cristek Interconnects, Inc. (a maker of connectors and cabling for medical and military applications in Anaheim, California): "Access to capital and the acceptance of women in the workplace and as business owners has improved dramatically over the past 15 years."

Shari L. Parrack, president of Texas Motor Transportation Consultants (a professional registration, tax, and title service company in Houston, Texas): "In 2003, I find that being female does nothing but help me to grow my business. What was once a negative has become a positive?"

Terrie Jones, CEO and owner of AGSI (a provider of Internet technology resource solutions in Atlanta, Georgia): "In 22 years, I've seen the business world evolve tremendously. In a similar way businessmen helped their 'fraternity brothers' in the past, they are more willing to help women today."

Women are definitely making inroads into the entrepreneurial world, and the trend will only accelerate in the future.

1.6.5 Entrepreneurial Teams

Entrepreneurial teams are becoming increasingly common, particularly in ventures of any substantial size. An entrepreneurial team consists of two or more individuals who combine their efforts to function in the capacity of entrepreneurs. In this way, the talents, skills, and resources of two or more entrepreneurs can be concentrated on one endeavour.

1.7 Integrity and Entrepreneurship

Today there are lot of stories in the news media concerning insider trading, fraud, and bribery usually involve large corporations. In the less-publicised day-to-day activities of small businesses, decision makers regularly face ethical dilemmas and temptations to compromise principles for the sake of business or personal advantage. This strikes at the heart of integrity.

1.7.1 What is Integrity?

The seeds of corporate misdeeds are formed when individuals compromise their personal integrity, as they do not do what they believe to be right and proper. Some acts, such as cheating on taxes, clearly violate this standard, while others are more subtle but just as inappropriate. For example, one entrepreneur who owned a flooring sales business often sold sheets of linoleum at first-quality prices, even though they were graded as "seconds" by the factory. To hide his deception, he developed an ink roller that changed the factory stamp from "SECONDS" to read "SECONDS TO NONE!" Those who caught the inaccuracy probably figured it was a typo never turned back, but unsuspecting customers were paying for first-quality flooring, only to receive imperfect goods. By anyone's measure, this shady business practice reveals a lack of integrity on the part of the entrepreneur.

The entrepreneurial experience is satisfying, when the entrepreneur understands that the core purpose of the business is to create value for interested customers. This perspective makes clear that relationships are critical and integrity is essential to success. Money is important, but it cannot be the only goal of interest. Excessive focus on financial gain can quickly lead to distortions in business behaviour; and is certainly the root cause of many ethical failings.

If lapses in integrity are discovered, quickly make the headlines when they involve large, high-profile corporations, but the problem does not end there. Small business owners and managers confront situations every day that require them to make ethical decisions. They must decide which course of action will preserve the integrity of the company and safeguard its reputation, a decision that can be especially difficult when doing the right thing runs counter to the immediate financial interests of the business.

1.7.2 Frame Work of Integrity

In order to pinpoint the types of ethical issues that are most troublesome for small companies, small business owners nationwide were asked the following question: "What is the most difficult ethical issue that you have faced in your work?"

These responses provide a general idea of the kinds of issues that challenge the integrity of small business owners. The issues mentioned most often are related to customers and competitors. The second most common category is concerned with the way a company treats its employees, including decisions about layoffs, workplace discrimination, and fairness in promotions. This set of issues received almost as many responses as the first should not be surprising, given the challenges of the current economic climate. This category was near the bottom of the list when entrepreneurs responded to the same survey six years earlier and now times have changed.

The third category is related to the obligations of employees to their employers, focusing on the actions of personnel that may not align with the best interests of their companies. In the fourth place are management processes and relationships. Management relationship issues can be especially disturbing because they reflect the moral fiber or culture of the firm, including weaknesses in managerial actions and commitments.

The entrepreneurs must consider the interests of a number of groups when making decisions, such as owners (or stockholders), customers, employees, the community, and the government. The individuals in these groups are sometimes referred to as stakeholders, indicating that they have a stake in the operation of the business. In essence, stakeholders are those who either can affect the performance of the company or are affected by it.

Because the interests of various stakeholder groups are different, they sometimes conflict; thus, decisions can be very difficult to make. And since there is often no obviously right or wrong position to take, managing the process can be extremely complicated.

1.7.3 Social Responsibility and Small Business

To most people, an ethical business is one that not only treats customers and employees honestly but also acts as a good citizen in its community. These broader obligations of citizenship are called social responsibilities.

Some considers social responsibility as a price of freedom to operate independently in a free economy. They believe that the public has certain social expectations regarding business behaviour, not all of which are required by law. They regard some socially responsible expenditure as proper, even when they are costly.

Companies have increasingly been accepting responsibility to the communities where they do business. Their contribution starts with creating jobs and adding to local tax revenues, but many entrepreneurs feel a duty to give back even more to the community in return for the local support they enjoy and they usually benefit from increased goodwill as a result. It is important that opinions differ and businesses are obligated to engage in socially desirable activities, and the response of small businesses to those obligations also varies. Some emphasise environmentalism, minority contracting, or regional economic development, while others focus their attention on volunteerism, generosity, or even day care for employees ‘dependents. Still others give only minimal attention to peripheral social issues.

1.7.4 Governmental Laws and Regulations

Government serves a purpose, though there is room to debate whether it has too much power or too little. It intervenes directly in the economy when it establishes laws to ensure healthy competition. But it extends into other business matters also such as workplace safety, equal employment opportunities, fair pay, clean air, and safe products, etc. Entrepreneurs must comply with government laws and regulations if they are to maintain integrity and avoid spending time behind bars.

One glaring example of unethical behaviour by small firm management is fraudulent reporting of income and expenses for income tax purposes. This conduct includes skimming that is, concealing some income as well as improperly claiming personal expenses as business expenses. It does not imply that all or even most small firm engage in such practices. However, tax evasion does occur within small firm, and the practice is widespread enough to be recognised as a general problem.

The Internal Revenue Service regularly uncovers cases of income tax fraud. For example, the John E. Long family, the largest promoter of country folk art shows in the nation, was forced to pay millions in back taxes, and four members of the family were given prison terms for tax law violations. The Longs did not record the cash they collected for admission to their shows. Instead, they deposited into corporate accounts and received from such sources as booth rentals and magazine sales. Unfortunately for the Longs, the IRS discovered 2,000 unreported deposits that members of the family made into 37 different accounts. The Longs had reported that their business was losing money when, in fact, it was doing very well.

The IRS finds many violations like the Longs’ every year. However, tax avoidance can be much less flagrant, though nonetheless illegal, and entrepreneurs sometimes come up short on their tax commitments because of casual accounting systems, single-minded focus on their product or service, or both. One student entrepreneur confesses that he had a close brush with the law because he and his friends were creating clothing in his dorm room and selling it on his campus, but the company did not legally exist and he was not keeping track of sales and expenses because he didn’t take seriously the obligations and advantages of keeping good records.

Summary

- Entrepreneurs are those individuals who discover market needs and launch new business to meet those needs.
- Different individuals have varied reasons and motivations to own their own business. In one study, researchers identified 38 different reasons for self-employment.
- Freedom to operate independently is another reward of entrepreneurship.
- Starting one's own business is a way to earn money.
- People sometimes use entrepreneurship as an escape hatch, to free themselves from an undesirable situation.
- Entrepreneurs frequently speak of the satisfaction they experience in their own businesses; some even refer to their work as fun.
- Some people are drawn to entrepreneurship by their desire to do good things, to give some positive contribution to their communities.
- Entrepreneurship is marked by diversity, as there is great variety both in the people and in the firms termed entrepreneurial.
- The largest share of women-owned firm is in the service sector.
- The seeds of corporate misdeeds are formed when individuals compromise their personal integrity, as they do not do what they believe to be right and proper.
- An ethical business is one that not only treats customers and employees honestly but also acts as a good citizen in its community.
- Companies have increasingly been accepting responsibility to the communities where they do business.

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Recommended Reading

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8. Which of the following statements is false?
   a. The self-employed people are generally considered as earning four times more, and are likely to be millionaires than those who work for others.
   b. Some entrepreneurs work hard just to have adequate profits to survive, while others receive a modest income for their time and investment.
   c. From an economic perspective, the financial return of a business should compensate its owner not only for the investment of personal time, but also for personal money invested in the business.
   d. A few entrepreneurs are highly motivated by the prospect of profits.

9. Which of the following statements is true?
   a. Freedom to operate independently is another reward of entrepreneurship.
   b. Independence guarantees an easy life.
   c. The basic thing to remember in a business is that the entrepreneur is ultimately the boss.
   d. The customer is the person who gets out of the shower and acts on those ideas.

10. Match the following.

1. Entrepreneurs	A. No. of employees in business <100
2. Small business	B. Discover market needs
3. Reward of entrepreneurship	C. Part-time businesses and one-person firms
4. Smallest businesses	D. Independence

   a. 1-A, 2-D, 3-B, 4-C
   b. 1-C, 2-D, 3-B, 4-A
   c. 1-B, 2-A, 3-D, 4-C
   d. 1-C, 2-B, 3-D, 4-A

Chapter II

The Right Small Business

Aim

The aim of this chapter is to:

- enumerate business objectives
- examine personal objectives
- identify business start up ideas

Objectives

The objectives of this chapter are to:

- analyse how business ideas can get converted to successful business
- explain different business ideas
- discuss the conversion of hobbies to business

Learning outcome

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

- explore ways to achieve innovative business ideas
- know the sources of start up ideas
- apply innovative thinking to business ideas

2.1 Introduction

To find right small business to meet your individual strengths, needs, and goals has two components:

- What kind of business is to be started?

  Many people who want to start a small business have a pretty good idea of what type of business they want to own. But some only have a general idea, while others don't have any idea at all.

- Should you buy an existing business rather than build from the ground up?

  A business or franchise that is already operating can save time and sometimes, money. This brings us at the helm of the question that this chapter discuss about that what or which can be the right small business?

2.2 Examining Your Personal Objectives

Begin with examining why you want to start a business. People come to business ownership for a variety of reasons. They want to "be their own boss", "follow the American dream", "earn lot of money". It is necessary to look closely at why you want to start and run a business and know the motivating factors.

There seems to be two schools of thought regarding business ownership:

- Choose a business with great profit potential
- Choose a business that is of your interest

If profit is your motivation, a business must be able to cover all of its costs, pay for all of its expenses, cover the owner's personal financial needs and have enough net revenue left to allow the business to grow. Another consideration is whether this business provides with a full income or supplements your current income. Before going much further, it is necessary to look at what your personal financial needs are. A personal monthly expense worksheet should be designed to help you to determine your total living expenses as well as your 'owner equity' or 'draw' .i.e., the cash to be paid out worksheet for your business.

If the business is out of motivation, try to analyse that a market is found according to your dream. It's very important to determine the profitability of your business before you devote time and money to its development.

A successful business allows making a profit while doing work that is enjoyable. With careful research and planning you can develop a business that fills a need, brings you pleasure and pride, and earns enough revenue to meet your personal needs, pay for itself, and provide profits for future growth. The key words here are research and planning. Continue with some research into what you, the owner, will bring to this business.

2.3 Exploring and Identifying Business/Start-up Ideas

Ideas for new businesses come from many sources. A personal interest can be developed into a business. It is possible to make hobbies, volunteer experience, and leisure activities into business. Any specialised knowledge or skill can be turned into a business. It is possible to write a newspaper column, write a book, present workshops, and conduct seminars in your area of expertise. An understanding of the internet can lead to a business of designing, monitoring and updating Web sites. This same knowledge can be used to retrieve information useful to other businesses. Others demographic studies, databases, market surveys, and information resource lists etc.

A business based on equipment is dependent on technology that can be understood. Examples are video recording and photography of special events. Many new businesses are started by individuals who utilise existing skills from their salaried jobs. Accountants, payroll administrators, technical writers, and computer specialists are examples of employees who have marketable skills that can be developed into service businesses. When companies downsize and outsource, new opportunities arise for entrepreneurs.

Any task or responsibility people don't like to do or don't have time to do can be the basis for a service business. Housecleaning, home repairs, gardening, proofreading, gift purchasing, and furniture refinishing may fill needs in your community. Those ideas are taking classes, apprenticeship, or work in an area dealing with your new field of interest. The other fields are food industry, work at a restaurant, and lot of work associated like supplies ordering, handling deliveries, controlling inventories, handling food, handling invoices and orders etc.

An inventive entrepreneur can develop a new product or improve an existing one. New products are usually spawned out of the imagination. If you can't think of something new, remember that many existing products can be improved upon. A welder designed an improved version of a jack used for levelling mobile homes. He used his creative talent in designing the new jack and his welding skill in manufacturing his product. He has created a double need for his talents. His product is timely, and today he is a busy, happy, and prosperous man.

It is very critical to determine whether an idea for a new business actually represents a good opportunity. Many people have ideas about new products or services that seem like winners, but just because something is a good idea does not mean it is a good opportunity. In fact, those who become infatuated with an idea, sometimes underestimates the difficulty of tapping into market interest. To qualify as a good investment opportunity, a product or service must meet a real market need, such as a problem for which the entrepreneur offers a sensible solution. If consumers are convinced that the benefits of a product or service are worth the price they will have to pay to get it, they will likely want to buy it, assuming they know about it and can afford it. All of these factors are critical. Amar Bhide, an entrepreneurship expert and professor at Columbia University, put it this way: "Start-ups with products that do not serve clear and important needs cannot expect to be 'discovered' by enough customers to make a difference."

Many popular frameworks highlight important factors to consider when deciding whether a new business idea can lead to a promising business opportunity. Some of the more important features of these approaches follow.

- **Market factors:** The product or service must meet a clearly defined market need; furthermore, the timing must be right. Even when the concept is good, success requires an opportunity that remains open long enough for an entrepreneur to take advantage of it. If the window closes before the enterprise can get established, it is unlikely to survive for long.
- **Competitive advantage:** A competitive advantage exists when a firm offers a product or service that customers perceive to be superior to those offered by competitors. It follows that the business must be able to achieve an edge that can withstand challenges from rival businesses. Many start-ups fail as entrepreneurs do not understand the nature and importance of a competitive advantage.
- **Economic:** The venture has to be financially rewarding, allowing for significant profit and growth potential. Its profit potential must be sufficient to allow for errors and mistakes and still offer acceptable economic benefits. At a minimum, the enterprise must offer a reasonable path to profitability—no business can operate for long when it is losing money. And without adequate growth, the business will not be able to provide sufficient returns to attract investors, if they are ever needed.
- **Management capability:** The fit between entrepreneur and opportunity must be good.
- In other words, a business idea is an opportunity only for the entrepreneur who has the appropriate experience, skills, and access to the resources necessary for the venture's launch and growth.
- **Fatal flaws:** There must be no fatal flaw in the venture, that is, no circumstance or development that could, make the business unsuccessful. John Osher, serial innovator and entrepreneur, estimates that nine out of ten entrepreneurs fail because their business concept is deficient. In his words, "They want to be in business so much that they often don't do the work they need to do ahead of time, so everything they do is doomed. They can be very talented, do everything else right, and fail because they have ideas that are fl awed."

2.4 Creating a New Business from Scratch

Several motivations lead you to start a business from scratch rather than pursuing other alternatives, such as buying a franchise or an existing business or joining a family business. They include:

- A personal desire to develop the commercial market for a recently invented or newly developed product or service
- Tap into unique resources that are available, such as an ideal location, new equipment technologies, or exceptional employees, suppliers, and bankers
- Avoiding undesirable features of existing companies, including unfavourable cultures, policies, procedures, and legal commitments
- Wanting the challenge of succeeding (or failing) on your own. Assuming you have sound reasons for considering a start-up, you should still address several basic questions before making the commitment:
    - What are some other types of start-up ideas you might consider?
    - What are some sources for additional new business ideas?
    - How can you identify a genuine opportunity that creates value, for both the customer and the company's owner(s)?
    - How should you refine your business idea?
    - What could you do to increase the odds of success in your business?
    - What competitive advantage could your business have over its rivals?

