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Text and Cases



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Entrepreneurial Strategies

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Text and Cases

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Foreword

Entrepreneurship as a field of study has been developing rapidly. More than 150 universities now offer at least one course in the subject. In addition, hundreds of short courses directed at entrepreneurs and new business owners are offered every year by universities, government agencies, chambers of commerce, and trade associations. The study of entrepreneurship has become a growth industry.

The steady increase in entrepreneurial education parallels the remarkable growth in the number of new firms started each year. For instance, in 1950 about 90,000 new corporations were started in the United States. This number increased to about 200,000 in 1965, to 300,000 in 1975, to 600,000 in 1981, and to 700,000 in 1986. In addition, much of the job creation, innovation, and vitality in our economy seems to be centered in these new firms. Clearly we are in an entrepreneurial society.

Entrepreneurial Strategies: Text and Cases can help the aspiring entrepreneur in many ways. It provides analytical frameworks for thinking about key activities, such as self-assessment and developing a business strategy. Each chapter lists references for those who wish to pursue a subject in greater depth. A large number of examples about entrepreneurs, both famous and obscure, illustrate the practices followed and problems encountered in the challenging process of establishing and building a business. Knowledge is provided about relevant research studies, sources of information, and factors bearing upon the

success of new firms. One chapter focuses upon the challenging task of making large organizations more entrepreneurial. Entrepreneurship is an active process, rather than a passive one; it is, therefore, appropriate that exercises throughout the book help the reader develop the requisite skills.

Entrepreneurial Strategies should be of value to those who follow various career paths, not just those who become entrepreneurs. Some may work with entrepreneurs as bankers, accountants, attorneys, or consultants. Others may deal with them as suppliers, sales representatives, or franchisers. Some may seek to revitalize larger organizations by making them more venturesome and entrepreneurial. All can benefit from understanding more fully the entrepreneurial process, if only to draw more informed conclusions about whether an entrepreneurial career is for them.

Arnold C. Cooper
Purdue University

Preface

Entrepreneurs are a colorful lot; and their careers are exciting, if not always filled with success. Most individuals who start viable businesses have certain characteristics in common. It is for these business starters and for the even larger number of entrepreneurial career seekers that this book is written. *Entrepreneurial Strategies: Text and Cases* provides understanding of two broad questions:

What product-market strategies are open to new businesses?

What organizational structures are used to implement those strategies?

Strategies — that is, ideas or plans — for a new business are developed from a product or service notion and an image of the potential user. The notion and the image (or profile) must cohere on paper and, more importantly, must work together when propelled by the entrepreneur.

Unlike earlier entrepreneurial texts, *Entrepreneurial Strategies: Text and Cases* adapts broad, generic product-user models from the disciplines of economics, marketing, and business strategy. The book identifies the industry and market conditions to which generic product and service options are suited. Depending on these industry and market conditions and on the individual entrepreneur's strengths, the text shows the logic of establishing (1) either a narrowly focused or broad new business and (2) either a cost-based business or one that offers some other competitive advantage.

After a description of the various product and market strategy choices, the reader is provided with the structural and implementive choices entrepreneurs must make: choices among suppliers; choices on whether to acquire, franchise, license, or start a business from scratch; and choices of what financial sources to tap.

To enhance entrepreneurial thinking — what opportunities there are, which one to pursue, and how to pursue that one — exercises are integrated with the text and follow most major topics. Each chapter contains two or more exercises to stimulate, guide, and enrich the reader's involvement in new business strategy. To many who have evaluated *Entrepreneurial Strategies,* the exercises are its most interesting feature.

Accounts, or cases, of actual businesses in different stages of development allow readers to test themselves and practice entrepreneurial analyses before betting large sums on the real thing.

Finally, to assist the user, a business plan guide has been developed and appendixes covering the basics of accounting, financial statements, legal organizational forms, and spreadsheet analysis are provided. The appendixes are followed by a glossary containing entrepreneurially specific terms.

When used in a course, *Entrepreneurial Strategies: Text and Cases* is intended for intense use at the beginning of the term and as a reference later in the term when an entrepreneurial project is being developed. First the text should be studied, then cases should be reviewed, and finally projects should be assigned and selected visitors asked to share their entrepreneurial experiences. This book provides the reader with the main ingredients of entrepreneuring and describes the relationship among these ingredients. It is meant to kindle ideas and guide thinking, as much as to instruct.

The following individuals should find this book useful:

Those who are considering and must *decide* whether to pursue an entrepreneurial career or more traditional employment.

Those who have decided to start or expand a business and want to learn more about *how* to do so.

Those who plan to expand a family business.

Those who want to own a business but want to reduce the risk by franchising or acquiring an existing business.

Those who want to start or manage a new venture within a larger organization.

Those who may become seriously involved with an entrepreneur, such as a spouse, an employee, or an investor.

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Lawrence Finley

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PART I

Entrepreneurs

CHAPTER 1

Introduction

No athlete is crowned but in the sweat of his brow.

— St. Jerome

In this book you will find widely accepted ideas on starting and growing businesses. The research behind these ideas comes from many sources, from careful academic studies to the personal experiences of those who started or enlarged their own businesses. You will see examples of success in retailing, manufacturing, construction, and service industries. Because we also learn from failures, both our own and others', we will read about ventures that did not go very far.

We learn best by doing. Therefore, in *Entrepreneurial Strategies* you will be asked to work through entrepreneurial *exercises*. These exercises, which are designed to illustrate and supplement text material, will help to bridge the gap between your situation as a student of business start-ups and the world of entrepreneurship, with its competition, risks, problems, and payoffs.

Most successful entrepreneurs prepare for their venture. Preparation may take the form of years of related business experience or courses in business, accounting, and business law. This book will help you to prepare yourself by acquainting you with the experiences of others and the principles of marketing new products, financing new businesses, and planning new businesses.

Part I focuses on preparation of the *person* for entrepreneurship. You will learn about *entrepreneurial career strategy*: to assess yourself and your needs, experiences, contacts, strengths, and weaknesses relative to entrepreneurial tasks. (You can apply these assessment concepts and tools to potential partners as well as to yourself.) You will be asked to review your previous experiences and accomplishments. Your "history" both helps predict your future and provides resources to draw on in the future. Studying characteristics of entrepreneurs and their experiences will help you understand the entrepreneurial task.

Part II focuses on your start-up *ideas* and the *strategies* to implement them. What customer benefit will the business sell — what product or service — and to what market? How will you improve your customers' lives in ways existing businesses do not? You will see where venture ideas come from and how to separate out the large number of less promising ideas; the product idea with the best chance is the one that best exploits a disequilibrium signaled by the market. We will describe how to achieve an internally consistent set of product-market thrusts, or strategy. We will present analyses of the market for the idea, the profit margin potential of the idea, and competitors in the same product or service market. Finally, we explain how to establish effective relations with customers and suppliers for the new business.

Part III takes you through new *structure options* of franchising, licensing, acquisition, and financing. We will describe financial resource requirements and sources and how to gain access to them. Entrepreneurs must carefully study these options before working up their *business plan.* The business plan projects sales, costs, and cash flow based on earlier strategy and structure choices.

The appendixes contain a basic background for some of your financing decisions (to supplement Chapter 13 on new business financing): interpretation of financial statements, legal forms of business organization, and the tax implications of each form. With this preview of the material in this book, we now turn our attention to the importance of entrepreneurship to individuals and to the economy.

Importance of Entrepreneurship

David Birch, in the book *Job Creation in America* (1987), reports on a major research project covering 12 million companies. The study found that companies with fewer than 100 employees created more jobs than companies with more than 100 employees in nine out of ten years. These job-creating companies, called **gazelles**, are entrepreneurial and important.

Is entrepreneurship important enough to merit a place in a college curriculum and to merit the serious attention and efforts of a student? To answer

these questions, we consider what entrepreneurship (defined as venturing into new business activity) means to the individuals who do it—a process we call *microanalysis*. Then we consider the effects of entrepreneurship on the economy as a whole — *microanalysis*.

> At the individual level, Stephen Wozniak, a young employee of Hewlett-Packard in 1976, was unable to convince his Hewlett-Packard managers that personal computers were marketable items. He escaped a career in a bureaucracy by moving on to a challenging and rewarding career as cofounder of Apple Computer, Inc. (*New York Times* 1985).
>
> Consider another venturesome youth who left the family business in Boston at age 18 and later found work in a Philadelphia print shop. There, he decided that the two print shop owners were not suited to managing a business. A few months later he opened his own shop on High Street, which is now Market Street. Thus, entrepreneurship offered Benjamin Franklin an alternative outlet for his energies and ideas.