The entrepreneur's ability to carefully and honestly examine questions such as those above will determine the direction to follow. We will examine the issues raised by these questions later in this chapter.

Criteria	**Attractiveness**	
Market factors	**Favourable**	**Unfavourable**
Need for the product	Well identified	Unfocused
Customers	Reachable; receptive	Unreachable; strong loyalty to competitor's product or service
Value created for customers	Significant	Not significant
Market structure	Emerging industry; not highly competitive	Mature or declining industry; highly concentrated competition
Market growth rate	Growing by at least 15% a year	Growing by less than 10% a year
Competitive advantage		
Control over prices, costs, and distribution	Moderate to strong	Weak to nonexistent
Barriers to entry		
Proprietary information or regulatory protection	Have or can develop	Not possible
Response/lead time advantage	Competition slow, nonresponsive	Unable to gain an edge

Legal/contractual advantage	Proprietary or exclusive	Nonexistent
Contacts and networks	Well developed; accessible	Poorly developed; limited
Economics		
Return on investment	25% or more; sustainable	Less than 15%; unpredictable
Investment requirements	Small to moderate; easily financed	Large; difficult to finance
Time required to break even or to reach positive cash flows	Under 2 years	More than 4 years
Management capability	Management team with diverse skills and relevant experience	Solo entrepreneur with no related Experience
Fatal flaws	None	One or more

Table 2.1 Selected evaluation criteria for a start-up

2.4.1 Finding Start-up Ideas

Business ideas are not all equal, and they originate from many different sources. By recognising the nature and origin of start-up ideas, the entrepreneur can broaden the range of new ideas available for his or her consideration.

Types of start-up ideas

The figure given below shows three basic types of ideas that develop into start-ups: ideas to enter new markets, ideas based on new technologies, and ideas to offer new benefits.

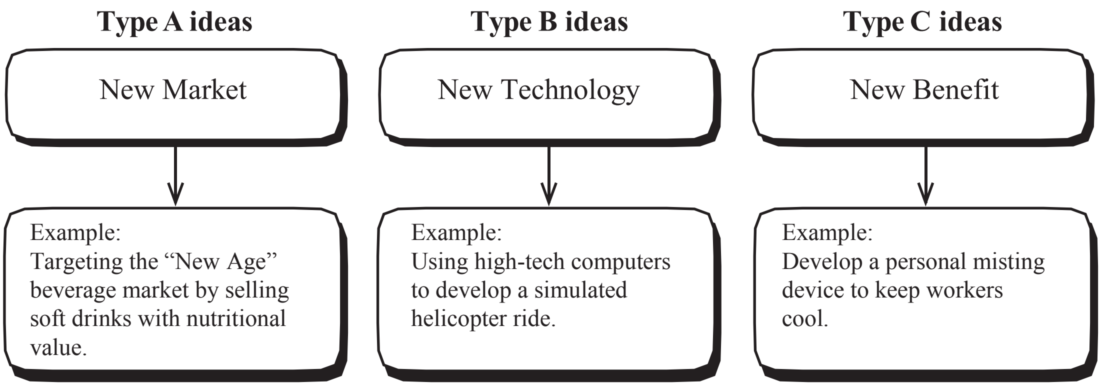

Fig. 2.1 Types of start-up ideas

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Many start-ups developed from Type A ideas, are those concerned with providing customers with a product or service that does not exist in a particular market. Randall Rothenberg, an author and the director of intellectual capital at consulting powerhouse Booz Allen Hamilton, says that this type of start-up idea may have the greatest potential: "There is ample evidence that some of the biggest businesses are built by taking existing ideas and applying them in a new context." Many small businesses are built on this platform.

Filmmaker Christian D'Andrea was making a documentary on Special Forces when he saw a soldier chomping down an energy bar issued by the United States military, which had been developed specifically to provide the extra boost those in uniform need on the battlefield. D'Andrea recognised an opportunity to take the product, which civilians couldn't buy, to a whole new market. He and his brother, Mark, signed a deal in 2004 giving them license to use the science behind the product, and they used it to create the Hoorah! Bar, a pick-me-up snack that today sells in thousands of stores and online outlets. Business is good, and growing; in fact, their Los Angeles–based start-up, D'Andrea Brothers LLC, recently expanded its product line to include an energy drink based on the same formulation. With sales poised to cross the $1 million mark, it is clear that tapping "military intelligence" to take an existing product to the civilian market can yield impressive results.

Very few start-ups are based on Type B ideas, which involve new or relatively new technology. This type of start-up can be high risk because there is usually no model of success to follow, but it can also have tremendous potential. In 1998, Richard Mayer and Malcolm Currie launched Currie Technologies, a Van Nuys, California, venture that produces electric bicycles and scooters. Within five years, the company was employing 40 people and had revenues of $10 million, but it was only the beginning. With the spike in fuel prices and escalating concerns about global warming, the company's products make better sense than ever. Perhaps one of Currie's executives best captured the essence of the business: "Clean, green and no gasoline!"

Type C ideas are those based on offering customers benefits from new and improved ways of performing old functions, probably account for the largest number of start-ups. In fact, most new ventures, especially in the service industry, are founded on "me, too" strategies, as they set themselves apart through features such as superior service or lower prices. Laurie Johnson's took effort to redefine the common crutch fits into the Type C category.

As founder of LemonAid Crutches, Johnson found a way to take some of the sting out of having to be oncrutches after an injury. Her designer crutches were born of experience. While Johnson was recovering from a broken leg sustained in a small-plane crash that took the lives of her husband and two-year-old son, her sister tried to cheer her up some by spray painting her crutches and trimming the handles in fabric. It made her feel better. Deciding to turn life's lemons into lemonade (hence the name of the company), Johnson decided to run with the concept and help other crutch users feel better, too. In mid-2005, she launched her venture to sell a variety of fashionably functional crutches.

2.4.2 Sources of Start-Up Ideas

There are a number of sources you can turn to for inspiration. And if one source fails to lead to the idea of dreams, its better to keep looking, as inspiration can come from many different places. Several studies have identified sources of ideas for small business start-ups. The figure given below shows the results of one such study by the National Federation of Independent Business (NFIB), which found that prior work experience accounted for 45 percent of new ideas. This finding is consistent with another national study of entrepreneurs, as the Panel Study of Entrepreneurial Dynamics (PSED).

The PSED data also show that entrepreneurs most often consider work experience in a particular industry or market to be the source of their start-up ideas. There are other important sources also. The NFIB study found that personal interests and hobbies represented 16 percent of the total, and chance happenings accounted for 11 percent. Ideas for a start-up can come from virtually anywhere, but we will focus on four possible sources like personal experience, hobbies, accidental discovery, and deliberate search.

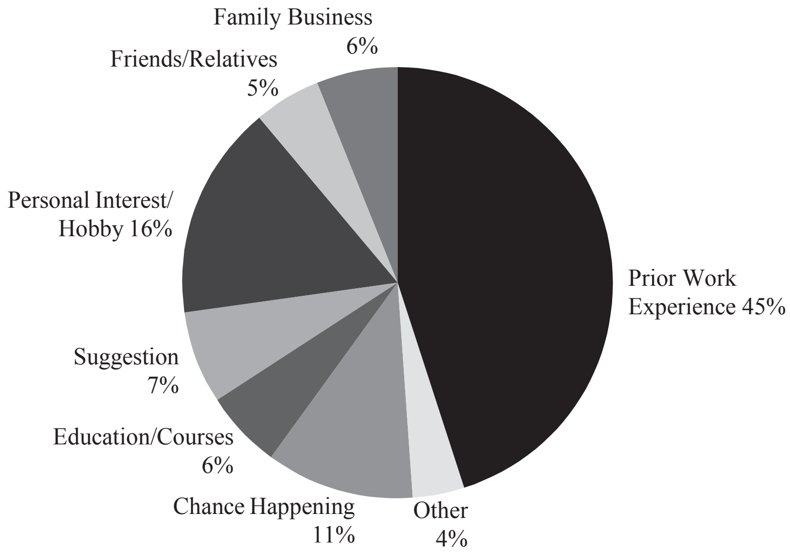

Fig. 2.2 Sources of start-up ideas

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Personal experience

The primary source of start-up ideas is personal experience, either at work or at home. Knowledge gained from a present or former job often allows a person to see possibilities for modifying an existing product, improving a service, or duplicating a business concept in a different location. Personal contacts may open up conversations with suppliers who are interested in working with you or customers who have needs that are not currently being met. These insights may lead you to an opportunity with tremendous potential.

Ken and Jennifer Miller started their outdoor-clothing company, Thousand Mile, based on Ken's personal experience as a lifeguard in Carlsbad, California. The faded swimming trunks of fellow lifeguards inspired Ken and his wife-to-be, Jennifer, to buy material and make 30 pairs of trunks. When the trunks quickly sold to Ken's co-workers, the couple knew their business idea was an attractive start-up opportunity. After several years of development, they now have a complete line of mail-order outdoor wear. Here work experience played a role in the launching of this business, as did close interactions with customers who recognised that Thousand Mile provided a product they could really use.

Hobbies and personal interests

Sometimes hobbies grow beyond being leisure activities and get converted become businesses. For instance, people who love skiing might start a ski equipment rental business as a way to make income from an activity that they enjoy, and those who love books might explore concepts that lead to new bookstore businesses.

Hobbies and personal interests certainly add passion to the start-up process. Kevin Rose was only in his mid-20s when he launched Digg.com in 2004 with two of his buddies, Owen Byrne and Jay Adelson, but his company is off to a fast start. The former UNIX administrator and TechTV personality found inspiration for his company in Slashdot, the wildly popular, community-driven tech news website. Rose described himself as "a big fan" of Slashdot, but he concluded that the website was missing out by restricting the participation of users.

He believed that the user community have complete control of content. This concept that led to the launch of Digg: "a site where users could submit stories that fall into a general queue, and if they were popular enough and if they got enough 'diggs' which are user endorsements, and would be promoted to the home page for everyone to see." This type of "democratic approach to the news" is becoming quite popular, and fast. Generating revenue from advertising is a no-brainer, which plans for expanding the range of features on the site, and it will only enhance the financial performance of the business, which is already a profitable operation with more than 180,000 registered users.

Accidental discovery

Another source of new start-up ideas is accidental discovery which involves something called serendipity, or a gift for making desirable discoveries by accident. Awareness obviously plays a role here, but anyone may stumble across a useful idea in the course of day-to-day living.

This is exactly what happened to Tia Wou, founder of Tote Le Monde, a handbag manufacturer in New York City. Wou had travelled to Bolivia for her friend's wedding in 1989 and loved the rich fabrics she saw in the marketplace. Wou, who was working in fashion at the time, got a creative spark from that trip. A few years later, she travelled to Japan and was on the hunt for the perfect handbag. Not finding what she wanted, Wou recalled the beautiful fabrics in Bolivia. That's when it hit her and she was able to design handbags like the ones she was looking for in Japan, using the materials she'd seen in Bolivia, and sell them in America.

Tote le Monde produces lifestyle brands, selling handbags, house-wares, travel pieces, and personal accessories featuring the company's stylish, environmentally friendly materials. And the entrepreneurial spirit of the business is alive and well, as is Tote le Monde's original mission: "To create innovation where function finds form." While considering the invention of the pocket protector an electrical engineer Gerson Strassberg in 1952. "It happened by accident," Strassberg says. "I was just starting up my company, and we were making the clear plastic covers that cover bankbooks. At that time, ballpoint pens were prone to leaking. One day I cut one side of the plastic longer than the other. The phone rang, so I stuck the plastic in my pocket and thought "Wow, this might make a great product." Sales for the pocket protector peaked in the late 1960s, but Strassberg still sells close to 30,000 of his nifty "fashion accessories" each year, which now retail at around $1 apiece.

Deliberate search

Many start-up possibilities emerge from an entrepreneur's deliberate search for new ideas. In fact, this kind of exploration may be especially useful because it stimulates a readiness of mind, and it motivates prospective entrepreneurs to be more receptive to new ideas from any source. A deliberate search often involves looking for change-based opportunities, but it may take a number of other paths.

An eye on change

Change is one of the most important sources of ideas for entrepreneurs. Whereas large firms prefer things to remain the same, entrepreneurs are much more likely to recognise change as an opportunity and to have the creativity and flexibility to adjust to it. Business guru Peter Drucker believed entrepreneurs should consider seven sources of opportunity as they prepare to launch or grow their enterprises, which are explained below.

2.5 Change-Based Sources of Entrepreneurial Opportunities

Drucker suggested that innovation is the means by which the entrepreneur either creates new wealth-producing resources or endows existing resources with enhanced potential for creating wealth. Entrepreneurship harnesses the power of creativity to provide innovative products and services.

Change factor	Definition	Illustration
Industry Factors		
The unexpected	Unanticipated events lead to either enterprise success or failure.	Pet pharmaceuticals have been very successful, with more than 30% of dogs and cats now taking medication.
The incongruous	What is expected is out of line with what will work.	Low-fat ice cream was developed for those trying to lose weight.
Process needs	Current technology is insufficient to address an emerging challenge.	Carmakers offer gas-electric hybrid cars to deal with rising energy costs.
Structural change	Changes in technology, markets, etc., alter industry dynamics.	Growth in the use of the Internet for e-commerce has been dramatic.
Human and economic factors		
Demographics	Shifts in population size, age structure, ethnicity, and income distribution impact product demand.	Many baby boomers are still in their prime income-earning years and are saving for retirement, promoting an increase in the need for financial planning.
Changes in perception	Perceptual variations determine product demand.	Perceived security threats have led to development of gated communities.
New knowledge	Learning opens the door to new product opportunities with commercial potential	Increased knowledge of the Internet has fuelled the growth of online investment firms.

Table 2.2 Change-based sources of entrepreneurial opportunities

Other idea leads

If analysing emerging changes does not reveal the specific entrepreneurial opportunity that is right for you, other sources of leads are available. The following have been useful to many entrepreneurs:

Tapping personal contacts with potential customers and suppliers, professors, patent attorneys, former or current employees or co-workers, venture capitalists, and chambers of commerce Visiting trade shows, production facilities, universities, and research institutes. Observing trends related to material limitations and energy shortages, emerging technologies, recreation, fads, pollution problems, personal security, and social movements.

Reading trade publications, bankruptcy announcements, Commerce Department publications, and business classifieds, Inc., Entrepreneur, My Business, and other periodicals are excellent sources of start-up ideas, as they provide articles on the creativity of entrepreneurs and various business opportunities.

Visiting the library and even looking through the Yellow Pages in other cities can spark new ideas as well. Travelling to other cities to visit entrepreneurs in your field of interest can also be extremely helpful. Of course, the Internet provides an unlimited amount of information regarding the start-up process and even specific opportunities.

2.6 Applying Innovative Thinking to Business Ideas

A creative person can find out useful ideas in many different places. It is important to commit to a lifestyle of creative thinking so that everyday thoughts can work in your favour. Although the following suggestions are designed to help guide your search for that one great idea for a start-up, they can also help keep an existing business fresh, alive, and moving forward.