Of course, not all entrepreneurs become rich and famous and not all are men. In fact, according to Scherschel (1984), the growth rate of start-ups by women exceeds the growth rate of start-ups by men. Their situations differ from that of men: many women encounter sex discrimination as they try to climb the corporate ladder, and many find that filling family and career roles simultaneously is more feasible if they enter business for themselves.

Exercise 1.A

Describe two individuals you know for whom entrepreneurship has been (or is) important.

At the macro level we can easily show the importance of entrepreneurship. According to the U.S. Small Business Administration (Swain 1985), of the 7 million jobs created during 1983 and 1984, 5 million were created by new or expanding small businesses. During the recession of 1981–1982, small firms added 2.6 million new jobs whereas large corporations lost 1.7 million jobs in this country. Recently T. Boone Pickens (1987) testified to a congressional committee that the very large Fortune 500 companies' combined employment fell by 600,000 in 1986, on top of a loss of 2 million jobs in the 1984–1985 period. Our economy needs entrepreneurs!

Apparently the U.S. economy includes attractive environments not only for small businesses, but for new businesses as well. New business incorporations in 1974 totaled almost 320,000 and rose every year (except during the 1981–1982 recession) to over 636,000 in 1984 (Swain 1985). The reader must be aware that "new business incorporations" is not the same thing as new businesses; these incorporations often are expansions of sole proprietorships and partnerships. Either way, the point is made — entrepreneurship is vital to our economy.

At the local labor market level, the following quote from the *Nashville Business Journal* (a new business) illustrates the importance of entrepreneurship (Reeves 1987). The background for this quotation is layoffs of more than 3,000 employees by a large local company.

> The Nashville job market — with a September unemployment rate of 3.9 percent in Davidson County and 4.5 percent in the eight-county metropolitan statistical area — can absorb quite a few people, Harris says. Nashville has had a net increase of 13,300 jobs [from new business] so far this year, he says. But only 100 have been in manufacturing. The rest are in service industries. As a matter of fact, the number of jobs in the area has been growing by about 3½ percent but the population has been growing by only 2 percent, Harris says.* [Fred Harris is the economic development director of the Nashville Area Chamber of Commerce.]

If you are skeptical, think beyond individuals you know or know of and beyond job statistics. Think about new products. Where do new products and services originate? Ball point pens, Fiberglas skis, Velcro adhesive strips, Big Mac hamburgers, breakaway basketball goals, overnight package delivery, discount long distance phone service, personal computers, most software, and many other new products and services come from individuals starting or expanding small businesses. (Not being an inventor should not discourage you; most entrepreneurs are not inventors in the traditional sense.)

Although academics, business people, and government officials do not

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* Used with permission of *Nashville Business Journal.*

agree on a definition of **entrepreneurship,** our concept of it is **starting or significantly expanding business activity,** which means creating new jobs and often new products in the marketplace. Starting or expanding a business and consequently creating jobs and products is the focus entrepreneurship studies should have. How should this study occur?

How Is Entrepreneurship Studied?

Entrepreneurship was studied in certain better schools of business as early as the late 1940s. The Harvard Business School offered a course for the many returning World War II GIs who wanted to start businesses. In the 1980s, growth of these courses was rapid. What learning formats are successful? Do professors simply assign a chapter or two in a textbook each class period, lecture, and give three tests and one term paper per semester? No. Education in entrepreneurship apparently must contain observations of real-life situations plus the experiences and plans for existing new businesses.

Educators who have bravely tackled teaching this field have done so in varied and unconventional ways. Often journals, speakers, visits from entrepreneurs, and students' business plans are used in addition to the more traditional text, case studies, and lectures. *Venturing* by definition is embarking on new creative actions with uncertain outcomes. Neither creativity nor risk can be fully taught. However, venturing tendencies can be nurtured and guided by focused effort.

Images of Entrepreneurs

Who were or are Andrew Carnegie, Henry Ford, Ray Kroc, Stephen Jobs, and Steven Wozniak? They were or are entrepreneurs in steel, autos, hamburgers, and computers. Entrepreneurs currently are popular people. A recent glamour story is that of Austin Furst (Bronson 1985). Austin, age 42, was successful before he became an entrepreneur.

> In 1981, Austin Furst was president of Time-Life Films, a movie subsidiary of Time-Life. Time-Life was not very interested in film media, so Austin quit his job and with his personal savings and a second mortgage on his house, bought the home-video rights to Time-Life's films. The demand for these videos was huge. In August 1985, Austin sold 15 percent of his company for $70 million, which makes his family's 85 percent worth $400 million on paper.

Austin may never become as well-known as Andrew Carnegie et al., but his story feeds the media frenzy regarding rich entrepreneurs. These stories make for fun reading but they are not representative, of course. The profiles, cases, and examples in this book are not as glamorous; but they are more typical and therefore, their experiences are more useful. Perhaps we should say the more typical entrepreneurs give us a truer picture of new ventures, though Austin Furst stimulates our ambitions. In addition to the glamorous stereotype of larger-than-life people accumulating wealth from leading a new personal-computer industry, there is a great variety of little-known, very successful entrepreneurs.

Unfolding Variety of Entrepreneurs and New Businesses

Much university-based research in entrepreneurship has proceeded from a fascination with the entrepreneur, how he or she differs from the remainder of the population and from managers in corporations (Brockhaus 1982). Chapter 2, "Self Assessment," presents the findings of such research in a way that guides the reader in assessing his or her entrepreneurial tendencies.

In addition to understanding the characteristics entrepreneurs have in common, it would be useful to know how they differ. Is a high technology engineer who starts a business supplying the computer industry similar to the person who starts a discount airline? Is an enterprising restaurateur similar to the person who starts a nursery? Initial research suggests there are fundamental differences among these entrepreneurs. Cooper and Dunkelberg (1981) found entrepreneurs differ from industry to industry, although we do not have systematic knowledge of the differences. The reader, however, can profit by thinking about the qualities most helpful in different kinds of business. Probably, the new supplier to the computer industry depends critically on engineering talent, and the new discount airline depends on marketing talent, for example.

Vesper (1990) introduces his study of new venture strategies with eight types of entrepreneurs.

1. Solos (work as self-employed individuals)
2. Deal-to-dealers (start several businesses)
3. Team builders (go on to build larger companies)
4. Independent innovators (start as inventors)
5. Pattern multipliers (run franchises or chain stores)
6. Economy-of-scale exploiters (discounters and miscellaneous)

7. Capital aggregators (especially start financial institutions)
8. Acquirers (may speculate or turn around businesses)

These types show the variety of entrepreneurs and the fact that this field of study is beyond its infancy.

New organizations vary also in their competitive strategies (the subject of Chapters 5 and 6), their legal form (Appendix C), and the relationships they establish with customers (Chapter 8), suppliers (Chapter 9), and financial backers (Chapter 13).

Environments

Are certain environments, strategies, roles, and paths more likely to lead to success than others? We believe that the reader (participant) can learn from the research and stories of many entrepreneurs, their business environments, strategies, roles, and paths.

Not only do different kinds of business depend critically on different forms of entrepreneurial expertise, but other factors affect the creation of new ventures. William Gartner (1985), finds four sets of factors most important in the creation of new businesses: (1) the individual(s), (2) the environment, (3) the process, and (4) the organization. The following list of environmental factors is based on those Gartner found important to successful start-ups.

financing availability
presence of experienced entrepreneurs
technically skilled labor force
accessibility of helpful suppliers
accessibility of customers or new markets
government support and lack of obstacles
proximity of universities
availability of land or facilities
accessibility of transportation
attitude of local population
availability of support services (office, communication, and so on)
living conditions
high occupational and industrial differentiation (specialization)
high percentages of recent immigrants in the population

large industrial base and larger urban areas
low barriers to entry (capital requirements, rivals, and so on)

These environmental factors, taken together, strongly support new ventures. Others have noted the key roles of existing incubator organizations (simply those influencing start-ups) and cultures that value entrepreneurship. The absence or opposites of these factors indicate lack of environmental support.

A recent study included two environmental factors affecting the success of women founders of businesses (Greckel 1986). Greckel found that most successful firms run by women on average were more likely to be in a growing industry and to have started when the economy was expanding. (Also, the successful companies were somewhat older than the unsuccessful, started with more capital, and their founders had more experience than did unsuccessful counterparts.)

Sandberg and Hofer (1987) find that industry environment and the strategy of the new business help determine new business performance. New ventures are more successful in the following environments: (1) industries having heterogeneous products, (2) industries in the development or growth stages rather than shakeout or maturity stages, (3) evident market disequilibria, and (4) presence of barriers to subsequent entry.

Examples will help clarify what is meant by the preceding environments. Book publishing, with the great variety of content and reading levels, is a heterogeneous industry, whereas disposable cups for beverages is a more homogeneous industry; the compact (audio) disc industry is in the growth stage, whereas certain record album companies are mature and others declining. Market disequilibria exist when city A has three Mexican restaurants and comparable city B has but one, or when a product sells for $5 a pound in one market and $7 a pound in a nearby market. A barrier to subsequent entry exists when a new wholesaler writes agreements with all the appropriate retailers, closing those distribution channels to subsequent wholesalers.

New Business Incubator Environment

Should a new business attempt to move into an incubator? Let us explore this recent attempt to provide the ideal environment. The concept of incubator suggests maintenance of a certain environment for the soon-to-be-born. The hatchling should be in a supportive, stable environment, in a protected medium until it is ready to break into the real world where none of these conditions prevail.

Smilor and Gill (1986), after experience and research, suggest incubators may provide four types of controlled conditions: facilities or space, secretarial support, administrative assistance, and business expertise.

Incubators may be classed into two development stages. Stage one, usually publicly funded incubators, emphasizes space for the fledgling company, its storage, production, and offices. This space is cheaper than comparable space leased privately, because the publicly funded incubator is a rent subsidy provided by some area taxpayers to encourage expansion of jobs in new and promising businesses.

Private incubators are likely to be stage two enterprises, whose business is to start new businesses. Their objective is achieved by taking on ownership interest in the tenants. Stage two incubators provide resources beyond space or facilities. Smilor learned that the typical stage two incubator provides, in addition to facilities, secretarial and administrative support plus consultation by experts in marketing, accounting, management, and financing. Certainly, the entrepreneur should expect a wide range of abilities to provide these services. Costs for these services range from market prices to significantly below market prices.

Special incubator features you might find are illustrated by four of Smilor's case studies of incubators. Technology Centers International (TCI) in Pennsylvania offers the usual services plus a center champion who helps tenants develop business plans, including marketing strategies and financing. TCI develops seed capital sources and makes financing available to qualifying tenants.

The Rubicon Group in Austin, Texas, is a private incubator emphasizing expertise and financing, in addition to the usual services. Each investment is a joint venture between the entrepreneur and the Rubicon Group's investment partnership.

Rensselaer Polytechnic Institute (RPI), a university in Troy, New York, has long been esteemed in engineering and technology. They have had an incubator for a decade now, emphasizing below market costs for space and ready access to the expertise of that university. This incubator also has equity financing—that is, it can accept stock as payment for certain services.

The Fulton-Carroll Center for Industry in Chicago is operated by a private not-for-profit organization with private and government funding. It provides subsidized facilities, secretarial support, and other services. In contrast to tenants in many university-connected incubators, tenants here employ mostly minority people from its urban renewal neighborhood.

In summary, incubator benefits to a tenant might include place, credibility, access to a network (of banks, customers, suppliers, human resources), and on-site consultation. The place is of first importance because its cost often is based on the ability to pay; it will remove headaches of building maintenance and insurance; and it will place the operation close to others with whom to swap insights, receive consolation, and ask questions. The facility's address may indicate passage through a screening process.

New businesses lack credibility, and an incubator address may provide it, depending on the incubator's credibility and on that credibility being trans-

ferred to the tenant's business. Has the incubator established a track record? Have most of its tenants succeeded? Besides considering the importance of environmental factors faced by a new business, we should also examine the internal factors in the success of new ventures, beginning with the roles played by the entrepreneur.

Entrepreneurial Roles: Can One Person Fill Them All?

Unlike most managers in large stable organizations entrepreneurs must play many *roles* in their business. In roughly the following sequence — and all are played almost daily — these roles are:

1. visualizer
2. planner
3. resource gatherer
4. resource organizer
5. salesperson
6. administrator

How does he or she do it? Poorly? By working heroic hours? By delegating tasks to others? By being an inexplicable genius? Often the answer is yes to all the above.

Visualizer

This role is central: an entrepreneur is someone who can look at products and services, even commonplace ones, and visualize what others fail to see — opportunities to create new value (Brown undated). For example,

> Archer Timmons looked at a large, old house next to the University of Cincinnati a few years back and "saw" that the building, a carpenter, a plumber, an electrician, plus $20,000 and many student renters, could be orchestrated into a business with $600 a month net cash flow and rising equity. This opportunity was later visualized as the basis for a substantial real estate business in that city.

The noted economist Frank Knight understands the role of visualizer as the key role of the entrepreneur. The visualizer is the one who sees and acts on disequilibria; no one else sees or acts on these opportunities. Knight's ideas on entrepreneurs are presented further in Chapter 4.

Planner

Planning is required to drive the opportunity toward reality. Exactly how will the house-developed-into-apartments be changed? What kind of apartments and how many will there be? What building permits will be required? What kind of students will be the tenants? Who are the best sources of needed skills, funds, and information? And what sequence is feasible in building this enterprise? The budding entrepreneur plans each move. Before gathering resources entrepreneurs work largely by themselves; although this type of person continually uses acquaintances for information, advice, and emotional support.

Resource Gatherer

As resource gatherer—the essence of entrepreneurship according to some economists—the entrepreneur intensely recruits and negotiates with others. A relative, friend, or banker supplies money. Skilled, experienced tradespeople or the entrepreneur supplies the rebuilding work. The next to secure are renters who will be compatible with the other residents and respectful of the property.

Resource Organizer

The fourth role, organizer, is often ambiguous. Tasks and resources have to be identified, divided, and coordinated. They must be fitted into an efficient and effective whole with resources applied to tasks. First, the entrepreneur decides what he will do himself and what he will assign to others. The organizer suggests relationships in the larger endeavor—how product design will cooperate with marketing and production or who will have primary sales responsibility, quality control, purchasing, and other responsibilities. Because the new venture will have more tasks than persons, which tasks will be grouped for one person's job? Will publicity be done primarily by the chief, by the head of marketing, or by someone else?

Salesperson

The entrepreneur "sells" herself, her company, and the product every time she meets with a resource supplier. In fact, she is likely to be the product or service salesperson in the beginning stages. She has the most thorough knowledge of the product, the customer, the costs, and the competition. Importantly, she has the desire to sell the product. Finally, the entrepreneur must constantly research the changing markets. Few visions of products and markets by venturers grow into the companies originally conceived.

Administrator

By administrator, role six, we mean the person who follows through after initial sales are made to see that efficiency is gained from experience and in turn results in a declining cost curve. Left alone, organizations disorganize, work standards are relaxed, precise product requirements become "good enough," and money vaporizes. The administrator counts hours and materials going into product units, days lapsing before shipments are made, bills owed, and account balances. Research shows that innovative, expansive persons — entrepreneurs — are often not good counters and administrators.

Start-up Paths

Our fourth factor in new venturing is called the *path* or the *process*. The process by which entrepreneurs bring about new businesses sometimes begins with skills or products and proceeds to markets. At other times the process is reversed: the market is identified first and the resources are developed later. For example, microwave ovens were invented, refined, and promoted for years before their market reluctantly developed; yet a strong market for safer food sweeteners surely awaits the sweetening compounds now being developed.

Alan Zakon, CEO of the Boston Consulting Group, catches the elusive roles of entrepreneurs and suggests their sequence (Brown undated):

> Think of the sequence. You create something. You grow it. You look for a competitive advantage. Then you really tie it down tight, making it as efficient as possible. Those are very different jobs. The entrepreneur is not at all, nor should he be, interested in efficiency. He needs to find that new value, which requires looking at things differently: Looking for put-togethers, looking for holes in the marketplace, looking for opportunities to translate, whatever. Then you have to make the translation to marketing, or you die. This requires a separate set of skills. Most companies fail because they can't go from the idea to the growth. The survivors have found a way to gain a marketing advantage. Having found that, they must become efficient. They divide management between creators and administrators. At times, such as the beginning, you want a creator running your company. It is very hard for administrators to choose to restart the cycle. A creator can.*

We close this presentation on process by citing from Gartner's model of variables in new venture creation again: The entrepreneur locates a business

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* Excerpted by permission of *Forbes* magazine, May 21, 1984. © Forbes Inc., 1984.

opportunity, accumulates resources, markets products and services, produces the product, builds an organization, and responds to government and society.