- When it comes to ideas, borrow heavily from existing products and services or other industries. "Good artists borrow; great artists steal," said Pablo Picasso or T. S. Eliot or Salvador Dali—no one seems to know for sure. This principle was launched Apple Computer on the road to greatness when its founder Steve Jobs identified technologies that Xerox had developed but was not using. Explore ideas and practices that come across, and think deeply about how you might put them to work in launching a start-up or accelerating the growth of an existing business. Research shows that this is a powerful starting place for innovation.
- Combine two businesses into one to create a market opening. A revolutionary concept is exceptionally practical for patrons. Many times have it would have happened like, rushed through dinner to get to the theatre, only to find that the movie you wanted to see was already sold out. That won't happen at this Glens Falls, New York, start-up after they combined the restaurant and the theatre. After a leisurely dinner, when the lights begin to dim, sit back in cushioned comfort and enjoy the show. The restaurant business is often ruthless, and the theatre industry is even more competitive, but bringing the two together puts Aimie's in a unique position.
- At some point, it make sense to start (or buy) more than one business (although not necessarily merging their operations as closely as Aimie's Dinner and Movie), through a strategy known as diversification. To see how this can work and be advantageous, consider the outdoor lighting company that Derek Norwood and his father have who owned for more than a decade. Their business had done pretty well over the years, but they found that the severe weather in Chicago (where they are located) typically hit their winter revenues hard. Norwood found a bright solution to the problem: He then launched a new company that offers holiday lighting supplies. Now the revenue lag has disappeared, and since many of Norwood's outdoor lighting customers are buying holiday lighting from him as well, cross-selling advantages are also helping to boost the bottom line. Experts warn, however, that becoming too diversified can sometimes cause an entrepreneur to lose focus, which can drag down performance on all fronts. It clearly pays to think through the pros and cons very carefully.
- Begin with a problem in mind. Bankable business ideas usually address problems that people have. It is sufficient to think about a significant problem, dissect it, chart it out on a sheet of paper, roll it over and over in your mind, and consider possible solutions. Sometimes amazing business ideas will come quickly to mind. For example, so many migratory birds were passing through Texas cities and settling on trees and buildings, becoming a nuisance, and making an incredible mess that they spawned their own pest-control industry. Numerous small companies started up to address this particular problem, using flashing lights, explosions, and even falcons to drive the winged menaces from urban areas. And though the problem is obviously a seasonal one, their services are very much in demand.
- Recognise a hot trend and ride the wave. Fads can lead to serious, though sometimes short-lived, money-making opportunities, but trends provide a much stronger foundation for businesses because they are connected to a larger change in society. Even more powerful is the product or service that builds on three or four trends as they come together. For example, one entrepreneurship expert observed that the iPod's outrageous success is the result of multiple merging trends: the desire for increased mobility, instant gratification, and customisation, all melded together with the natural pull toward fashion. But if the wave has already crashed on the shore, it is necessary to look for countertrends and every trend has one. For example, even as wireless technologies extend the reach of communication, people pay more to travel to destinations beyond the reach of their Black Berries. To identify a countertrend, make it a habit to ask those who resist a trend (like the coffee drinker who refuses to go to Starbucks) what products or services would appeal to them, and then see what possibilities come to mind. It is necessary to try to set aside your preconceived notions of necessary things and get into the minds of those who resist the flow. Trend can be used as a starting point, you will know better where to look for the countertrend, and that's where you can get ahead of the game.

- Study an existing product or service and explore ways to improve its function. Products or services that work can be improved so that they work even better. TissueKups is a tissue dispenser shaped so that it fits perfectly in a car cup holder. Lorraine Santoli came up with the seed of the idea in her car after struggling with a tissue box that kept sliding away from her. She knew there had to be a solution, and there was. The company was launched online in 2003 and reached sales of around $3 million within two years. The simplicity of the product may be its best feature.
- Think of possibilities that would streamline a customer's activities. Many people are busy, so they look for firms that can bear some of the burdens of life for them. That's what keeps businesses like dry cleaner and grocery delivery services going. Take some time to ponder the day-to-day experience of people in the market segment you would like to serve.
- Consider ways to adapt a product or service to meet customer needs in a different way. Darren Hitz realised that bachelor parties could be about more than just serious drinking and exotic dancers. That's when he came up with the idea to launch Adventure Bachelor Party, a company that brings thrills to bachelor parties by taking guys on packaged adventures like white-water rafting trips. The start-up has only been around since 2004, but Hitz already offers over 20 adventures, including cattle herding in Texas and fishing off the California coast. He also provides trips for bachelorette parties. In his words, "I enjoy being able to provide a service where everyone has a great time and is happy."
- Imagine the market for a product or service could be expanded. Jane Silber's 9-year-old daughter had a weight problem, and Silber found that few gyms allow children to use their facilities. Matching this information with the trend toward increased childhood obesity (up 300 percent since 1980), Silber realised that she had identified a wonderful business opportunity. In August of 2006, she opened Generation Now Fitness in Chatsworth, California, to expand the reach of fitness services to tweens and teens. Though this story is focused on one industry, the principle will apply to any market that may be of interest to you.
- It is necessary to keep an eye on new technologies. New technologies often open up potential for start-ups, but only those who take note of the possibilities can reap the rewards. Read widely, talk to industry experts, consult government offices that promote new technologies, go to a nearby research university and visit with faculty who work at the cutting edge of their fields, and there are so many sources of insight available. It is regardless of where you look, be sure to research innovations that have commercial value, particularly for new ventures. Chris Savarese is an avid golfer who wanted to find a way to use new technology to track golf balls hacked off into the rough and high brush. He searched a patent library (a good place to start) and found several possible approaches, but the answer to his question came from a trip to a department store. He observed that the security tags that stores attach to apparel items and other goods and figured they might work for his golf ball concept. Sure enough, they did!
- The radio frequency identification (RFID) technology that keeps track of an item's location (for example, a sweater that a shoplifter might like to walk away with) can also be used as a homing device in golf balls, allowing them to be detected from as far away as 100 feet. Savarese's company, RadarGolf, now packages a dozen radio-tagged balls with a locator to find them for $250, and the market really likes his innovation. His business is growing 30 percent a year, with revenues about to hit the $1 million mark. New technology was clearly the key that got the ball rolling for Savarese. It can be encouraged to seek and size up new venture ideas in whatever circumstances you find yourself. Then, by considering a number of internal and external factors, you should be able to bring together the pieces of the opportunity puzzle.

Summary

- If profit is your motivation, a business must be able to cover all of its costs, pay for all of its expenses, cover the owner's personal financial needs and have enough net revenue left to allow the business to grow.
- A successful business allows making a profit while doing work that is enjoyable.
- A business based on equipment is dependent on technology that can be understood.
- Any task or responsibility people don't like to do or don't have time to do can be the basis for a service business.
- An inventive entrepreneur can develop a new product or improve an existing one.
- It is very critical to determine whether an idea for a new business actually represents a good opportunity.
- Several motivations lead you to start a business from scratch rather than pursuing other alternatives, such as buying a franchise or an existing business or joining a family business.
- The primary source of start-up ideas is personal experience, either at work or at home.
- A creative person can find out useful ideas in many different places.

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Chapter III

Franchises and Buyouts

Aim

The aim of this chapter is to:

- explain franchising options and structure of the industry
- discuss the benefits of being a franchisee
- illustrate the advantages and disadvantages of a franchise

Objectives

The objectives of this chapter are to:

- understand franchises and buyouts
- identify the business opportunity by opening a franchise
- recognise the methods to acquire an established business

Learning outcome

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

- identify major pros and cons of franchising
- describe the process for evaluating a franchise opportunity
- understand the benefits of buying an existing business

3.1 Introduction

Franchises are also known as chain stores. They operate business under a special arrangement. Franchises are moderated industries that follow a set business model, which includes a name, an image, and a set of support services. The buyout process usually begins when an interested purchaser or group of purchasers makes a formal buyout offer to a company's board of directors, who are the representatives of the company's shareholders. Negotiations and tender offers ensue, and the board of directors eventually either recommends that the shareholders sell their shares to the purchaser or discourages the shareholders from doing so.

3.2 Pros and Cons of Franchising

"Look before you leap" is an old adage that should be followed by entrepreneurs considering franchising. Entrepreneurs should not let their enthusiasm to blind them to the realities of franchising, both good and bad. Weighing the purchase of a franchise against alternative paths to starting a business is an important task, which requires careful consideration of many factors. The table given below illustrates the major advantages and disadvantages of franchising.

Advantages	**Disadvantages**
Greater likelihood of success Formalised training Financial assistance Proven marketing methods Managerial assistance Quicker start-up time	Franchise fees Royalties Restrictions on growth Less independence in operations Franchisor may be sole supplier of some supplies Termination/renewal clauses

Table 3.1 Advantages and disadvantages of franchising

Among different personal goals and circumstances of individuals, franchising will not be the ideal choice for all prospective entrepreneurs. However, many people find a franchise to be the best alternative for owning a business. When you are evaluating future entrepreneurial opportunities, it is better to carefully weigh the pros and cons of franchising presented in this chapter. In the current context, a broad definition of franchising is necessary to encompass the term's diversity. Franchising is a marketing system revolving around a two-party legal agreement whereby one party (the franchisee) is granted the privilege to sell a product or service and conduct business as an individual owner, but is required to operate according to methods and terms specified by the other party (the franchisor). For example, Subway (the franchisor) franchises quick-service, fast-food outlets to local owners (franchisees).

3.2.1 Other Advantages of Franchising

Buying a franchise can be attractive for a variety of reasons. The greatest overall advantage by far is the probability of success. Franchisors offer a business model with proven success. Business data on failures of franchises are difficult to find and evaluate. Nevertheless, the success rate for franchises seems to be much higher than that for non-franchised businesses.

One explanation for the lower failure rate is that most franchisors are highly selective when granting franchises. Many potential franchisees who qualify financially are still rejected.

There are three additional, and more specific, reasons why a franchise opportunity is appealing. A franchise is typically attractive because it offers training, financial assistance, and operating benefits that are not readily available to the entrepreneur starting a business from scratch. Naturally, different franchises vary in the depth of support they provide for each of these forms of assistance. For example, McDonald's offers excellent training but no financing.

3.2.2 Training

The training given by franchisors is invaluable to many small entrepreneurs because it compensates for weaknesses in their managerial skills. Training by the franchisor often begins with an initial period of a few days or a few weeks at a central training school or another established location and then continues at a franchise site. McDonald's is widely recognised for its off-site franchisee training effort at Hamburger University.

The training by Kwik Kopy Printing, another famous franchisor, is extensively covering the technical aspects of running a printing business as well as the standard topics of accounting, computer purchasing and use, and leadership. Its training facility, located in the picturesque city of Northwest Forest, a few miles from Houston, Texas, looks like an amusement park, with a full-size replica of the Alamo. However, franchise trainees quickly realise that the three-week training program is very demanding. Classes start at 7:00 A.M. and conclude at 6:00 P.M., Monday through Friday, and they continue for a half-day on Saturday. Express Personnel Services (EPS) is also a strong believer in initial training for prospective franchisees. Consider this description of EPS's new franchisee training system: Franchisees and their staff attend and get benefitted from this intensive three-week start-up training.

Our curriculum involves three levels of learning. Cursory learning that provides an overview of materials. Working knowledge provides thorough understanding without performing tasks and the competency level involves performing the task, through role plays to enhance understanding and retention of knowledge. The first two weeks of learning are held at Express Personnel's international headquarters in Oklahoma City. This allows the students an opportunity to learn and practice the key functions they will be performing within their offices. The students are involved in various role-play scenarios, group exercises and classroom discussions to learn the three pillars of our business:

- Sales
- Recruiting
- Service

The first two weeks of training focus on inside sales, outside sales and business management. Third week allows the new franchisee to perform the major business functions in an Express University certified extension office. These offices are model offices that provide an avenue for the new franchisee to truly acquire live experience prior to their opening week.

3.2.3 Financial Assistance

The costs of starting an independent business are often high, and the typical entrepreneur's sources of capital are quite limited. The entrepreneur's standing as a prospective borrower is weakest at this point. By teaming up with a franchising organisation, the aspiring franchisee may enhance her or his likelihood of obtaining financial assistance.

If the franchising organisation considers the applicant to be a suitable prospect with a high probability of success, it frequently extends a helping hand financially. The franchisee is seldom required to pay upfront the complete cost of establishing the business. In addition, the beginning franchisee is normally given a payment schedule that can be met through successful operation. For example, in the early days of the Jiffy Lube franchise, the franchisor would loan the franchisee funds to purchase the real estate for a store. Also, the franchisor may permit the franchisee to delay payments for products or supplies obtained from the parent organisation, thus increasing the franchisee's working capital.

It is good to get associated with a well-established franchisor may also improve a new franchisee's credit standing with a bank. The reputation of the franchising organisation and the managerial and financial controls that it provides serve to recommend the new franchisee to a banker. Also, the franchisor will frequently co-sign a note with a local bank, thus, guaranteeing the franchisee's loan.

The U.S. Small Business Administration (SBA) has introduced the Franchise Registry (http://www.franchiseregistry.com), that expedites loan processing for small business franchisees. The Registry "enables lenders and SBA local office and verifies a franchise system's lending eligibility through the Internet. This reduces red tape, time, and cost for all concerned." Listing on this registry means that the SBA has found that the particular franchise agreement does not impose unacceptable control provisions on the franchisee. Therefore, loan applications for registered franchises can be reviewed and processed more quickly.

3.2.4 Operating Benefits

Most franchised products and services are widely known and accepted. For example, consumers will readily buy Baskin-Robbins ice cream or use PIP Printing services because they are aware of the reputation these businesses have.

Travellers will recognise a restaurant or a motel because of its name or type of roof or some other feature such as the "Golden Arches" of McDonald's. They may turn into a Denny's restaurant or a Holiday Inn because of their previous experiences with the chain and their knowledge that they can depend on the food and service these outlets provide. Thus, franchising offers both a proven line of business and product/service identification.

An entrepreneur who enters into a franchising agreement acquires the right to use the franchisor's nationally advertised trademark or brand name. This serves to identify the local enterprise with the widely recognised product or service. Of course, the value of product identification depends on the type of product or service and the extent to which it has been promoted. In any case, the franchisor must maintain the value of its name by continued advertising and promotion.

Franchisors also offer well-developed and thoroughly tested methods of marketing and management. The manuals and procedures supplied to franchisees enable them to function more efficiently from the start. This is one reason of franchisors insist on the observance of high quality methods of operation and performance. If one franchise were allowed to operate at a substandard level, it could easily destroy customers' confidence in the entire system.

The existence of proven products and methods, however, does not guarantee that a franchise will succeed. For example, a location that the franchisor's marketing research shows to be satisfactory may turn out to be inferior. Or the franchisee may lack ambition or perseverance. But the fact that a franchisor has a record of successful operation proves that the system can work, because it has worked elsewhere.

3.2.5 Limitations of Franchising

Franchising is like a coin, which has two sides. We have presented the positive side of franchising, but it is important that you also learn about its negative side. Four shortcomings, in particular, permeate the franchise form of business:

- The costs associated with the franchise
- The operating restrictions that can be a part of the franchise agreement
- The loss of entrepreneurial independence
- A lack of franchisor support

3.2.6 Franchise Costs

Higher costs characterise the better known and more successful franchises. Franchise costs have several components, all of which need to be recognised and considered.

- **Initial franchise fee**: The total cost of a franchise begins with an initial franchise fee, which may range from several hundred to many thousands of dollars. The initial fee for a Wing Zone, a takeout/delivery restaurant is $20,000–$25,000; McDonald's initial fee is $45,000.
- **Investment costs:** Significant costs may be involved in renting or building an outlet and stocking it with inventory and other equipment. Also, certain insurance premiums, legal fees, and other start-up expenses must be paid. It is often recommended that funds be available to cover personal expenses and emergencies for at least

six months. A reputable franchisor will always provide a detailed estimate of investment costs; The table given below shows the information provided by Wing Zone. Curves for Women, a women's workout facility, charges between $30,000 and $40,000 for a franchise, workout equipment included. The total net worth requirement for a KFC restaurant exceeds $1,000,000, and the prospective franchise must have cash and other personal assets worth this amount.

	Low	High
Franchise fee	$ 20,000	$ 25,000
Leasehold improvements	50,000	80,000
Equipment (excludes sales tax)	48,000	53,000
Signs	6,000	8,000
Computer P. O.S. system	18000	18,000
Office equipment/phone system	3,000	3,500
Drop safe and lock	1,000	1,500
Digital security system	0	3,000
Initial inventory	4,000	4,000
Start up marketing	3,000	3,000
Grand-opening fund	5,000	5,000
Insurance (down-payment)	3,000	3,500
Initial training expenses	2,000	3,000
Uniforms	1,000	1,000
Utility deposits	1,000	2,500
Architectural plans	5,000	8,000
Real estate cost	4,000	7,000
Working capital	15,000	20,000
Total Investment	**$189,000**	**$249,000**

Table 3.2 An estimate of investment costs by wing zone

- **Royalty payments:** A common practice is for the franchisor to receive continuing royalty payments, calculated as a percentage of the franchisee's gross income. McAlister's Deli, for example, charges a 5 percent royalty fee. McDonald's currently charges a "service fee" of 4 percent of monthly sales plus the greater of (a) a monthly base rent or (b) a percentage rent based on monthly sales.
- **Advertising costs:** Many franchisors require that franchisees to contribute an advertising fund so as to promote the franchise. These fees are generally 1 to 2 percent of sales or even more. If entrepreneurs could generate the same level of sales by setting up an independent business, they would save the franchise fee and some of the other costs. However, if the franchisor provides the benefits previously described, the money franchisees pay for their relationship with the franchisor may prove to be a very good investment.