There is no one best process or sequence. Life may present us with but one or two windows of significant opportunity. Our opportunity may begin with product, with customer, or with money. Having said this, the organization of this book reflects our view that generally the personal preparation is first, the idea next, the market follows, and then a strategy of market entry. Money to carry out these acts must follow, and ideally somewhere in this process a plan of it all is formulated. Note that the order of this book's chapters essentially follow this sequence.

As a footnote to Chapter 1, an underlying factor affecting new business success is the entrepreneur's information. A comprehensive guide to information of possible use to entrepreneurs is Gumpert and Timmons's (1982) *The Encyclopedia of Small Business Resources.* Categories of information include financing, franchising, and special aid to minorities and women. *Entrepreneurial Strategies* provides additional sources at the end of each chapter.

Summary

Chapter 1 provides an introduction to this book, noting its research base and anecdotes. The importance of entrepreneurship in our economy and for personal fulfillment is shown. Entrepreneurship is taught in a variety of ways, sometimes unconventional, but usually including entrepreneurial experiences. In this chapter the glamorous entrepreneur stereotype is identified and contrasted to the reality of an extremely varied world of business venturers. Benevolent environments, including incubators, and hostile surroundings are described. Processes of starting new business may begin with a product, a market, or other factors. The key roles of the entrepreneur are visualizer, planner, resource gatherer, resource organizer, salesperson, and administrator.

Exercise 1.B

1. Given the information under "How Entrepreneurship Is Studied" plus your own experience, describe your one best idea for learning entrepreneurship.

2. Think of a certain new or growing business about which you know something. Which of Gartner's creation factors was most important to that business? Explain.

   Which factor was least important? Explain.

3. In which of the entrepreneurial roles do you believe you are strongest? In which are you the weakest? Consider any experience you have, as well as talent and interest.

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CHAPTER 2

Self-Assessment: What Career Fits Me?

One would grow poor staying in one place long.

— Poem of the Cid

The career for which one is best fitted is partly a matter of behavioral requirements and partly depends on the individual's personality traits. For many years this trait approach to understanding entrepreneurship was felt to be very promising. Corollary to this main stream of inquiry, others explored situational and perceptual factors influencing business initiation decisions. In this chapter you will learn about the influences of traits, situational factors, and perceptual factors in entrepreneurial careers.

Before reading Chapter 2, a short self-assessment exercise is appropriate. Indicating your choices among the alternatives can provide you with useful insight about yourself in relationship to a career. Choose one alternative for each of the following sixteen situations.

Exercise 2.A

Answer on a separate sheet of paper.

1. Of the following, my favorite pastime is
   a. reading fiction.
   b. playing tennis.
   c. attending classes.
2. If given an assignment to toss poker chips into a bowl, I would
   a. stand close enough to score every time.
   b. stand at a distance where, with concentration and learning from my mistakes, I would come to score on maybe half the throws.
   c. stand back far enough so that if I scored it would be mostly luck.
3. During my life so far, when there have been opportunities to invest money in items with the hope of selling them for profit, I have
   a. invested but usually not profited.
   b. had opportunities but preferred not to take chances.
   c. not had such opportunities.
   d. invested several times and learned something each time.
4. As an employee in a full-time or part-time job, I have preferred to
   a. work under the supervision of an older person.
   b. work with a supervisor to show him what I could do.
   c. work alone so I could figure things out for myself.
   d. work only on tasks I know how to do and have done many times.
5. If given a choice between writing a letter to a friend I have not seen in two years and calling that person on the phone, I prefer
   a. writing.
   b. calling.
   c. letting the person contact me if he or she wants.
6. In jobs I have held (part-time, summer, other), getting approval to do something differently has
   a. never happened.
   b. happened and has been satisfying.
   c. happened and has been very irritating.
   d. happened and I have no feeling about it, positive or negative.
7. When my desk or study area is cluttered, I feel
   a. at ease and have no problem with it.
   b. guilty and sloppy.
   c. like it should be straightened and I do it.
   d. great; I love it.
8. If I jogged, I would probably
   a. jog only when I felt like it and only as far as I felt like jogging.
   b. jog regularly but no certain distance.
   c. jog often and far enough to strengthen my cardiovascular (heart-lung) system.

d. jog around the building and stop.

9. When I sign up for a college course that seems important, I am more likely to
   a. set goals for attendance, for homework, and for test scores.
   b. set a goal for a grade.
   c. set a goal but forget it soon afterward.
   d. set goals low enough so that I will not be disappointed.
10. Today I am
   a. behind on some projects or tasks.
   b. not working on any projects.
   c. just sort of killing time.
11. When my professor assigns a paper, I prefer the assignment
   a. be spelled out in specifics.
   b. be explained as to the goal.
   c. be left for me to exercise some creativity.
   d. not take time away from my studies.
12. I do best compared to others I know on
   a. new tasks that are interesting.
   b. tasks I have learned well and feel secure about.
   c. tasks involving others.
   d. tasks requiring computations.
13. Life is generally
   a. boring.
   b. interesting because there are things to try to figure out.
   c. a piece of cake.
   d. frustrating because things go wrong too much.
14. Decisions in my life such as what to major in at college and how to spend money are
   a. influenced strongly by my family and friends.
   b. a hassle and I wish someone else would make them.
   c. made mostly by me.
   d. fun, and I make decisions well.
15. If I started a business, it would probably be in order to
   a. make lots of money in a few years.
   b. work only the hours I wanted.
   c. slowly build a thriving business.
   d. be my own boss and not work for anyone else.
16. The difference between those who have it made and those who do not is primarily due to
   a. luck or lack of it.
   b. a good education or lack of it.
   c. an economic system that favors some and hurts others
   d. initiative and hard work or lack of them.

We will ask you to take this entrepreneurial self-assessment or inventory again after reading the following material about entrepreneurial characteris-

tics. This inventory was written by the author; other such inventories are by Baumback and Mancuso (1975) and Sexton and Van Auken (1982).

Compare Entrepreneurs' Traits to Yours

Implied in this heading is the question,"Are you a likely entrepreneur?" Now that you have roughly assessed your traits, read about the character traits of entrepreneurs and see how the two compare. Of the hundreds of entrepreneurs who have been systematically studied over the past fifty years, most have a number of character traits in common. The more of these traits you possess, the greater is the probability that you will be an entrepreneur. This is not to say, however, that persons *without* all of these characteristics will *not* become entrepreneurs or that persons *with* them *will.*

Before we study entrepreneurial traits, we should ask ourselves why we are doing this. The reason is that entrepreneurship is one of many careers you may follow. Whether you follow this career path or a career in sales, quality control, systems analysis, human resources, health care administration, or whatever, *self-assessment* is an important first step in choosing the right career (Bolles 1984; Baumback and Mancuso 1975; *Business Week Guide to Careers* 1985). Self-assessment here means taking inventory of your work-related traits. When you take inventory, counting many significant traits that are also traits of entrepreneurs tells you one thing. Counting few or no strong entrepreneurial traits tells you something else. Although you can, with serious prolonged effort, change certain behavior patterns and acquire certain character traits, you will probably be more successful and happier pursuing a career better suited to you. In addition, the person you will be at age 35 or older is likely to have traits and values similar to those of the person you are now. Thus, self-assessment now is useful even for career choices years into your future.

What are internal (personal) entrepreneurial character traits and how can you assess yourself to see how many you have and how strong these traits are?

Traits Entrepreneurs Score High On

Taking Manageable Risks to Achieve Goals

This discussion is based on research by McClelland (1953), Sexton and Bowman (1984) and Begley and Boyd (1987). *Risk* means a possibility of a loss of some type, such as having a building burn, losing a close relationship, or having no customers come to a store opening. Taking a manageable risk, on the other hand, means investing in a venture in which one can take steps to improve the

probabilities of success. Actions to reduce the preceding risks would be acquiring a building and then installing smoke alarms, developing several relationships and then cultivating them, or offering terrific inducements or advertisements before opening the store. Successful entrepreneurs usually find ways to manage their business risks.

Risk is a necessary element of business, especially in a competitive economy. The essential act of business is the purchase-sale transaction. Before a sale is made, however, the seller usually has invested money, time, and effort, not knowing whether there would be a profitable sale. In fact, this investment—placing time, effort, and assets at risk—may go on for months or even years before it turns a profit. Of course, many entrepreneurial investments are lost despite the entrepreneur's best efforts.

Even before risking investment, the entrepreneur generally loses income from having given up a job. When individuals are confronted with the choice, many may not willingly give up the security of their jobs. Typically, today's Master of Business Administration graduates, especially those with engineering or science training, are qualified to become manufacturing entrepreneurs; but they do not often do so. Why not? We don't know the answer for sure, but two factors may be that their starting job offers are very attractive (the opportunity cost of venturing is too high) and their training has not emphasized risk taking.

Besides the investment of many hours, the intense effort, and the loss of job security, entrepreneurs must accept an ego risk. To venture and "lose big" is to risk being the butt of jokes and enduring ridicule. Certain old school buddies, peers at work, other friends, and perhaps even members of your family may take special delight when, after setting out to do great things, you fail instead.

So why bother? What makes the entrepreneur start a business? Again, we do not know all the answers, but other traits provide some light.

Desiring Independence

This discussion is based on research by Collins and Moore (1970), Hornaday and Aboud (1971), and Sexton and Bowman (1984). A main reason entrepreneurs take risks seems to be to achieve independence from bosses. They typically do not get along well with their bosses, and this is often a reason for "striking out on their own." We should quickly add that just because you do not like your boss, you should not tell him or her off and go into business for yourself. Nevertheless, a strong desire to be your own boss is one stimulus to becoming an entrepreneur.

More generally, dissatisfaction with the restrictions and approval requirements of a job are more than a little annoying to potential entrepreneurs. They tend to look for new ways to do things, and most organizations are bureaucratic enough to follow tried-and-tested ways.

Conformity and independence are contrary traits. A recent study (Sexton and Bowman 1984) of entrepreneurship majors at Baylor University found they were significantly lower in conformity than other business majors or nonbusiness majors. A low-conformity person refuses to go along with the crowd, is unaffected and unswayed by the opinion of others, and is independent in thought and action.

Needing to Achieve and Achieving

This discussion of achievement is based on research by McClelland (1953), Sexton and Bowman (1984), and Begley and Boyd (1987). The **need for achievement** was the earliest trait identified as being entrepreneurial. (Some of the studies employed methodology now questioned and certain studies found managers score as high on this trait as entrepreneurs.) The need for achievement, abbreviated n(ach), is a configuration or pattern of four component traits: taking risks, taking initiative, setting goals, and needing performance feedback. This need may stem from childhood, with the child striving to be as good or better at important accomplishments as the role model — for example, a parent. The entrepreneur's n(ach) often takes the form of striving to beat one's past performance.

Entrepreneurs seem to need to build. They do not appear to be primarily interested in getting rich quick, although money is important to most. The entrepreneur's business dream is to build a significant business or businesses, which will then be looked upon by the builder and others as an undeniable achievement. Evaluation of the business and its monetary value is performance feedback to the entrepreneur.

Another part of n(ach) is goal setting. Many entrepreneurs and managers exhibit "Type A" behaviors: they are competitive, restless strivers who constantly struggle against the limitations of time. Their goals are often to beat their own best performance, or to beat the clock or calendar. Examples would be running a 10-kilometer roadrace in 45 minutes or building sales 50 percent in a year. Entrepreneurs set their goals realistically. They do not engage in activities where they cannot manage or at least affect the outcome. For example, they are not gamblers, nor are they disinterested investors, as stockholders often are.

Type A people tend to be very aware of the clock and the passage of time: they want to finish a project on time, they want to arrive on time or be early to appointments. They set goals in schoolwork, athletic participation, job assignments, and in most areas of their lives.

Trainers in achievement and time management and students of industrial psychology all recognize the importance of goal setting in high achievement. The entrepreneur seems to develop this habit well.

Tolerating Uncertainty and Ambiguity

This discussion is based on research by Schere (1981), Sexton and Bowman (1984), and Begley and Boyd (1987). Entrepreneurs seek independence and will take risks to achieve it. Part of risk taking is the uncertainty of tomorrow. Tolerance for this uncertainty is seen plainly when the aspiring entrepreneur leaves the security of a job. Think about it. What percentage of people you know are courageous enough to leave their jobs, even if they dislike those jobs? How many of us even try a significant new hobby or project? What new skill have you tried to acquire in the last five years? Fearing the unknown is natural, but so is inertia. This is illustrated by the fact that industrial psychologists and managers have long wrestled with the problem of how to bring employees to participate positively in change in the workplace.

Uncertainty denotes a lack of assurance about an outcome, whether of a job change or of the production of a new kind of snow ski in the basement. Entrepreneurs can tolerate this uncertainty and ambiguity. A vague class assignment is very upsetting to most of us; a job transfer presents an unclear and ambiguous situation for a while. "As a new box inspector, what do I do about print discoloration, about a peculiar sagging when I pick up the box? They didn't cover that." In fact, a new situation is almost always an ambiguous one. We are not saying that entrepreneurs prefer uncertainty and ambiguity, we are saying the evidence suggests that they handle it better than the rest of us. Security and clarity about their futures and roles are less important to entrepreneurs relative to their goals than to most persons.

Taking Initiative—Venturing

The discussion of initiative is based on research by Schallenberger (1968). Most of us do what our jobs require and what we are expected to do by our managers, customers, peers, and family members. Carrying out others' expectations and filling roles are important to the continuity and success of businesses, universities, and communities. But the entrepreneur does not fit this mold, rather he or she initiates and ventures. The entrepreneur who sees a deficiency in an employer's customer service will insist on improving it; he or she may "make waves" to straighten out the problem. The employee who encounters resistance from the employer may leave the employer and start a business to serve customers better.

The entrepreneur is not one to weigh pros and cons of a customer service alternative, to do simulations, or otherwise to analyze a problem forever. She or he is a doer. Problems are seen not as barriers but as hurdles to be taken when confronted. The "doer" characteristic fits into a larger gestalt along with the desire for independence, the need to achieve, the inclination to set goals, and the capacity to live with uncertainty. Leaving a well-paying job and venturing

into the unknown world of a new business involves all four characteristics. This large step involves other entrepreneurial traits as well. We will sketch these quickly to complete the discussion.

Other Researched Characteristics of Entrepreneurs

This material is based on research by Kilby (1971), Sexton and Bowman (1984), and Begley and Boyd (1987). Earlier a distinction was drawn between persons whose lives are filled largely with meeting others' expectations and persons who take initiative. These latter persons believe it is important to follow their own expectations. They are said to be inner directed as opposed to other directed and to have an internal locus of control. They believe their ventures will succeed or fail primarily because they make right or wrong moves. They neither give credit to a benevolent environment when they "make it," nor do they blame "the system" when their ventures miss. One's condition is largely self-determined, they feel. However, it is not unusual for an entrepreneur to have considerable respect for luck, and we should also point out that in certain studies managers as well as entrepreneurs indicate greater internal direction than the general population.

A recent Baylor University study found entrepreneurship majors, compared to others, tend to be emotionally aloof, to prefer impersonal to personal relationships, to display little compassion for other people's problems, and to be emotionally unresponsive to those around them. At the same time these majors indicated skill at persuading others to achieve a particular goal; they occasionally seem manipulative but are ordinarily diplomatic and *socially skilled* (Sexton and Bowman 1984).

A characteristic that is somewhat unexpected is the entrepreneur's tendency to *seek help,* especially information, where he or she is not informed. This may seem inconsistent with the need for independence, perhaps with risk taking, and certainly with some larger-than-life images we have of Henry Ford or Andrew Carnegie, the giants among American entrepreneurs. Information seeking is compatible with independence from an employer or boss, however. It is compatible with managing risk. We never said entrepreneurs were larger than life.

Exercise 2.B

At this time, turn again to Exercise 2.A and, using your choice sheet numbered 1–16 and based on what you just read, write in a different color from your own responses the letter of choice you think entrepreneurs would select. Our scores

of entrepreneur choices are found in the Exercises Answer Form at the end of this chapter. Turn there after you select entrepreneur choices and check your reading comprehension. Also compare your score to our entrepreneurial score. The range of scores is from 6 to 57. If you score, say, 40, you have several of the ingredients. We are not going to label anyone, certainly not on the basis of a few questions. Now consider pursuing this self-assessment in more depth.

From Personality to Situations — and Beyond

Whereas most research on entrepreneurs has assumed that certain traits distinguish these people from others, a few researchers conclude that such traits are overrated (Brockhaus and Horwitz 1986). Traits are said to predispose but must be coupled with other factors to predict venture initiation. Carsrud and Johnson (1987) suggest that one's role-set or network significantly influences the decision to start a business. This network may include family members, friends, partners, bankers, distributors, and venture capitalists.