3.2.7 Restrictions on Business Operations

Franchisors are concerned about the image of their businesses; make every effort to control how franchisees conduct certain aspects of the franchise business. Thus, the franchisee is restricted in her or his ability to use personal business judgment. The following types of control are frequently exercised by a franchisor:

- Restricting sales territories
- Requiring site approval for the retail outlet and imposing requirements regarding outlet appearance
- Restricting goods and services offered for sale
- Restricting advertising and hours of operation

3.2.8 Loss of Independence

Frequently, individuals leave salaried employment for entrepreneurship because they dislike working under the direct supervision and control of others. But when they enter into a franchise relationship, such individuals may find that a different pattern of supervision has taken over. The franchisee surrenders a considerable amount of independence in signing a franchise agreement.

Even though the franchisor's influence on business operations may be helpful in ensuring success, the level of control exerted may be unpleasant to an entrepreneur who cherishes independence. In addition, some franchise contracts go to extremes, covering unimportant details or specifying practices that are more helpful to others in the chain than to the local operation. For example, a food franchise may be prevented from selling a non-approved product in a local market.

Entrepreneurs should recognise that they can lose the right to a franchise if they do not abide by performance standards or fail to pay royalties. Additionally, there is no guarantee that a franchise will be renewed beyond the contracted time, which is typically 15 to 20 years.

3.2.9 Lack of Franchisor Support

Just like a marriage, a franchisor/franchisee relationship can experience stress, which may lead to a breakup. Perceived lack of franchisor support sometimes creates disputes, especially when the franchisee believes the franchisor is not honouring its commitments. Disputes may revolve around a lack of continued training, poor promotional support, or other issues. Once a communication breakdown occurs between the two parties, the well-being of the franchise is in jeopardy. Entrepreneurs who are considering purchasing a franchise should recognise this inherent disadvantage of franchising.

3.3 Franchising Options

The term franchising was derived from a French word meaning "freedom" or "exemption from duties." In business, franchising describes a unique type of business option that offers entrepreneurs the possibility of reducing the overall risk associated with buying an independent business or starting a business from scratch. The franchise arrangement allows new business operators to benefit from the accumulated business experience of all members of the franchise system.

The potential value of a franchising arrangement is defined by the rights contained in a legal agreement known as the franchise contract; the rights it conveys are called the franchise. The extent and importance of these rights may be quite varied. When the main benefit the franchisee receives is the privilege of using a widely recognised product name, the arrangement between the franchisor (supplier) and the franchisee (buyer) is called product and trade name franchising. Automobile tire outlets carrying the Goodyear brand name and soft drink bottlers distributing Dr Pepper are both engaged in this type of franchising.

Alternatively, entrepreneurs who receive an entire marketing and management system are participating in a broader type of arrangement referred to as business format franchising. Fast-food outlets (for example, Burger King), hotels and motels (for example, Radisson), and business services (for example, Mail Boxes) typically engage in this type of franchising. The volume of sales and the number of franchise units associated with business format franchising have increased steadily over the years.

A master licensee is a firm or individual which have a continuing contractual relationship with a franchisor to sell its franchises. This independent company or businessperson is a type of middleman or sales agent. Master licensees are responsible for finding new franchisees within a specified territory. Sometimes, they even provide support services such as training and warehousing, which are more traditionally provided by the franchisor. Also gaining widespread usage is multiple-unit ownership, in which a single franchisee owns more than one unit of the franchised business. Some of these franchisees are area developers, individuals or firms that obtain the legal right to open several outlets in a given area.

Piggyback franchising refers to the operation of a retail franchise within the physical facilities of a host store. Examples of piggyback franchising include a cookie franchise doing business inside an Arby's fast-food outlet and a Krispy Kreme donut franchise operating within a Wal-Mart store. A new trend in piggyback franchising is locating walk-in health clinics in Wal-Marts, Target stores, drugstores, and other retail outlets. This form of franchising benefits both parties. The host store is able to add a new product line, and the franchisee obtains a location near prospective customers.

3.4 Structure of Franchising Industry

Franchisors and franchisees are the two main parties in the franchise industry. A franchisor may be a manufacturer or another channel member (a wholesaler or retailer) that has an attractive business concept worthy of duplication. As shown in the figure given below, a franchise can be sold by the franchisor directly to individual franchisees or marketed through master licensees or area developers. Most franchisors also own one or more outlets that are not franchised. These outlets are referred to as company-owned stores.

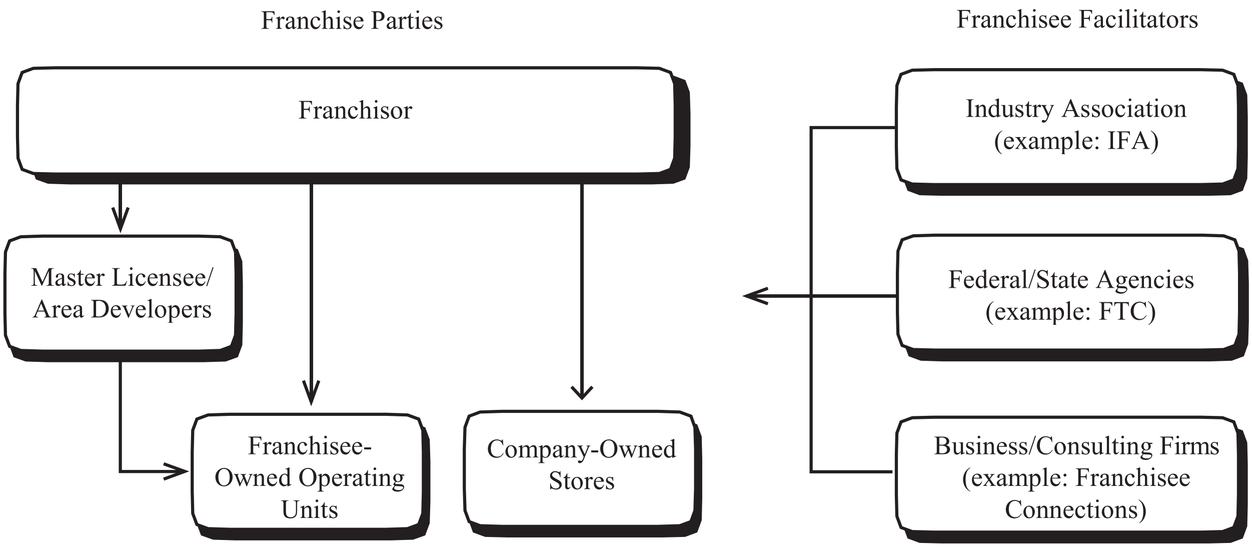

Fig. 3.1 The structure of franchising

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

In addition to these parties, the franchising industry contains other important groups called facilitators. Facilitators include industry associations, governmental agencies and private businesses.

The International Franchise Association (http://www.franchise.org), or IFA, is an important industry association that serves franchise members by attempting to safeguard and enhance the business and regulatory environment of the industry. It has over 30,000 members—franchisors, franchisees, and suppliers—that operate in more than 100 countries. Nevertheless, the IFA is highly selective, and not all companies applying for membership are accepted. Referring to itself as "The Voice of Franchising," the IFA sponsors legal and government affairs conferences, franchise management workshops, seminars on franchisor/franchisee relations, and trade shows. The IFA also champions the causes of minority business groups. For example, the Women's Franchise Committee (WFC), formed in 1996, provides leadership conferences, mentoring programs, a network of professionals, and other services for women franchisees.

Numerous federal and state agencies are involved in the franchise industry. Agencies such as the Federal Trade Commission (http://www.ftc.gov), or FTC, provide information on franchise opportunities and enforce franchising laws and regulations. Presale franchise disclosure practices are subject to special scrutiny by these agencies.

A third category of facilitators includes private businesses providing franchise information and consulting services to franchisors and franchisees. For example, Franchise Connections (http://www.franchiseconnections.com) and The Franchise Company (http://www.thefranchisecompany.com) are two businesses that assist with franchising evaluation and offer development services.

3.5 Evaluating Franchise Opportunities

After making a decision to pursue a franchising opportunity, the prospective franchisee must identify a franchise candidate and investigate it completely. As we discuss the investigation process, we will continue to use examples involving Wing Zone, a takeout/ delivery restaurant franchise featuring buffalo wings.

3.5.1 Selecting a Franchise

With the growth of franchising over the years, the task of selecting an appropriate franchise has become easier. Personal observation frequently sparks interest, or awareness may begin with exposure to an advertisement in a newspaper or magazine or on the Internet. The headlines of these advertisements usually highlight the financial and personal rewards sought by the entrepreneur. Inc., Entrepreneur, and the Wall Street Journal are three examples of publications that include advertisements of franchisors.

3.5.2 Investigating the Potential Franchise

The nature of the commitment required in franchising justifies careful investigation of information on franchising. Basically, three sources of information should be tapped:

Independent third-party sources of information

- State and federal agencies are valuable sources of franchising information. Since most states require registration of franchises, a prospective franchisee should not overlook state offices as a source of assistance. The Federal Trade Commission publishes the Franchise Opportunities Handbook, which is a useful directory of hundreds of franchisors. Also, a comprehensive listing of franchisors can be found in the Franchise Opportunities Guide, which is published by the International Franchise Association. Launching a franchised business typically requires a substantial financial investment, usually many thousands of dollars. Furthermore, the business relationship generally continues over a period of years.
- The evaluation process is a two-way process. The franchisor wishes to investigate the franchisee, and the franchisee obviously wishes to evaluate the franchisor and the type of opportunity being offered. Time is required for this kind of analysis. It should be sceptical of a franchisor pressurising to sign a contract without time for proper investigation.

The franchisor as a source of information

- Obviously, the franchisor being evaluated is a primary source of information. However, information provided by a franchisor must be viewed in light of its purpose—to promote the franchise.
- One way to obtain information about franchisors is to communicate directly with them. For example, when we decided to investigate the franchise Wing Zone, we first accessed its home page. Request was given for the information, and within a few days packet containing an attractive brochure and various marketing materials reached. The brochure included such information as start-up costs and franchisees' testimonials.
- It is important for potential franchisees that many of the financial figures provided in the franchisor's information packet are only estimates. While profit claims are becoming more common, reputable franchisors are careful not to misrepresent what a franchisee can expect to attain in terms of sales, gross income, and profits. The importance of earnings to a prospective franchisee makes the subject of profit claims a particularly sensitive one.
- After an entrepreneur has expressed further interest in a franchise by completing the application form and the franchisor has tentatively qualified the potential franchisee, a meeting is usually arranged to discuss the disclosure document. A disclosure document is a detailed statement of such information as the franchisor's finances, experience, size, and involvement in litigation. The document must inform potential franchisees of any restrictions, costs, and provisions for renewal or cancellation of the franchise.

Existing and previous franchisees as sources of information

- There is better source of franchise facts than existing franchisees. Sometimes, however, the distant location of other franchisees precludes a visit to their place of business. In that case, a simple telephone call can elicit that person's viewpoint. If possible, talk also with franchisees that left the business; they can offer valuable insights into their decision to give up the franchise.

3.5.3 Finding Global Franchising Opportunities

A great opportunity continues to exist for small business firms in the United States to franchise internationally. Traditionally, U.S. franchisors did most of their international franchising in Canada because of that country's proximity and language similarity. This, however, has changed. A combination of events, including the structuring of the European Union (EU) and the passage of the North American Free Trade Agreement (NAFTA), has opened other foreign markets to U.S. franchisors.

Although the appeal of foreign markets is substantial, the task of franchising abroad is not easy. The challenges of international franchising are described on the website of Gaebler Ventures in the following way: International franchising is more risky than domestic franchising, but there's a world of opportunity out there. Whether you are a franchisor or a franchisee, international franchising could put you on track to achieve your business and personal goals beyond your wildest dreams. But, be sure you understand some of the differences between international franchising and domestic franchising. Unlike domestic franchising, international franchising requires an added level of expertise, primarily around issues involved with doing business in an unfamiliar cultural context.

The good news is that the challenges of international franchising are not insurmountable. Regardless of whether you are a current business owner exploring the possibility of franchising your company internationally or a potential new business owner interested in opening a franchise abroad, you can take advantage of opportunities in international franchising by addressing a few issues upfront.

Many sources of international franchising information are available to entrepreneurs. Many U.S. government publications are helpful, as is the information on several websites, such as that of the International Herald-Tribune. Also, individual foreign countries may host websites that contain useful information about franchising opportunities in that country; the British Franchising Association's site at http://british-franchise.org is one example.

3.5.4 Legal Issues in Franchising

Last but not the least, one must consider the legal issues in franchising.

The franchise contract

The basic features of the relationship between the franchisor and the franchisee are included in the franchise contract. This contract is typically a complex document, running to many pages. Because of its importance as the legal basis for the franchised business, the franchise contract should never be signed by the franchisee without legal counsel. In fact, reputable franchisors insist that the franchisee have legal counsel before signing the agreement. An attorney may anticipate trouble spots and note any objectionable features of the contract. In addition to consulting an attorney, a prospective franchisee should use as many other sources of help as practical.

In particular, he or she should discuss the franchise proposal with a banker, going over it in as much detail as possible. The prospective franchisee should also obtain the services of a professional accounting firm in examining the franchisor's statements of projected sales, operating expenses, and net income. An accountant can help in evaluating the quality of these estimates and in identifying projections that may be unlikely to be realised.

One of the most important features of the franchise contract is the condition relating to termination and transfer of the franchise. Some franchisors have been accused of devising agreements that permit arbitrary cancellation of the franchise relationship. Of course, it is reasonable for the franchisor to have legal protection in the event that a franchisee fails to obtain an appropriate level of operation or to maintain satisfactory quality standards.

The prospective franchisee should be wary of contract provisions that contain overly strict cancellation policies. Similarly, the rights of the franchisee to sell the business to a third party should be clearly stipulated. A franchisor who can restrict the sale of the business to a third party could potentially assume ownership of the business at an unreasonably low price. The right of the franchisee to renew the contract after the business has been built up to a successful operating level should also be clearly stated in the contract.

Franchise disclosure requirements

The offer and sale of a franchise are regulated by both state and federal laws. At the federal level, the minimum disclosure standards are specified by Rule 436 of the Federal Trade Commission (FTC). The rule, formally entitled "Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures," went into effect in October of 1979.

A guide to the rule can be found on the Federal Trade Commission's website at http://www.ftc.gov/bcp/franchise/netrule.htm. Addresses of the state offices administering franchise disclosure laws can be found at http://www.ftc.gov/bcp/franchise/netdiscl.htm.

A document called the Uniform Franchise Offering Circular (UFOC) provides the accepted format for satisfying the franchise disclosure requirements of the FTC. The original UFOC format was amended in April 1993 by its creator, the North American Securities Administrators Association (NASAA). On January 1, 1996, all franchisors using the UFOC disclosure format were obliged to abide by the new amendments.

The UFOC disclosure must include information on a variety of items, including litigation and bankruptcy history, investment requirements, and conditions that would affect renewal, termination, or sale of the franchise. Most franchise experts recommend that a franchisee's attorney and accountant review the document. Another option for the entrepreneur seeking to make his or her dream a reality is buying an existing business. In the next section, we discuss some of the issues facing the individual who chooses this alternative.

3.6 Buying an Existing Business

For would-be entrepreneurs, one alternative to starting from scratch or buying a franchise is to buy an established business. The decision to purchase an existing business should be made only after careful consideration of the advantages and disadvantages.

3.6.1 Reasons for Buying an Existing Business

The reasons for buying an existing business can be condensed into the following four general categories:

- To reduce some of the uncertainties and unknowns that must be faced in starting a business from the ground up
- To acquire a business with ongoing operations and established relationships with customers and suppliers
- To obtain an established business at a price below what it would cost to start a new business or to buy a franchise
- To begin a business more quickly than by starting from scratch

Reduction of uncertainties

A successful business has already demonstrated its ability to attract customers, manage costs, and make a profit. Although future operations may be different, the firm's past record shows what it can do under actual market conditions. For example, just the fact that the location must be satisfactory eliminates one major uncertainty. Although traffic counts are useful in assessing the value of a potential location, the acid test comes when a business opens its doors at that location. This test has already been met in the case of an existing firm. The results are available in the form of sales and profit data. Non-compete agreements are needed, however, to discourage the seller from starting a new company that will compete directly with the one being sold.

Acquisition of ongoing operations and relationships

The buyer of an existing business typically acquires its personnel, inventories, physical facilities, established banking connections, and ongoing relationships with trade suppliers and customers. Extensive time and effort would be required to build these elements from scratch. Of course, the advantage derived from buying an established firm's assets depends on the nature of the assets. For example, a firm's skilled, experienced employees constitute a valuable asset only if they will continue to work for the new owner. The physical facilities must not be obsolete, and the firm's relationships with banks, suppliers, and customers must be healthy. In any case, new agreements will probably have to be negotiated with current vendors and leaseholders.

A new business owner who fails to carefully consider the nature of the assets may face some unpleasant surprises. Consider the experience of Norman Savage. Shortly after buying a small mortgage company in Fort Wayne, Indiana, Savage learned that the seller had given some employees 20 percent pay increases after the deal was made, effectively buying for himself credit for being a generous boss and leaving the cost of that generosity for Savage to pay. In addition, some of the firm's business licenses were about to expire, and Savage had difficulty locating the necessary documents to renew them. To top it off, one of the office computers needed to be replaced.

On the other hand, Thomas J. Cerri encountered no such problems when he bought Mill Valley Lumber Company in Mill Valley, California. He recalls, "When we took over, eight key employees stayed on with us, and it really made all the difference." The sales staff had nearly 100 years of experience among them and "seemed to be friends with everyone in the area." With a well-connected sales staff and other key employees staying on the job, Mill Valley Lumber continued to enjoy a close relationship with its customers, despite the invasion of giant competitors like Home Depot.

A bargain price

If the seller is more eager to sell than the buyer is to buy, an existing business may be available at what seems to be a low price. Whether it is actually a good buy, however, must be determined by the prospective new owner. Several factors could make a "bargain price" anything but a bargain. For example, the business may be losing money, the neighbourhood location may be deteriorating, or the seller may intend to open a competing business nearby. On the other hand, if research indicates that the business indeed is a bargain, purchasing it is likely to turn out to be a wise investment.

A quick start

Most entrepreneurs are eager to easily jump in their new business and may not be comfortable waiting the months and years sometimes required to launch a business from scratch. Buying an existing business may be an excellent way to begin operations much more quickly.

3.6.2 Finding a Business to Buy

Sometimes, in the course of day-to-day living and working, a would-be buyer comes across an opportunity to buy an existing business. For example, a sales representative for a manufacturer or a wholesaler may be offered an opportunity to buy a customer's retail business. In other cases, the prospective buyer needs to search for a business to buy.

Sources of leads about businesses available for purchase include suppliers, distributors, trade associations, and even bankers. Realtors particularly those who specialise in the sale of business firms and business properties can also provide leads.

In addition, there are specialised brokers, called matchmakers, who handle all the arrangements for closing a buyout. A large number of matchmakers, such as Certified Business Brokers (http://www.certifi edbb.com) in Houston, Texas, deal with mergers and acquisitions of small and mid-sized companies in the United States. Entrepreneurs need to be wary of potential conflicts of interest with matchmakers, however. For example, if matchmakers are paid only if a buy–sell transaction occurs, they may be tempted to do whatever it takes to close the deal, even if doing so is detrimental to the buyer.

3.6.3 Investigating and Evaluating Available Businesses

Regardless of the source of the lead, a business opportunity requires careful evaluation— what some call due diligence. As a preliminary step, the buyer needs to acquire background information about the business, some of which can be obtained through personal observation or discussion with the seller. Talking with other informed parties, such as suppliers, bankers, employees, and customers of the business, is also important.

Relying on professionals

Although some aspects of due diligence require personal checking, a buyer can also seek the help of outside experts. The two most valuable sources of outside assistance are accountants and lawyers. It is also wise to seek out others who have acquired a business, in order to learn from their experience. Their perspective will be different from that of a consultant, and it will bring some balance to the counsel received.

The time and money spent on securing professional help in investigating a business can pay big dividends, especially when the buyer is inexperienced. However, the final consequences of a business purchase, good and bad, are borne by the buyer, and thus the prospective buyer should never leave the final decision to the experts. For one thing, it is a mistake to assume that professionals' help is either unbiased or infallible, particularly when their fees may be greater if the business is acquired. Prospective buyers should seek advice and counsel, but they must make the final decision themselves, as it is too important to entrust to someone else.

Finding out why the business is for sale

The seller's real reasons for selling may or may not be the stated ones. When a business is for sale, always question the owner's reasons for selling. There is a real possibility that the firm is not doing well or that underlying problems exist that will affect its future performance. The buyer will be different; therefore it is better to take the seller's explanations at face value.

Here are some of the most common reasons that owners offer their businesses for sale:

- Old age or illness
- Desire to relocate to a different part of the country
- Decision to accept a position with another company
- Unprofitability of the business
- Loss of an exclusive sales franchise
- Maturing of the industry and lack of growth potential

A prospective buyer cannot be certain that the seller-owner will be honest in presenting all the facts about the business, especially concerning financial matters. Too frequently, sellers have "cooked the books" or taken unreported cash out of the business.

The only way for the buyer to avoid an unpleasant surprise later is to do his or her best to determine whether the seller is an ethical person. The following story highlights the importance of investigating the honesty of people selling a business:

An employee at a private equity firm (a company that buys or invests in other companies) was responsible for expansion into Eastern Europe. He discovered an opportunity to invest in a manufacturing company that had been formerly owned by the government and recently privatised. The chief executive officer of this company was likable and highly competent. However, as the negotiations carried on for months, it was discovered that the CEO had been convicted of embezzling money from his former employer and had ties to organised crime. In light of this discovery, negotiations with the CEO were terminated immediately.

The important lesson in this story is that background checks on key personnel should be the first action performed when conducting due diligence.

Examining the financial data

The first stage in evaluating the financial health of a firm is to review the financial statements and tax returns for the past five years or for as many years as they are available. This first stage helps determine whether the buyer and the seller are in the same ballpark. If so, the parties move on to the second stage (discussed in the next section) valuing the firm.

To determine the history of the business and the direction in which it is moving the buyer, must examine financial data pertaining to the company's operation. If financial statements are available for the past five years, the buyer can use these to get some idea of trends for the business. As an ethical matter, the prospective buyer is obligated to show the financial statements to others, such as a potential lender or legal advisor, only on a need-to-know basis. To do otherwise is a violation of trust and confidentiality.

The buyer should recognise that financial statements can be misleading and may require normalising to yield a realistic picture of the business. For example, business owners sometimes understate business income in an effort to minimise taxable income. On the other hand, expenses for such entries as employee training and advertising may be reduced to abnormally low levels in an effort to make the income look good in the hope of selling the business.

Other financial entries that may need adjustment include personal expenses and wage or salary payments. For example, costs related to personal use of business vehicles frequently appear as a business expense. Family members may receive excessive compensation or none at all. All entries must be examined to ensure that they relate to the business and are appropriate.

The buyer should also scrutinise the seller's balance sheet to see whether asset book values are realistic. Property often appreciates in value after it is recorded on the books. In contrast, physical facilities, inventory, and receivables may decline in value, so their actual worth is less than their accounting book value. Although these changes in value are generally not reflected in the accountant's records, they should be considered by the prospective buyer.

Valuing the business

Once the initial investigation and evaluation have been completed, the buyer must arrive at a fair value for the firm. Valuing a business is not easy or exact, even in the best of circumstances. Despite the fact that buyers prefer audited financial statements, many firms operate without them. In valuing such firms, the buyer will have to rely on federal tax returns and state sales tax statements. It may also be helpful to scrutinise invoices and receipts of customers and suppliers as well as the firm's bank statements.

Although numerous techniques are used for valuing a company, they are typically derivations of three basic approaches:

- Asset-based valuation
- Market-comparable valuation
- Cash flow based valuation

3.6.4 Non-quantitative Factors in Valuing a Business

There are a lot of factors for evaluating the current business. These factors include:

- **Competition:** The prospective buyer should look into the extent, intensity, and location of competing businesses. In particular, the buyer should check to see whether the business in question is gaining or losing in its race with competitors. Additionally, new competitors to the marketplace (for example, Wal-Mart) may dramatically change an existing firm's likelihood of success. Past performance is no guarantee of future performance.
- **Market:** The ability of the market to support all competing business units, including the one to be purchased, should be determined. This requires marketing research, study of census data, and personal, on-the-spot observation at each competitor's place of business.
- **Future community development:** Examples of future developments in the community that could have an indirect impact on a business include a change in zoning ordinances already enacted but not yet in effect, a change from a two-way traffic flow to a one-way traffic flow, and the widening of a road or construction of an overpass.
- **Legal commitments:** Legal commitments may include contingent liabilities, unsettled lawsuits, delinquent tax payments, missed payrolls, overdue rent or instalment payments, and mortgages of record against any of the real property acquired.
- **Union contracts:** The prospective buyer should determine what type of labour agreement, if any, is in force, as well as the quality of the firm's employee relations. Private conversations with key employees and rank-and-file workers can be helpful in determining their job satisfaction and the company's likelihood of success.
- **Buildings:** The quality of the buildings housing the business should be checked, with particular attention paid to any fire hazards. In addition, the buyer should determine whether there are any restrictions on access to the buildings.
- **Product prices:** The prospective owner should compare the prices of the seller's products with those listed in manufacturers' or wholesalers' catalogues and also with the prices of competing products in the locality. This is necessary to ensure full and fair pricing of goods whose sales are reported on the seller's financial statements.

3.6.5 Negotiating and Closing the Deal

The purchase price of a business is determined by negotiation between buyer and seller. Although the calculated value may not be the price eventually paid for the business, it gives the buyer an estimated value to use when negotiating price. Typically, the buyer tries to purchase the firm for something less than the full estimated value; of course, the seller tries to get more than that value.

In some cases, the buyer may have the option of purchasing the assets only, rather than the business as a whole. When a business is purchased as a total entity, the buyer takes control of the assets but also assumes any outstanding debt, including any hidden or unknown liabilities. Even if the financial records are audited, such debts may not surface.

If the buyer instead purchases only the assets, then the seller is responsible for settling any outstanding debts previously incurred. An indemnification clause in the sales contract may serve a similar function, protecting the buyer from liability for unreported debt.

An important part of the negotiation process is the terms of purchase. In many cases, the buyer is unable to pay the full price in cash and must seek extended terms. At the same time, the seller may be concerned about taxes on the profit from the sale. Terms may become more attractive to the buyer and the seller as the amount of the down payment is reduced and/or the length of the repayment period is extended. Like a purchase of real estate, the purchase of a business is closed at a specific time. A title company or an attorney usually handles the closing. Preferably, the closing occurs under the direction of an independent third party. If the seller's attorney is the closing agent, the buyer should exercise caution—a buyer should never go through a closing without the aid of an experienced attorney who represents only the buyer.

A number of important documents are completed during the closing. These include a bill of sale, certifications as to taxing and other government regulations, and agreements pertaining to future payments and related guarantees to the seller. The buyer should apply for new federal and state tax identification numbers to avoid being held responsible for past obligations associated with the old numbers.

Summary

- Franchises are also known as chain stores. They operate business under a special arrangement.
- The buyout process usually begins when an interested purchaser or group of purchasers makes a formal buyout offer to a company's board of directors, who are the representatives of the company's shareholders.
- The training given by franchisors is invaluable to many small entrepreneurs because it compensates for weaknesses in their managerial skills.
- The costs of starting an independent business are often high, and the typical entrepreneur's sources of capital are quite limited.
- Most franchised products and services are widely known and accepted.
- Higher costs characterise the better known and more successful franchises.
- Franchisors are concerned about the image of their businesses; make every effort to control how franchisees conduct certain aspects of the franchise business.
- Frequently, individuals leave salaried employment for entrepreneurship because they dislike working under the direct supervision and control of others.
- The potential value of a franchising arrangement is defined by the rights contained in a legal agreement known as the franchise contract; the rights it conveys are called the franchise.
- The basic features of the relationship between the franchisor and the franchisee are included in the franchise contract.
- A successful business has already demonstrated its ability to attract customers, manage costs, and make a profit.
- Most entrepreneurs are eager to easily jump in their new business and may not be comfortable waiting the months and years sometimes required to launch a business from scratch.
- Although some aspects of due diligence require personal checking, a buyer can also seek the help of outside experts.

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Recommended Reading

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- Stokes, D. & Wilson, N., 2006. *Small business management and entrepreneurship*, 5th ed., Cengage Learning EMEA.
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Chapter IV

Developing the New Venture Business Plan

Aim

The aim of this chapter is to:

- introduce the purpose of business plan in small business
- recognise importance of selecting a good location for small scale business
- identify financing options available for small business

Objectives

The objectives of this chapter are to:

- analyse the business plans for small scale industry
- explain the type of loans available for small scale business
- discuss the need for financial considerations

Learning outcome

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

- understand the need and purpose of a business plan
- know the different financial options
- discuss the benefits of a good location for small scale industry

4.1 Introduction

A business plan is a formal statement of a set of business goals, which are believed to be attainable, and the plan for reaching those goals. It may also contain background information about the organisation or team attempting to reach those goals. Business plans may also target changes in perception and branding by the customer, client, tax-payer, or larger community. When the existing business is to assume a major change or when planning a new venture a 3 to 5 year business plan is required, since investors will look for their annual return in the 3 to 5 year time.

4.2 The Purpose of a Business Plan

There is no one correct formula for a business plan. After all, no one plan will work in all situations. But, in general, a business plan is a document that outlines the basic idea underlying a business and describes related start-up considerations. A business plan is an entrepreneur's game plan; it crystallises the dreams and hopes that motivate an entrepreneur to take the start-up plunge. The business plan should lay out your basic idea for the venture and include descriptions of where you are now, where you want to go, and how you intend to get there.

David Gumpert, who headed up the MIT Enterprise Forum, offers a concise and practical definition of a business plan, "It's a document that convincingly demonstrates that your business can sell enough of its product or service to make a satisfactory profit and to be attractive to potential backers."For Gumpert, the business plan is essentially a selling document used to convince key individuals, both inside and outside the firm, that the venture has real potential. Equally important, it is an opportunity to convince yourself, the entrepreneur, that what appears to be a good idea is also a good investment opportunity, both economically and in terms of your personal goals.