Greenberger and Sexton (1987), reviewing research and hypothesizing about venture initiation factors identify situational factors plus vision and perceived control as important. Situational factors felt to influence one to initiate business are

social alienation (being estranged, ostracized, "shafted")

displacement or other precipitating event (being fired, fleeing war or persecution)

social support (having family or friends who reinforce venturing tendencies)

financial support (having family, friends, bankers, or others who are willing to "buy in")

and environmental support (perceiving that a market can be found).

Additional initiation factors include the person's vision of his or her business — the product, the market opportunity, the establishment — and the behaviors needed for success in that business. Then if one sees a relation between one's actions and the desired outcomes — called *personal control* — the initiation probability is higher. Finally, does one visualize, even label oneself an entrepreneur, and do others agree? Figure 2.1 at the top of the next page depicts these personality, situational, and perceptual factors in the business start-up decision. (Note: marketing research on buying and human resource research on job changing distinguish between intention and behavior. Similarly, an intention to start a business occurs in many more people than does the action, and the intention is often harbored for long periods in initiators before they take the step.)

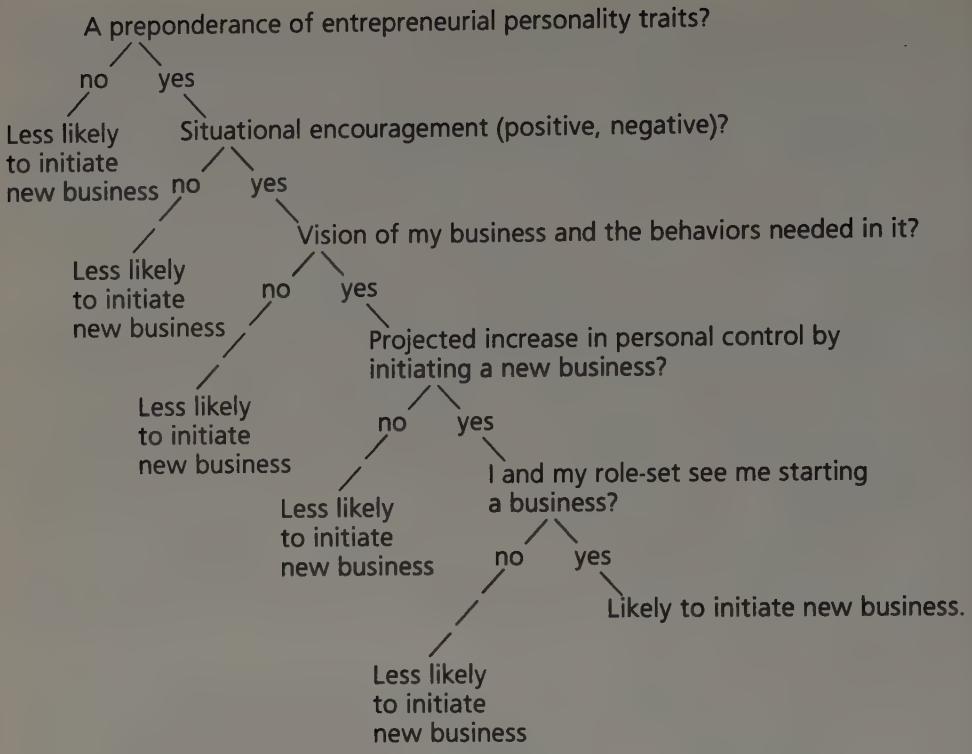


FIGURE 2 Tracking the Future Entrepreneur

Exercise 2.C

There are eight key ideas in the material on personality traits you have just finished: risk to achieve, desire for independence, need for achievement, goal setting, tolerance for uncertainty, taking initiative, being inner directed, and seeking information. These are listed on following pages as Exercise 2.C for you to write some notes about yourself.

1. Next to each characteristic in the list, identify evidence that this characteristic does or does not fit you. Include things you have done at home, at school, at work, in clubs, and so on. When you finish, add up the evidence of fit (left column) then add up the evidence of no fit (right column).

Characteristic	Why That's Me	Why That's Not Me
a. Risk to achieve	_____	_____
	_____	_____
b. Desire for independence	_____	_____
	_____	_____

c. Need for achievement _____ _____

d. Goal setting _____ _____

e. Tolerance for uncertainty _____ _____

f. Taking initiative _____ _____

g. Inner directed _____ _____

h. Information seeking _____ _____

2. First, count all evidences of "fit entrepreneur." _____
3. Second, count all evidences of "do not fit entrepreneur." _____
4. Ratio of first/second: _____ / _____

If this ratio is less than 1, continue for the learning, but you apparently are one of the majority of people who prefer a stable job to becoming an entrepreneur! If your ratio was greater than one, consider Exercise 5:

5. This exercise requires a more serious commitment of time and energy. If you are a potential entrepreneur, however, you do not let this dissuade you. In this exercise, we will address the problem of adding objectivity to our self-assessment. None of us see ourselves exactly the way we maintain a self-image. We inflate certain characteristics and deflate others.

   To get beyond this subjectivity problem, ask others who have seen you work (at home, at school, on the job, in a club, and so on) about your characteristics. Discuss each of these eight characteristics and record the other person's observations. As you finish each characteristic, ask the person who has observed you to place you in either the top 5 percent, next 20 percent, or remaining 75 percent of all the persons he or she knows.

When you have finished Exercise 5, answer the following.

6. How many "others" placed you in the top 5 percent, adding all the characteristics? _____
7. How many others placed you in the next 20 percent? _____
8. How many others placed you in the remaining 75 percent? _____
9. Few persons are serious entrepreneurs. You will find your position in Exercise 5 helpful in determining your tendencies in that direction.

Summary

Chapter 2 presents an overview of the main personal traits found to be associated with entrepreneurs: the need to achieve, risk taking, goal setting, desire for independence, tolerance for ambiguity and uncertainty, taking initiative, being inner-directed, information seeking, low interpersonal behaviors, and high social skills. The presence of these traits indicates a predisposition toward an entrepreneurial career.

The addition of negative and positive situational factors plus vision of a business and perceptions of yourself as an entrepreneur all increase the likelihood you will be one. These are complex variables; and, although not fully understood, they are substantially our understanding of the entrepreneurial personality and other venture factors.

Exercise 2.D

1. How does the need for achievement fit the requirements of entrepreneurial success? Explain.

2. How do you reconcile the entrepreneur's tendency to be impersonal and aloof with the requirement to sell new products or services to customers and to sell the new company idea to investors? Discuss.

3. Identify the one personality characteristic you feel to be most important to entrepreneurial success. Explain.

Exercises Answer Form 2.A, 2.B. Entrepreneur choices, with highest point being first choice, and so on.

	Points	Points	Points	Points	Your Choice	Your Points	Entrepreneur's Choice, Points
1.	(a) N/A	(b) N/A	(c) N/A		_____	_____	_____
2.	(a) 0	(b) 5	(c) 0		_____	_____	_____
3.	(a) 2	(b) 0	(c) 0	(d) 5	_____	_____	_____
4.	(a) 0	(b) 3	(c) 5	(d) 0	_____	_____	_____
5.	(a) N/A	(b) N/A	(c) N/A		_____	_____	_____
6.	(a) 0	(b) 3	(c) 3	(d) 1	_____	_____	_____
7.	(a) N/A	(b) N/A	(c) N/A	(d) N/A	_____	_____	_____
8.	(a) 1	(b) 1	(c) 5	(d) 0	_____	_____	_____
9.	(a) 5	(b) 1	(c) 0	(d) 1	_____	_____	_____
10.	(a) 4	(b) 0	(c) 0		_____	_____	_____
11.	(a) 1	(b) 2	(c) 4	(d) 1	_____	_____	_____
12.	(a) 4	(b) 1	(c) 1	(d) 1	_____	_____	_____
13.	(a) 1	(b) 4	(c) 3	(d) 1	_____	_____	_____
14.	(a) 1	(b) 1	(c) 3	(d) 4	_____	_____	_____
15.	(a) 1	(b) 1	(c) 5	(d) 5	_____	_____	_____
16.	(a) 1	(b) 2	(c) 1	(d) 4	_____	_____	_____
				Total	_____	_____	_____

We developed this inventory for use only as an exercise. On its face the questionnaire assesses characteristics widely felt to be associated with entrepreneurs and follows the discussion of those characteristics in this chapter. Beyond this, no statistical validity or reliability is claimed.