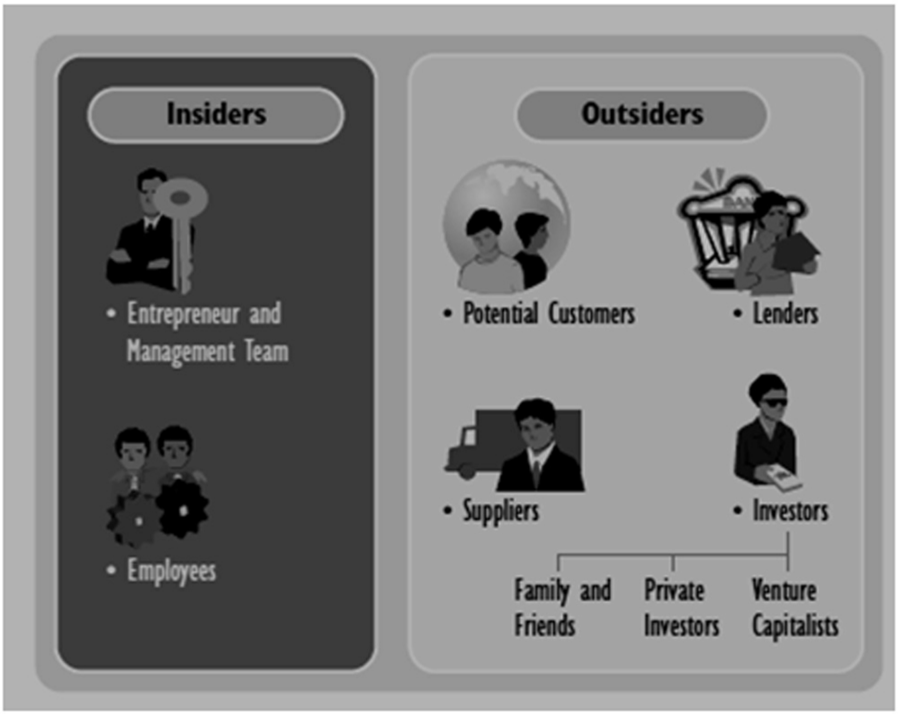

Fig. 4.1 Users of business plan

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

For the entrepreneur starting a new venture, a business plan has three basic objectives:

- To identify the nature and the context of the business opportunity i.e., why does such an opportunity exist
- To present the approach the entrepreneur plans to use to exploit the opportunity
- To recognise factors that will determine whether the venture will be successful

The figure given above provides an overview of those who might have an interest in a business plan for a new venture.

The first group consists of the internal users of the plan:
- The entrepreneur
- The new firm's management and employees

The second group consists of outsiders who are critical to the firm's success:
- Its prospective customers
- Suppliers
- Lenders
- Investors

4.2.1 Need of Business Plan

The justification used for not writing a business plan goes something like this: "Companies that start up based on business plans are no more successful than those that do not." It is true that studies attempting to measure the success of entrepreneurs with business plans against the success of those without have produced mixed results.

Given what we know about Apple, Calvin Klein, and other businesses started without business plans, clearly having a business plan is not a prerequisite for success. This simply tells us that the business plan is not the business. It may well be that some entrepreneurs spend untold hours writing a 60-page business plan with another 50 pages of appendixes but never follow the plan.

In such cases, writing the plan was a waste of time. If the plan is not going to lead to action, there is no need to bother to write it. Only if you execute the business plan, it has a good chance of making a difference. Thomas Stemberg, the founder of Staples who later became a venture capitalist, says it well.

4.3 Marketing of Small Business

Marketing is always different things to different people. Some entrepreneurs view marketing as simply selling a product or service. Others see marketing as those activities directing the flow of goods and services from producer to consumer or user. In reality, small business marketing is much broader. It consists of many activities, some of which occur even before a product is produced and made ready for distribution and sale.

A comprehensive definition of small business marketing helps to convey its true scope to entrepreneurs. Small business marketing consists of those business activities that direct the creation, development, and delivery of a bundle of satisfaction from the creator to the targeted user and that satisfy the targeted user. It should be noticed that this definition emphasises the concept of a bundle of satisfaction, i.e., a core product and or service plus all its important extras. It may be helpful to view a product/service as having three levels as seen in the figure given below.
- Core product/service
- Actual product/service
- Augmented product/ service

The core product/service is the fundamental benefit or solution sought by customers. The actual product/service is the basic physical product/service that delivers those benefits. The augmented product/service is the basic product/ service plus extra or unsolicited benefits to the consumer that may prompt a purchase.

In the case of television, for example, the core product is entertainment and/or information (the news); the actual product is the physical television set. The augmented product might include the ability to vote on acts that appear on American Idol or the ability to watch a live sports event.

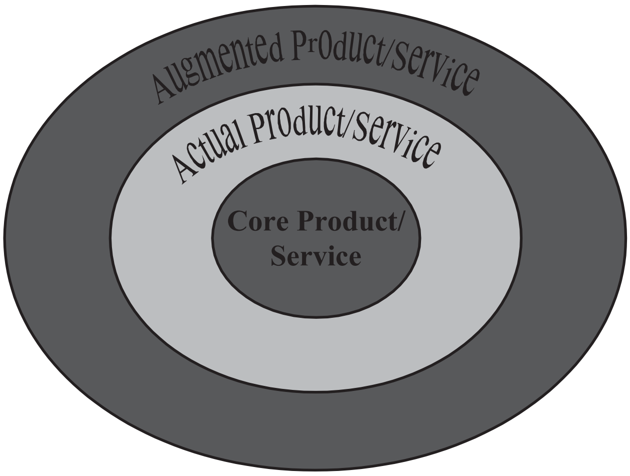

Fig. 4.2 The three levels of a product/service
(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures,* 14th ed., Thomson South-Western.)

Ultimately, a business provides satisfaction to its customers, not merely the tangible product or intangible service that is the focus of the exchange. Let us consider Blue Nile Incorporated, which sells engagement rings and other jewellery through website. Although Jewellery is its core product, the bundle of satisfaction the firm provides includes more than jewellery. In keeping with the company's strong commitment to helping customers make the right purchase, Blue Nile's website provides a great deal of extra information. This assistance, along with competitive prices and free shipping, is part of the bundle of satisfaction offered. And it appears to be working well.

4.3.1 Marketing Plan

After the entrepreneur's idea has been examined and judged to be a viable opportunity, whether he or she is ready to prepare the formal marketing plan. Each business venture is different; therefore, each marketing plan is unique. An entrepreneur should not feel it necessary to develop a cloned version of a plan created by someone else i.e., even the one suggested by the authors of this textbook. Nevertheless, most marketing plans should cover market analysis, the competition, and marketing strategy.

Fig. 4.3 Marketing plan and supporting marketing activities
(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures,* 14th ed., Thomson South-Western.)

4.3.2 Market Analysis

In the market analysis section of the marketing plan, the entrepreneur describes the target market. This description of potential customers is commonly called a customer profile.

Marketing research information, compiled from both secondary and primary data, can be used to construct this profile. A detailed discussion of the major benefits to customers provided by the new product or service should also be included in this section of the plan. Obviously, these benefits must be reasonable and consistent with statements in the product/service section of the plan. The review the following excerpt from the "Market Needs" section of the marketing plan of Adorable Pet Photography, a home-based business located in Atlanta, Georgia.

If an entrepreneur envisions several target markets, each segment must have a corresponding customer profile. Likewise, different target markets may call for an equal number of related marketing strategies. Typically, however, a new venture will initially concentrate on a select few target markets or even just one. Another major component of market analysis is the actual sales forecast. It is usually desirable to include three sales forecasts covering the "most likely," "pessimistic," and "optimistic" scenarios. These scenarios provide investors and the entrepreneur with different numbers on which to base their decisions.

4.3.3 Competition

Frequently, entrepreneurs ignore the reality of competition for new ventures, believing that the marketplace contains no close substitutes or that their success will not attract other entrepreneurs. This is simply not realistic. Existing competitors should be studied carefully, and their key management personnel profiled. A brief discussion of competitors' overall strengths and weaknesses should be a part of the competition section of the plan. Also, related products currently being marketed or tested by competitors should be noted.

An assessment should be made of the likelihood that any of these firms will enter the entrepreneur's target market. A SWOT analysis is always a good idea. It is important that your company have a clear understanding of what it does well (strengths), what it doesn't do so well (weaknesses), available market opportunities, and threats from competitors as well as from changes in the company's operating environment (social, technological, economic, political, and other environmental variables).

4.3.4 Marketing Strategy

A well-prepared market analysis and competition discussions are important to the formal marketing plan. But the information on marketing strategy forms the most detailed section of the marketing plan and, in many respects, is subject to the closest scrutiny from potential investors. Such a strategy plots the course of the marketing actions that will make or break the entrepreneur's vision.

Four areas of marketing strategy that should be addressed include:

- Product decisions that will transform the basic product or service idea into a bundle of satisfaction
- Distribution activities regarding the delivery of the product to customers
- Pricing decisions that will set an acceptable exchange value on the total product or service
- Promotion activities that will communicate the necessary information to target markets

4.4 Location Plan

An entrepreneur has several options when deciding where to locate his or her business either:

- In a brick-and- mortar building
- At home
- On the Web
- In some combination of the above places

The Internet has radically transformed how business is conducted; it is now the location of choice for many entrepreneurs. The online auction site eBay is a shining example of what's possible on the Internet.

The entrepreneur when decides to purchase a franchise or an existing business usually receives considerable location guidance from the franchisor or members of the existing firm. But for the entrepreneur who chooses to start a venture from scratch, the location decision is very time consuming. Regardless of how the decision is made, all location intentions should be described in the business plan.

In many cases, the choice of a location is a one-time decision. However, an entrepreneur may later consider relocating the business to reduce operating costs or gain other advantages. Here consideration is required for three primary options for the initial location decision, a traditional physical building, the entrepreneur's home, and a website on the Internet.

Although we recognise that the Internet can be an integral part of operations for both a traditional and a home-based business, we treat e-commerce ventures in a separate category because of the Internet's significance as a sole sales outlet for these small businesses. The figure given below depicts the three location options.

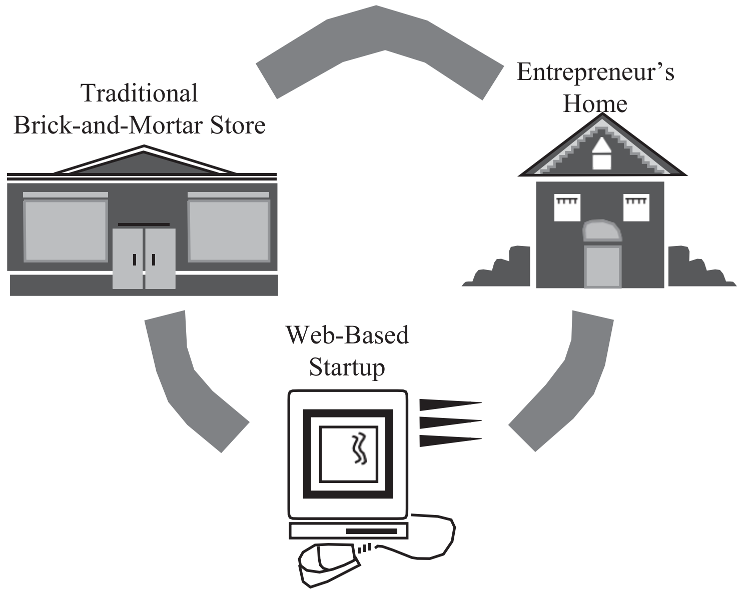

Fig. 4.4 Location options for the start-up

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures,* 14th ed., Thomson South-Western.)

4.4.1 Importance of Location Decision

The importance of the initial decision is where to locate a traditional physical building, a brick-and-mortar store which is underscored by both the high cost of such a store and the hassle of pulling up stakes and moving an established business. Also, if the site is particularly poor, the business may never become successful, even with adequate financing and superior managerial ability. The importance of location is so clearly recognised by national chains that they spend thousands of dollars investigating sites before establishing new stores.

The choice of a good location is much more vital to some businesses than to others. For example, the site chosen for a dress shop can make or break the business because it must be convenient for customers. In contrast, the physical location of the office of a painting contractor is of less importance, since customers do not need frequent access to the facility. Even painting contractors, however, may suffer if their business site is poorly chosen.

4.4.2 Factors in Selecting a Good Location

Five key factors are shown in figure given below to guide the location selection process:

- Customer accessibility
- Business environment conditions
- Availability of resources
- The entrepreneur's personal preference
- Site availability and costs

Other factors relevant to location include neighbour mix, security and safety, services, past tenants' fate, and the life-cycle stage of the area. In this particular situation, one factor may carry more weight than others. However, each of the five key factors should always have some influence on the final location decision.

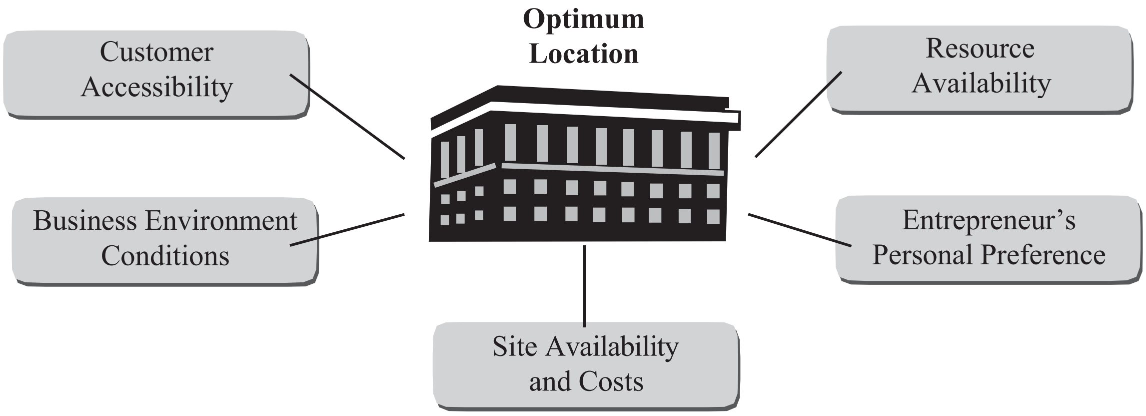

Fig. 4.5 Five key factors in determining a good business location

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Customer accessibility

Customer accessibility is an important consideration in selecting a location. Retail outlets and service firms are typical examples of businesses that must be located so as to make access convenient for target customers. Rarely will customers be willing to regularly travel long distances to shop. Many products, such as snack foods and gasoline, are convenience goods, which require a retail location close to target customers; otherwise, consumers will substitute competitive brands when a need arises. Services such as tire repair and hair styling also require a location readily accessible to customers.

Choosing the best location for a retail store used to be a hit-or-miss proposition. The recent emergence of site-selection software has removed much of the guesswork from finding a good location. Its popularity has taken off as the software has become more sophisticated and user-friendly.

Site-selection software programs can now give users access to demographic information such as age, income, and race for specific neighbourhoods, as well as information on other businesses located nearby, climate, traffic flow, and more. Convenient access for customers is one reason small businesses have successfully created such a strong presence on the Internet. With the appropriate computer connection, customers can access a small business's home page from anywhere in the world.

Business environment conditions

A start-up business is affected in a number of ways by the environment in which it operates. Environmental conditions can hinder or promote success. Weather is one important environmental factor that influences the location decision, as well as the demand for many products such as air conditioners and outdoor swimming pools. Environmental issues were particularly important to entrepreneur Tsering Gyalzen, who planned to build a cybercafé, containing eight laptop computers and solar-powered generators, at the 17,400-foot-high base camp of Mount Everest. He will be forced to construct a temporary structure because the base camp sits on a glacier that moves several inches each day.

Competition, legal requirements, and tax structure are a few of the other critical environmental factors. Every entrepreneur seeks profits; therefore, all factors affecting the financial picture are of great concern. State and local governments can help or hinder a new business by forgiving or levying taxes. Obviously, the best time to evaluate environmental conditions is prior to making a location commitment.

While most efforts of state and city governments are designed to support start-ups, most cities have regulations that restrict new business operations under certain circumstances.

For example, cities have zoning ordinances that may limit the operations of home-based businesses. Limitations typically relate to vehicular traffic and parking, signage, nonrelated employees working in a home, the use of a home more as a business than as a residence, the sale of retail goods to the public, and the storage of hazardous materials and work-related equipment.

Availability of resources

The availability of resources associated with producing a product and operating a business should be considered in selecting a location. Raw materials, labour supply, and transportation are some of the factors that have a bearing on location. Nearness to raw materials and suitability of labour supply are particularly critical considerations in the location of a manufacturing business.

- **Suitability of labour supply:** A manufacturer's labour requirements depend on the nature of its production process. Availability of workers, wage rates, labour productivity, and a history of peaceful relations with employees are all particularly important considerations for labour-intensive firms. In some cases, the need for semiskilled or unskilled labour justifies locating in an area with surplus labour. In other cases, firms find it desirable to seek a pool of highly skilled labour.
- **Availability of transportation:** Access to good transportation is important to almost all firms. For example, good highways and bus systems provide customers with convenient access to retail stores. For small manufacturers, quality transportation is especially vital. They must carefully evaluate all the trucking routes that support their transportation needs, considering the costs of both transporting supplies to the manufacturing location and shipping the finished product to customers. It is critical that they know whether these costs will allow their product to be competitively priced.

Personal preference of the entrepreneur

As a practical matter, many entrepreneurs discount customer accessibility, business environment conditions, and resource availability and consider only their personal preference in locating a business. Often, their personal preference is to stay in their home community; the possibility of locating elsewhere never enters their mind. On the other hand, locating a business in one's home community is not necessarily illogical. In fact, it offers certain advantages.

From a personal standpoint, the entrepreneur generally appreciates and feels comfortable with the atmosphere of the home community, whether it is a small town or a large city. From a practical business standpoint, the entrepreneur can more easily establish credit. Hometown bankers can be dealt with more confidently, and other businesspersons may be of great service in helping evaluate a given opportunity.

Site availability and costs

Once an entrepreneur has settled on a certain area of the country, a specific site must still be chosen. The availability of potential sites and the costs associated with obtaining them must be investigated. Site availability should be after evaluating a site for his new business, one entrepreneur is said to have exclaimed, "It must be a good site, I know of four businesses that have been there in the last two years!" Fortunately, such a misguided approach to site evaluation is not typical of entrepreneurs, many of whom recognise the value of seeking professional assistance in determining site availability and appropriateness.

If an entrepreneur's top choices are unavailable, other options must be considered. One choice is shared facilities. In recent years, business incubators have sprung up in all areas of the country. A business incubator is a facility that rents space to new businesses or to people wishing to start businesses. Incubators are often located in recycled buildings, such as abandoned warehouses or schools. They serve fledgling businesses by making space available, offering management advice, and providing clerical assistance, all of which help lower operating costs. An incubator tenant can be fully operational the day after moving in, without buying phones, renting a copier, or hiring office employees.

Ultimately, the site selection process must depend on evaluation of relevant costs. The costs involved in building on a new site may be prohibitive, or the purchase price of an existing structure may exceed the entrepreneur's budget. Assuming that a suitable building is available, the entrepreneur must decide whether to lease or buy. Although ownership confers greater freedom in the modification and use of a building, the advantages of leasing usually outweigh these benefits. We recommend that most new firms lease for two reasons:

- A large cash outlay is avoided. This is important for a new small firm, which typically lacks adequate financial resources.
- Risk is reduced by avoiding substantial investment and by postponing commitments for space until the success of the business is assured and the nature of building requirements is better known.

When entering into a leasing agreement, the entrepreneur should check the landlord's insurance policies to be sure there is proper coverage for various types of risks. If not, the lessee should seek coverage under his or her own policy. It is important to have the terms of the leasing agreement reviewed by an attorney.

4.4.3 Attraction of Home-Based Business

The main attractions of a home-based business relate to financial and family lifestyle considerations as given in figure below.

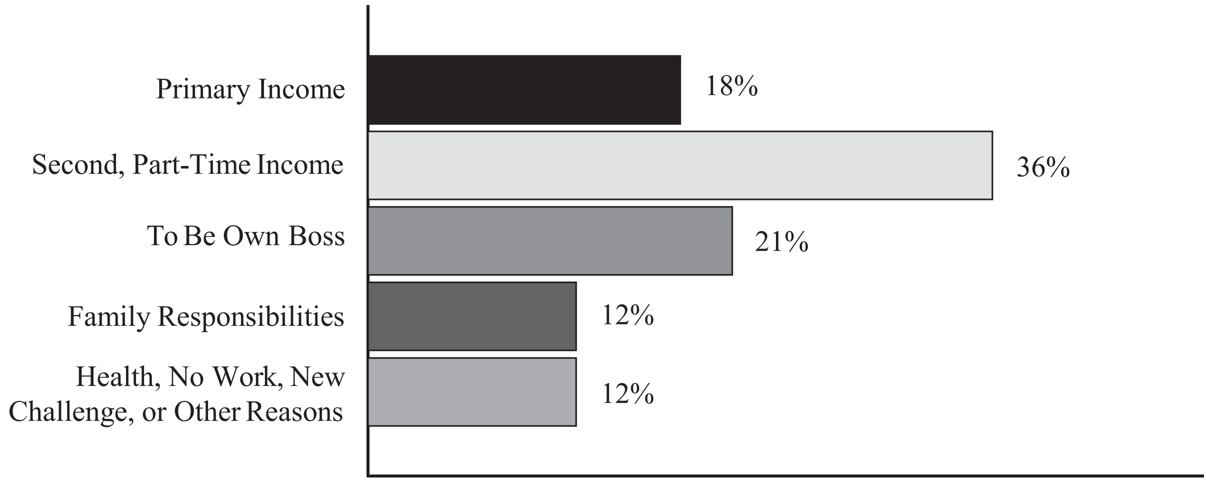

Fig. 4.6 Entrepreneurs' reasons for operating a home-based business

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

Financial considerations

Like most business ventures, a home-based business has an important goal, earning money and locating at home helps increase profits by reducing costs. This was the motivation of Bianca Wright, who does freelance writing for magazines. She needed a computer, office supplies, and an Internet connection for her home-based business venture. With the ups and downs of the advertising industry, Donavan Andrews, 31, and Stephen Smyk, 35, thought it would be best to start their fledgling advertising agency in their home.

Receiving full compensation for her work was Rose Anne Raphael's motivation for starting a home-based business. Her boyfriend noticed that her employer was billing clients more than seven times as much as Raphael was earning. "I was getting paid $17 an hour and the company was billing clients at $125 an hour for my work. That's when I thought I had the opportunity to become self-employed," says Raphael. She's been running a public-relations firm out of a one-bedroom apartment.

Family lifestyle considerations

Many young entrepreneurs remain in a family business because of close family ties. Similarly, entrepreneurs who locate business operations in the home are frequently motivated by the desire to spend more time with family members. Consider the following examples.

Joyce Thomas, 47, owns Chino Hills, California–based Medical Reimbursement Specialists (MRS), a Medicare-compliance company. MRS started out handling electronic claims for local physicians. After two years, Thomas decided to use her experience to train other women to process claims from their homes. She helped start 500 affiliate businesses across the country and won contracts with hospitals nationwide.

4.4.4 Technology and Challenges of Home-Based Business

The challenges of home-based businesses are mainly on their location. Advancements in business-application technology are a major catalyst in the rapid growth of home-based businesses. Personal computers, fax machines, voice mail, and e-mail are among the technological tools that help the home-based business compete effectively with commercial-site businesses. Such technology makes it possible to operate many types of businesses almost anywhere. One important technological tool available to home-based businesses is the Internet. Millions of small firms, which are based at home, are using websites to sell products and services. Virtually every product sold in traditional retail outlets is now sold over the Internet.

Just as most businesses located at commercial sites have their problems; home-based businesses face special challenges attributable to their location. We will briefly examine two of these challenges, business image and legal considerations.

Business image

Maintaining an image of professionalism, while working at home is a major challenge for home-based entrepreneurs. Allowing young children to answer the telephone, for example, may undermine a professional image. Likewise, a baby crying or a dog barking in the background during a phone call can be distracting to a client.

If clients or salespeople visit the home-based business, it is critical that a professional office area be maintained. Space limitations sometimes make this difficult.

Legal considerations

Some local laws pose a problem for home-based businesses. Zoning ordinances, for example, regulate the types of enterprises permitted in various geographical areas. Some cities outlaw any type of home-based business within city limits. Many zoning laws, dating as far back as the 1930s, have never been updated. The intent of such laws is to protect a neighbourhood's residential quality by preventing commercial signs and parking problems. There is also tax issues related to a home-based business. Generally, a separate space must be clearly devoted to business activities in order for the entrepreneur to claim a tax deduction. A certified public accountant can be helpful in explaining these tax regulations. Insurance considerations may also affect a home-based business. An entrepreneur's homeowner's policy is not likely to cover business activities, liabilities, and equipment.

4.4.5 Start-Up Business on Internet

We currently live in a digital economy fuelled by the tremendous growth of the Internet. Access to the Internet continues to transform the way we live and the way business is conducted. It is important for aspiring entrepreneurs to learn as much as they can about cyberspace because there's opportunity online.

Few primary questions to be addressed include:

- What is the Internet and how does it support e-commerce?
- What benefits does e-commerce offer the start-up?
- What business models reflect an e-commerce strategy?

4.4.6 E-Commerce Business Model

E-commerce means electronic commerce, or the paperless exchange of business information via the Internet. It is an alternative means of conducting business transactions that traditionally have been carried out by telephone, by mail, or face to face in brick-and-mortar stores. It is logical to study the circumstances surrounding e-commerce in order to uncover the opportunities the Internet offers as a start-up location.

Let's begin by examining some existing e-commerce business models. The term business model describes a group of shared characteristics, behaviours, and goals that a firm follows in a particular business situation. Online business firms differ in their decisions concerning which customers to serve, how best to become profitable, and what to include on their websites. The real world of e-commerce contains endless combinations of business models. However, it is important to keep in mind that a poorly devised business model can be a major factor in business failure.

Type of customers served

Marketing theory classifies traditional brick-and mortar firms as manufacturers, wholesalers, or retailers, depending on the customers they serve. E-commerce businesses also are commonly distinguished according to customer focus. There are three major categories of e-commerce business models:

- Business-to-business models
  - (B2B) model (selling to business customers) are significantly greater than those for firms with a business-to-consumer (B2C) model (selling to final consumers). Because B2B success stories generally receive less publicity than B2C ventures do, the potential of a B2B opportunity may be overlooked. Aspiring entrepreneurs should be sure to consider the B2B model. All B2B firms do not look alike. One form of B2B strategy emphasises sales transactions. By using online capabilities, a B2B firm can achieve greater efficiency in its selling and buying. International Business Machines (IBM) is a good example. By dealing directly with its corporate customers online, it is able to build its computer systems and related products to meet the specific needs of its customers. As much as IBM relies on the Internet to deliver its business solution, it also has an extensive sales force and consulting services to deliver value to its many customers worldwide.
- Business-to-consumer models
  - In contrast to a B2B model, a business-to-consumer (B2C) model has final consumers as customers. In the traditional retail setting, customers generally approach a business location (a brick-and-mortar store) with the intent of shopping or purchasing. Alternatively, customers might purchase via telephone or mail order, using a printed catalogue. The B2C model introduces another alternative for consumers for buying online.
- Auction site models
  - Here, some entrepreneurs sell their wares over the Internet without either a website or a storefront, by means of e-commerce sites based on the auction site model. Internet auction sites are Web-based businesses offering participants the final consumers and businesses, the ability to list products for bidding by potential buyers. Revenues to the auction site are derived from listing fees and commissions on sales.

4.5 Financial Forecasting

Using the basic financial information discussed helps an owner-manager can develop pro forma financial statements, or projected financial statements. The necessity of financial forecasting is described quite aptly by small business consultant Paul A. Broni:

The pwurpose of pro forma financial statements is to answer three questions:

- How profitable can the firm be expected to be, given the projected sales levels and the expected sales–expense relationships?
- How much and what type of financing (debt or equity) will be used?
- Will the firm have adequate cash flows? If so, how will they be used; if not, where will the additional cash come from?

Preparing historical financial statements, such as income statements, balance sheets, and cash flow statements, is not a difficult task; accountants have perfected that process. Projecting the financials for a new company is another matter, however, and presents a real challenge.

Forecasting profitability

Profits reward an owner for investing in a company and constitute a primary source of financing for future growth. Therefore, it is critical for an entrepreneur to understand the factors that drive profits. A firm's net income is dependent on five variables:

- **Amount of sales:** The dollar amount of sales equals the price of the product or service times the number of units sold or the amount of service rendered.
- **Cost of goods sold**: Cost of goods sold is the cost of producing or purchasing the firm's products or services. These costs can be either fixed (those that do not vary with a change in sales volume) or variable (those that change proportionally with sales).
- **Operating expenses**: These expenses relate to marketing and distributing the product, general and administrative expenses, and depreciation expenses. As with cost of goods sold, operating expenses can be fixed or variable in nature.
- **Interest expense:** An entrepreneur who borrows money agrees to pay interest on the loan principal. For example, a loan of $25,000 for a full year at a 12 percent interest rate results in an interest expense of $3,000 for the year (0.12 _ $25,000).
- **Taxes:** A firm's income taxes are figured as a percentage of taxable income (earnings before taxes).

4.6 Sources of Financing

When initially financing a small business, an entrepreneur will rely on personal savings and then seek financing from family and friends. If these sources are inadequate, the entrepreneur may then turn to more formal channels of financing, such as banks and outside investors.

The figure below gives an overview of the sources of financing of smaller companies. As indicated, some sources of financing, such as banks, business suppliers, asset-based lenders, and the government which are essentially limited to providing debt financing. Equity financing for most entrepreneurs comes from personal savings and, in rare instances, from selling stock to the public. Other sources including friends and family, other individual investors, venture capitalists, and large corporations may provide either debt or equity financing, depending on the situation. Keep in mind that the use of these and other sources of funds are not limited to a start-up's initial financing. Such sources may also be used to finance a firm's day-to-day operations and business expansions.

In presenting the different sources of financing for smaller companies, we will look at

- Sources "close to home"—personal savings, friends and family, and credit cards
- Bank financing, which becomes a primary financing source as the firm grows
- Business suppliers and asset-based lenders
- Private equity investors
- The government
- Large companies and stock sales

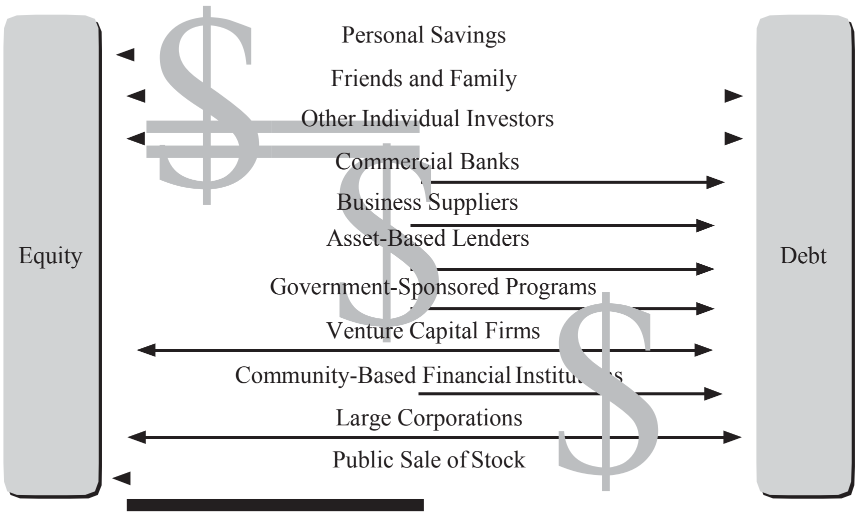

Fig. 4.7 Sources of funds

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

4.6.1 Sources Close to Home

The search for financial support usually begins close to home. The aspiring entrepreneur basically has three sources of early financing: personal savings, friends and family, and credit cards.

Personal savings

It is imperative for an entrepreneur to have some personal investment in the business, which typically comes from personal savings. Indeed, personal savings is by far the most common source of equity financing used in starting a new business. With few exceptions, the entrepreneur must provide an equity base. A new business needs equity to allow for a margin of error. In its first few years, a firm can ill afford large fixed outlays for debt repayment. Also, a banker—or anyone else for that matter—is unlikely to loan venture money if the entrepreneur does not have his or her own money at risk, which is sometimes referred to as "having skin in the game."

Friends and family

Personal savings is the primary source of financing for most small business start-ups, with friends and family following in a distant second place. The figure given below shows that friends, close family, and other relatives provide almost 80 percent of start-up capital from personal sources beyond the entrepreneur's personal savings. Entrepreneurs who acquire financing from friends and family are putting more than just their financial futures on the line as they're putting important personal relationships in jeopardy, too.