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CHAPTER 3

Preparation for an Entrepreneurial Career

Eagles don't flock.

— H. Ross Perot

Because we look at a career as a rather personal concept, this chapter will be written in "second person," to you the reader. We begin with the account of Johnny Webb, founder, owner, and CEO of Southern School Supply in Bowling Green, Kentucky. He is a successful entrepreneur who attributes his success to preparation. Briefly here is his story.

> Johnny left college in 1966, lacking two credit hours and his practice teaching needed for earning his education degree and teaching certificate. For fourteen months, he installed store fixtures for his brother-in-law, who left Johnny the business when he began a new venture. Johnny continued this briefly; then he was asked to sell boats for his brother-in-law's new company. A year later, he was hired to sell cars for the local Lincoln-Mercury dealership. While selling cars, he completed his degree and teaching certificate. Practice teaching left him with a lasting interest in teaching, students, and schools.

He applied for a teaching position but received no response. Johnny visited the college placement office and stated that he was in serious need of a job. He said he could sell, and the placement office set up an interview with the 3M Company. He was hired and assigned to sell visual aid products to school administrators. 3M's marketing plan included "seminars" for teachers, titled "More Effective Teaching." Johnny began arranging and conducting these presentations. Although not called sales presentations, they often resulted in sales of visual products made by 3M. Overhead projectors were new high-sales items.

The practice at 3M was to carry the equipment into the school administrator's office, demonstrate it, then sell it. Their sales performance index, a "batting average," was calculated as the percentage of demonstrations to calls. Johnny batted 400, which was above average. Although he felt that 3M's success meant that the firm must be doing things right, he became disappointed and began feeling sorry for himself. He was doing everything right but the sales were not coming as expected. On the verge of quitting his job, he called his sales manager in Nashville, Todd Clark. They met in Springfield, Tennessee, the next day for lunch. Todd convinced Johnny he was doing everything right and that he had great potential. He just had to be patient while the seeds he was planting began to grow. Sales started to climb shortly thereafter. And climb and climb! Johnny soon won a number of sales awards from 3M.

He did not know he would later start his own business, but during the years at 3M Johnny learned a number of things that proved invaluable in his career as an entrepreneur:

1. 3M's sales training was excellent and he now feels he could not have received such training at smaller companies.
2. He became friends and aligned himself with the more successful people at 3M. He copied selected behaviors of these people. They were role models.
3. He observed one man who could deliver a speech that would make a sales representative want to sell for 72 hours nonstop. But this man could only talk, and Johnny did not wish to be like him. He wanted to be a doer.
4. He came to want success very much and learned to work very hard to achieve it.

After four years of selling, Johnny was offered the sales management position in Nashville, but he and his wife decided to remain in Bowling Green. The job and the new boss, whose job he had been offered, began to lose his interest.

He asked himself, "What can I do?" The answer was, sell, and in particular sell to the school administrators who were his 3M customers. But sell what? He located a book containing names, products, and so on, of seventy manufacturers of school supplies. In early 1972 he wrote to all of them, describing what he had done and what he wanted to do. He wanted to sell the school supplies they manufactured. Only three manufacturers replied.

Instead of being discouraged that 96 percent turned him down, he saw opportunity in the three manufacturers who expressed interest in supplying his new venture. He was able to borrow $3500 from his bank, and soon his garage contained boxes of school supplies. He loaded his station wagon early in the mornings and hit the road, returning late in the day with an empty or nearly empty wagon. Having sold certain items not in the wagon, he would package items to fill those orders when he arrived home each day. These he would immediately ship to the customer. Each evening he typed invoices covering the day's sales, which he mailed the next morning.

Sales came but, since payments were slow, he had to borrow more money. He was able to sell the bank on his business and borrow $10,000 in November 1972. Since then, expansion has followed constant attention to customer needs. In 1985, thirteen years after starting, Southern School Supply employs forty to fifty people, depending on the season, including nine outside salespeople. In addition, sales are generated by an extensive catalog, by inside salespeople who take phone orders, by bidding for large orders, and by two retail stores where teachers shop.*

In this chapter we present ideas about how individuals accumulate tangible and intangible resources as preparation for entrepreneurship. Most people who start businesses have accumulated education, employment experience, and money. Do you, right now, have any of the experience so vital to starting a viable business? If you have sold items, bought items for resale, or helped produce goods or services, then you may have more useful experience than you think.

In Chapter 2 we looked at what has been learned about personal characteristics of entrepreneurs. Studies of many hundreds of persons who have started successful businesses indicate that most share certain experiences. Activities they have engaged in while in school or working full time for employers before starting their own businesses, inform their business decision. Rather than write this chapter for you as a recitation of what percent in a certain study sold something in high school, what percent in another study

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* Used with permission of Johnny Webb.

gained experience prior to starting the business, and so on, we will present the information from your perspective — that is, without assuming you have any specific experience, we ask, "What activities might I pursue to prepare myself to start a business?"

Experience as Preparation

You might gain useful insights about a business by working part time and summers in a small, preferably new, business. Ideally, you might have an interest in a specific industry and a specific kind of work within a business. For example, say you find residential construction holds your interest, and within this industry you like carpentry work. Then you might want to gain all the experience you can in house carpentry, without interfering with your classroom education. You could learn the tools, the woods, the fasteners, the dimensions, and the techniques of accurate measuring and cutting. Along the way you could study and learn to read blueprints. You should learn customers' and suppliers' businesses. After gaining proficiency in these matters, you would be ideally positioned to talk to realtors who might sell a new house for you if you built one. You might observe advertisements for new houses and gain the opportunity to talk to home buyers. An option would be to study real estate practice, get a sponsor realtor, take a test and become a licensed realtor. By selling houses, you would learn the forward, or downstream, end of the business, which is often crucial (Kroc 1977). Alternately, or in addition to a stint in home sales, you might work for a building products supplier. The object here would be to learn thoroughly the available materials, costs, possible substitutes, brand characteristics (cabinets, bath fixtures, and so on), and purchase terms.

Along the way, through talks with home financiers such as savings and loan associations and banks, you would develop an understanding of the problems facing home buyers. Then you would know the financing problems your customers might have when you try to sell your houses later. For example, a lender might loan 95 percent of the price of a brick house meeting certain building specifications located in a certain development. But the loan might be for much less if these conditions were not met. This lender requirement would affect your thinking about the kind of house to build. The point is, it is so much less costly to gain this knowledge before you risk your hard earned savings and your income — which you do when you start a business.

So, considerable useful understanding of business generally can be acquired by the time you graduate from college or while working for someone else. You might be fortunate enough to learn by working in the particular kind of business (the industry) you will later start for yourself. Even further, the

knowledge of carpentry, for example, gained in the experience-building years will be invaluable later when you employ carpenters, supervise construction, and evaluate quantity and quality of work performed by your crew or crews. You may identify ways of performing tasks at significant cost savings. For example, fifty years ago almost all the parts of a house were constructed on site. Today doors, windows, fireplaces, trusses, and cabinets are usually manufactured elsewhere and hauled to the site for assembly, at considerable cost saving. Many entrepreneurs get their start by identifying a better way to produce something while working for someone else.

To summarize thus far, you will be way ahead if you gain valuable "operating skill" before starting your own business. Additionally, you can learn administrative (bookkeeping, cost control) skills and gain a perspective on a whole business. This knowledge coupled with your education will produce ability greater than both separately. You can get a synergy: $2 + 2 = 5$! (This particular synergy we also call *mileage*, meaning you go a great distance on a limited resource.)

When you work, you are paid a wage. If that work also becomes experience that aids you in starting or running a business, the extra "income" is synergy.

Education as Preparation

Education helps us appreciate and function in the world. If it complements our work experience so that each means more to us as a result of the other, that is synergy. We, then, encourage you to choose educational and work experiences that are synergistic.

The role of education in entrepreneurship is generally positive, despite some folklore to the contrary (Weinrauch 1984). Certainly high technology entrepreneurs, innovating a complex production process or product, acquire much of their background knowledge in college. In fact, if you want to invent patentable products or processes and move into engineering or scientific-based fields, you need at least a master's degree in your chosen field. Despite the stories of geniuses who invented and innovated engineering wonders without benefit of formal education, the research evidence is clearly in favor of the highly educated person.

Evidence is even emerging (and many claims are made by professors) that courses in entrepreneurship lead to successful ventures (Robinet 1985). This is plausible for two reasons. First, you learn certain requirements for starting a business, seeing why some succeed whereas others fail. Second, you also meet possible entrepreneurial models by enrolling in an entrepreneurial course: persons who are interested sign up and persons who are not do not enroll (Clark et al. 1984).