However, friends and relatives who provide business loans sometimes feel that they have the right to offer suggestions concerning the management of the business. Also, hard business times may strain the relationship. But if relatives and friends are the only available source of financing, the entrepreneur has no alternative. To minimise the chance of damaging important personal relationships, the entrepreneur should plan to repay such loans as soon as possible. In addition, any agreements made should be put in writing, as memories tend to become fussy over time.

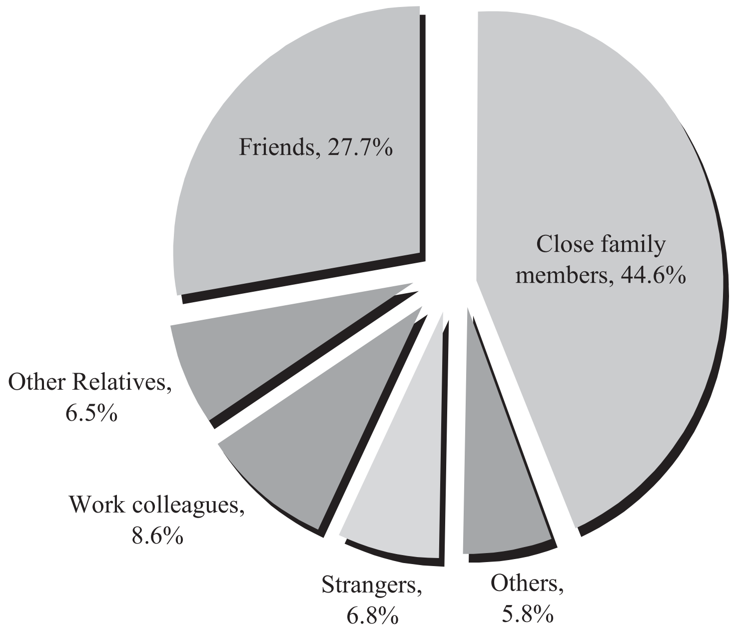

Fig. 4.8 Sources of personal capital for small firms

(Source: Longenecker, J. G., Moore, C. W., Petty, J. W. & Palich, L. E., 2008. *Small Business Management: Launching and Growing Entrepreneurial Ventures*, 14th ed., Thomson South-Western.)

For someone who cannot acquire more traditional financing, such as a bank loan, credit card financing may be an option, but a necessary one. The interest costs can become overwhelming over time, especially because of the tendency to borrow beyond the ability to repay. So it is essential that an entrepreneur using credit card financing be extremely self-disciplined to avoid becoming over-extended.

4.6.2 Bank Financing

Commercial banks are the primary providers of debt capital to small companies. However, banks tend to limit their lending to providing for the working-capital needs of established firms, specifically for financing accounts receivable and inventory. Quite simply, they want firms with proven track records and preferably plenty of collateral in the form of hard assets. Bankers are reluctant to loan money to finance losses, research and development expenses, marketing campaigns, and other "soft" assets. Such expenditures should be financed by equity sources. Nevertheless, it is wise to cultivate a relationship with a banker sooner rather than later, and well in advance of making a loan request.

Types of loans

Bankers primarily make business loans in one of three forms: lines of credit, term loans, and mortgages.

- **Lines of credit:** A line of credit is an informal agreement or understanding between the borrower and the bank as to the maximum amount of credit the bank will provide the borrower at any one time. Under this type of agreement, the bank has no legal obligation to provide the stated capital. The entrepreneur should arrange for a line of credit in advance of an actual need because banks extend credit only in situations about which they are well informed. Attempts to obtain a loan on a spur-of-the-moment basis are generally ineffective.
- **Term loans:** Under certain circumstances, banks will loan money on a 5- to 10-year term. Such term loans are generally used to finance equipment with a useful life corresponding to the loan's term. Since the economic benefits of investing in such equipment extend beyond a single year, banks can be persuaded to lend on terms that more closely match the cash flows to be received from the investment.
- **Mortgages:** Mortgages, which represent a long-term source of debt capital, can be one of two types: chattel mortgages and real estate mortgages. A chattel mortgage is a loan for which certain items of inventory or other movable property serve as collateral. The borrower retains title to the inventory but cannot sell it without the banker's consent. A real estate mortgage is a loan for which real property, such as land or a building provides the collateral. Typically, these mortgages extend over 25 or 30 years.

Understanding banker's perspective

To be effective in acquiring a loan, an entrepreneur needs to understand a banker's perspective about making loans. All bankers have two fundamental concerns when they make a loan:

- How much income the loan will provide the bank, both in interest income and in other forms of income such as fees?
- The likelihood is that the borrower will default on the loan. A banker is not rewarded adequately to assume large amounts of risk and will, therefore, design loan agreements so as to reduce the risk to the bank.

In making a loan decision, a banker always considers the "five C's of credit":

- The borrower's character
- The borrower's capacity to repay the loan
- The capital being invested in the venture by the borrower
- The conditions of the industry and economy
- The collateral available to secure the loan

When seeking a loan, an entrepreneur will be required to provide certain information in support of the loan request. Failure to provide such information in an effective manner will almost certainly result in rejection by the banker. Thus, the goal is not merely to present the needed information, but to make an effective presentation. Providing inaccurate information or not being able to justify assumptions made in forecasting financial results is sure to make the banker question the entrepreneur's business acumen.

Selecting a banker

The wide variety of services provided by banks makes choosing a bank a critical decision. For a typical small firm, the provision of checking-account facilities and the extension of short-term (and possibly long-term) loans are the two most important services of a bank. Normally, loans are negotiated with the same bank in which the firm maintains its checking account. In addition, the firm may use the bank's safe-deposit vault or its services in collecting notes or securing credit information. An experienced banker can also provide management advice, particularly in financial matters, to a new entrepreneur. The location factor limits the range of possible choices of banks. For convenience in making deposits and conferring about loans and other matters, a bank should be located in the same general vicinity as the firm. All banks are interested in their home communities and, therefore, tend to be sympathetic to the needs of local business firms. Except in very small communities, two or more local banks are usually available, thus permitting some freedom of choice.

Negotiating the loan

In negotiating a bank loan, the owner must consider the terms that will accompany the loan. Four key terms are included in all loan agreements: the interest rate, the loan maturity date, the repayment schedule, and the loan covenants.

Interest rate

The interest rate charged by banks is usually stated in terms of either the prime rate or the LIBOR. The prime rate is the rate of interest charged by banks on loans to their most creditworthy customers. The LIBOR (London Inter-Bank Offered Rate) is the interest rate that London-based banks charge other banks in London, which is considerably lower than the prime rate. This rate is published each day in the Wall Street Journal.

Although a small firm should always seek a competitive interest rate, concern about the interest rate should not override consideration of the loan's maturity date, its repayment schedule, and any loan covenants.

Loan maturity date

A loan's term should coincide with the use of the money; short-term needs require short-term financing, while long-term needs demand long-term financing. For example, since a line of credit is intended to help a firm with only its short-term needs, it is generally limited to one year. Some banks require that a firm "clean up" a line of credit one month each year. Because such a loan can be outstanding for only 11 months, the borrower can use the money to finance seasonal needs but cannot use it to provide permanent increases in working capital, such as accounts receivable and inventories.

Repayment schedule

With a term loan, the loan is set to be repaid over 5 to 10 years, depending on the type of assets used for collateral. However, the banker may have the option of imposing a balloon payment, i.e., a very large payment that the borrower is required to make at a specified point about halfway through the term over which the payments were calculated, repaying the rest of the loan in full. However, if the lender has the option of imposing a balloon payment whereby the rest of the loan comes due in full in three years rather than seven years, the lender can reassess the quality of the loan and decide whether to collect the balance or to renew the loan.

Loan covenants

In addition to setting the interest rate and specifying when and how the loan is to be repaid, a bank normally imposes other restrictions, such as loan covenants, on the borrower. Loan covenants require certain activities (positive covenants) and limit other activities (negative covenants) of the borrower to increase the chance that the borrower will be able to repay the loan. Some types of loan covenants a borrower might encounter include the following:

- A bank will usually require that the business provide financial statements on a monthly basis or, at the very least, quarterly.
- A way to restrict a firm's management from siphoning cash out of the business, the bank may limit managers' salaries. It also may prohibit any personal loans from the business to the owners.
- A bank may put limits on various financial ratios to make certain that a firm can handle its loan payments. Or the bank might limit the amount of debt the firm can borrow in the future, as measured by the ratio of total debt to the firm's total assets.
- The borrower will normally be required to personally guarantee the firm's loan. A banker wants the right to use both the firm's assets and the owner's personal assets as collateral. If a business is structured as a corporation, the owner and the corporation are separate legal entities and the owner can escape personal liability for the firm's debts—that is, the owner has limited liability. However, most banks are not willing to lend money to any small business without the owner's personal guarantee as well.

4.6.3 Business Suppliers and Asset-Based Lenders

Companies that have business dealings with a new firm are possible sources of funds for financing inventories and equipment. Both wholesalers and equipment manufacturers/suppliers can provide trade credit (accounts payable) or equipment loans and leases.

Accounts payable (trade credit)

Credit extended by suppliers is very important to a start-up. In fact, trade (or mercantile) credit is the source of short-term funds most widely used by small firms. Accounts payable (trade credit) are of short duration of 30 days is the customary credit period. Most commonly, this type of credit involves an unsecured, open-book account. The supplier (seller) sends merchandise to the purchasing firm; the buyer then sets up an account payable for the amount of the purchase. The amount of trade credit available to a new company depends on the type of business and the supplier's confidence in the firm.

More often, however, a firm has to pay its suppliers prior to receiving cash from its customers. In fact, this can be a serious problem for many small firms, particularly those that sell to large companies.

Equipment loans and leases

Some small businesses, such as restaurants, use equipment that is purchased on an instalment basis through an equipment loan. A down payment of 25 to 35 percent is usually required, and the contract period normally runs from three to five years. The equipment manufacturer or supplier typically extends credit on the basis of a conditional sales contract (or mortgage) on the equipment. During the loan period, the equipment cannot serve as collateral for another loan. Instead of borrowing money from suppliers to purchase equipment, an increasing number of small businesses are beginning to lease equipment, especially computers, photocopiers, and fax machines.

Three reasons are commonly given for the increasing popularity of leasing:

- The firm's cash remains free for other purpose
- Available lines of credit (a form of bank loan) can be used for other purposes
- Leasing provides a hedge against equipment obsolescence

While leasing is certainly an option to be considered for financing the acquisition of needed equipment, an entrepreneur should not simply assume that leasing is always the right decision. A business owner can make a good choice only after carefully comparing the interest charged on a loan to the implied interest cost of a lease, calculating the tax consequences of leasing versus borrowing, and examining the significance of the obsolescence factor. Also, the owner must be careful about contracting for so much equipment that it becomes difficult to meet instalment or lease payments.

Asset-based lending

As its name implies, an asset-based loan is a line of credit secured primarily by assets, such as receivables, inventory, or both. The lender cushions its risk by advancing only a percentage of the value of a firm's assets, generally, 65 to 85 percent against receivables and up to 55 percent against inventory. Of the several categories of asset-based lending, the most frequently used is factoring. Factoring is an option that makes cash available to a business before accounts receivable payments are received from customers.

4.6.4 Private Equity Investors

Over the past decade, private equity markets have been the fastest growing source of financing for entrepreneurial ventures that have potential for becoming significant businesses.

For an entrepreneur, these sources fall into two categories: business angels and venture capitalists.

Business angels

Business angels are private individuals who invest in early stage companies. They are the oldest and largest source of early-stage equity capital for entrepreneurs. The term angel originated in the early 1900s, referring to investors on Broadway who made risky investments to support theatrical productions. This type of financing has come to be known as informal venture capital because no established marketplace exists in which business angels regularly invest.

The majority of these individuals are self-made millionaires who have substantial business and entrepreneurial experience. Business angels generally make investments that are relatively small, over 80 percent of business angels invest in start-up firms with fewer than 20 employees. They invest locally, usually no more than 50 miles from their homes. Some limit their investments to industries in which they have had experience, while others invest in a wide variety of business sectors.

Along with providing needed money, private investors frequently contribute knowhow to new businesses. Because many of these individuals invest only in the types of businesses in which they have had experience, they can be very demanding. Also, they base their investment decision primarily on the potential risk and return of the investment, rather than on their personal relationship with the entrepreneur, unlike friends and family. Thus, the entrepreneur must be careful in structuring the terms of any such investors' involvement.

Venture capitalists

In addition to business angels who provide informal venture capital, small businesses also may seek out formal venture capitalists, groups of individuals who form limited partnerships for the purpose of raising capital from large institutional investors, such as pension plans and university endowments. Within the group, a venture capitalist serves as the general partner, with other investors constituting the limited partners. As limited partners, such investors have the benefit of limited liability. The venture capitalist raises a predetermined amount of money, called a fund. Once the money has been committed by the investors, the venture capitalist screens and evaluates investment opportunities in high-potential start-ups and existing firms.

For the investment, the venture capitalist receives the right to own a percentage of the entrepreneur's business. Reaching agreement on the exact percentage of ownership often involves considerable negotiation. The primary issues are the firm's expected profits in future years and the venture capitalist's required rate of return. Once an investment has been made, the venture capitalist carefully monitors the company, usually through a representative who serves on the firm's board.

Most often, investments by venture capitalists take the form of convertible debt or convertible preferred stock. In this way, venture capitalists ensure themselves senior claim over the owners and other equity investors in the event the firm is liquidated, but they can convert to stock and participate in the increased value of the business if it is successful. Although venture capital as a source of financing receives significant coverage in the business media, few small companies, especially start-ups, ever receive this kind of funding. No more than 1 or 2 percent of the business plans received by any venture capitalist are eventually funded—not exactly an encouraging statistic. Failure to receive funding from a venture capitalist, however, does not indicate that the venture lacks potential. Often, the venture is simply not a good fit for the investor. So, before trying to compete for venture capital financing, an entrepreneur should assess whether the firm and the management team are a good fit for a particular investor.

Summary

- A business plan is a formal statement of a set of business goals, which are believed to be attainable, and the plan for reaching those goals.
- A business plan is an entrepreneur's game plan; it crystallises the dreams and hopes that motivate an entrepreneur to take the start-up plunge.
- Marketing is always different things to different people. Some entrepreneurs view marketing as simply selling a product or service.
- Small business marketing consists of those business activities that direct the creation, development, and delivery of a bundle of satisfaction from the creator to the targeted user and that satisfy the targeted user.
- The core product/service is the fundamental benefit or solution sought by customers.
- In the market analysis section of the marketing plan, the entrepreneur describes the target market.
- A well-prepared market analysis and competition discussions are important to the formal marketing plan.
- The Internet has radically transformed how business is conducted; it is now the location of choice for many entrepreneurs.
- The choice of a good location is much more vital to some businesses than to others.
- Customer accessibility is an important consideration in selecting a location.
- A start-up business is affected in a number of ways by the environment in which it operates.
- Weather is one important environmental factor that influences the location decision, as well as the demand for many products such as air conditioners and outdoor swimming pools.
- The availability of resources associated with producing a product and operating a business should be considered in selecting a location.
- Once an entrepreneur has settled on a certain area of the country, a specific site must still be chosen.
- (B2B) model (selling to business customers) are significantly greater than those for firms with a business-to-consumer (B2C) model (selling to final consumers).
- In contrast to a B2B model, a business-to-consumer (B2C) model has final consumers as customers.
- Profits reward an owner for investing in a company and constitute a primary source of financing for future growth.
- Personal savings is the primary source of financing for most small business start-ups, with friends and family following in a distant second place.
- Commercial banks are the primary providers of debt capital to small companies.
- The interest rate charged by banks is usually stated in terms of either the prime rate or the LIBOR.
- Credit extended by suppliers is very important to a start-up.
- Business angels are private individuals who invest in early stage companies. They
- Within the group, a venture capitalist serves as the general partner, with other investors constituting the limited partners.

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