Full-Time Employment Preparation

Ronstadt (1984) classifies relevant experiences into four kinds: educational, technical, industrial, and entrepreneurial. Educational is the number of school years completed, technical is production (product or service) know-how, industrial is the type of business, and entrepreneurial is a start-up role. All are felt to be useful, but we do not have clear research findings. Sandberg (1987) investigated the possible relation between previous experiences of business owners and performance of their companies. Based on earlier studies, he supposed that entrepreneurs' performance would be enhanced by (1) previous entrepreneurial experience and (2) managerial experience in a related line of business. Further, Sandberg suspected that (3) managerial experience in an industry (in same line of business) would be more valuable in pursuing an imitative strategy, whereas (4) entrepreneurial experience would be more useful pursuing a nonimitative strategy. His findings were mixed.

1. First-time entrepreneurs performed better than others, but the relation between entrepreneurial experience and performance could have been by chance.
2. Ventures by individuals with managerial experience performed better than those without, but again the experience-performance relation was small enough that it may have been by chance.
3. Venture performance correlated negatively with years of managerial experience in similar industries, but again the relation was not strong enough to give confidence of understanding the finding.
4. Years of entrepreneurial experience was not found to predict better performance in new ventures.

These "nonfindings" mean that experience can be useless or even bad, as well as useful; and they humble us. There is much we do not understand; but there is also much we are beginning to understand. Sandberg's research found that new businesses whose strategies fit the industry circumstances prevailing at the time easily outperformed those not fitting it. Strategic fit is presented in later chapters.

We still see experience as potentially very useful. Mo Siegel, founder of Celestial Seasonings, says he wants to employ "winning players from winning teams." While winning players from losing teams have ready excuses, winners from winning teams have ambition and confidence.

We believe that high performance experience in a high-performing venture predicts future high performance in a related venture. Venture capitalists, in general, are better than most at predicting new venture performance (Sandberg 1987). They look at the entrepreneur's track record and back certain of those with experiences (records) of success. We see experience as more or less

related to a business a person later starts. We can illustrate four levels of relatedness, by the following:

Closest relation	You work in a hamburger restaurant. You later acquire this restaurant or open a hamburger restaurant a block away, with the same suppliers, customers, and so forth.
Less relation	You work in a hamburger restaurant. You later open a hamburger restaurant in another city.
Still less relation	You work in a hamburger restaurant. You later open a fried chicken restaurant.
Least relation	You work in a hamburger restaurant. Later you start a construction company.

Exercise 3.A

Identify three activities you have engaged in that relate to a salable service or product (examples are fitness workouts and cooking); then describe three businesses you might establish, capitalizing on that activity.

Activity	Related Business I Might Start
1.	
2.	

3.

You might prepare and discuss these with a knowledgeable acquaintance. We suggest you focus on (1) how common is the skill you now have, (2) how likely is it that you could become the best skilled at this task or best salesperson of this service or product in a market area, and (3) who if anyone might buy this product or service.

A key concept, which may prove to be the difference between success and failure later, is the transferability of skill and experience. If at age 35 you start a business, how much skill and experience can you transfer into it from your prior employment? Simply working in a newspaper for ten years does not automatically qualify one to own and manage even a small newspaper. Such experience would be necessary for most persons, but sufficient for few — you must have experience, but experience alone is not enough. If you devote five years to a business, feeling you will someday manage one yourself, you are likely to absorb much more information than if you have no such ambition. Five years working in preparation for starting or operating your own business will give you much more transferable skill and experience than simply working. The transfer of learning between certain businesses will be much greater than between others, depending on the relatedness of the businesses and the uses to which you put your employment.

Earlier we mentioned that while working in a business you might conceive an idea for performing a task more easily than your employer does and use that idea to start your own business. A word of caution is needed. Techniques or products that you develop on your employer's time may be owned (called *proprietary*) by that employer. A researcher may sign a statement relinquishing rights to patents secured while employed or rights to processes developed on the job and later patented. Generally, however, inefficiencies or poor workmanship that you observe on a job may provide wedges you can use to open a new competing business later. Opportunities to compete through efficiency (low cost) or greater customer benefits are the topics of Chapters 5 and 6.

Research among 154 members of the National Federation of Independent Business by Cooper, Dunkelberg, and Futura (1985) yielded findings pertinent to preparation for business start-up. Almost three-fourths of the

business starters came from businesses (previous employment) with fewer than one hundred employees. Many had held multiple jobs with different organizations. These and other of their findings suggest that aspiring entrepreneurs who join particular organizations may be influencing their later start-up paths in a number of ways, including the type of business they later start and the amount of capital they have to start. This brings us to the next asset to accumulate, money.

Financial Preparation

Besides gaining insights to buying and selling, bookkeeping and control techniques, operations skill and experience, and perhaps the business idea, you need at least one other asset that employment will help obtain. This is capital. We refer to dollars as capital if invested for a long time and as money, if expected to be returned quickly. By whatever name, few entrepreneurs start without funds of their own. Often a husband and wife will both build a significant savings account before starting a business. Start-up can occur with only other people's funds, but this seldom happens. Although Chapter 13 will present a fuller discussion of start-up financing, the importance of financial preparation to later financing cannot be overlooked now.

Essentially, the importance of preparation in the form of saving dollars is this. Say it is 1996 and you are 29 years old; you know the plumbing wholesale business well—all your skill and experience bases are covered. You know manufacturers, builders who buy at wholesale, and the rest. You need $100,000 to cover lease deposit, initial inventory, start-up costs, and expenses of operation until cash from sales starts coming in steadily. You go to your banker, who wants to know how much of the $100,000 you are personally investing. The banker's decision to lend or not could easily depend on whether you have $5000 or $10,000 equity to invest.

Why is your equity such important preparation? For two reasons. First, your $10,000 tells the banker (or other financier) something about you and your potential as an entrepreneur. It tells the banker whether you have thought about your possible needs for a long while or just only recently. It indicates the duration and intensity of your commitment to the venture. It demonstrates your ability to control your personal expenses and thus whether you might be able to control business expenses. It establishes your commitment—you stand to lose more than time if the business fails.

The second reason your money is important is that, in the event of a wrong guess, the banker wants to get out without losing. What would happen to the bank's money if you folded before repaying the loan? Would there be enough money from liquidating (selling assets) to repay the loan? The greater the proportion that your equity is to the assets that can be sold, the greater will

be the probability the bank will recover its money. In sum, during the years preceding the start-up of a business, the future entrepreneur can help his or her cause considerably by accumulating capital—saving, if you will. Most entrepreneurs—not all, but most—have saved money first.

So far, we have noted the importance of acquiring experience in running all or at least part of a business, and we have shown the importance of having seed money for a start-up. Observation, part-time ventures, and hobbies often facilitate an individual's start-up.

Other Factors Facilitating Start-ups

The children of entrepreneurs are more likely to become entrepreneurs than are the children of other parents. When these young persons see it done, they learn that it can be done, and they learn something about the process and requirements. You cannot choose your parents, but you probably have opportunities to observe someone start a business. Is anyone you know starting a photography business, a manufacturing business, a retail store, restaurant, software, construction, photocopy service, video games, or fitness center? If you observe, ask questions, and perhaps help them, you gain two benefits. First, you will learn that you can do it if you prepare. Second, you will learn some of how it is done.

Another opportunity to prepare for start-up and also for operating the fledging business is to begin a part-time venture. A few high school students sell T-shirts or calendars, after designing and getting them manufactured. Even just selling magazine subscriptions or other items gives one the taste. You may decide you like it and want more or you may decide that one taste is enough.

Hobbies often turn into part-time businesses, and a few of these become full-time ventures. Two points are mentioned now and pursued further in later chapters. First, part-time ventures or hobbies are often not suitable for later development into full-time businesses because the skill or service provided is too common. Many persons can take photographs and even develop and enlarge them, so this field is often crowded. This point is explored further in Chapter 7, on new business entry wedges. The second point, on the positive side, is that during the first venture you will get ideas for another venture. During the next venture you will get ideas for still others. This so-called corridor principle is discussed in Chapter 4, on sources of new business ideas.

Examples of Entrepreneurship Preparation

Two famous examples will be given of preparation for entrepreneurship, then two not-famous examples. It is easy to find such examples. The difficult task is to find successful entrepreneurs without preparation.

Entrepreneur on Wheels

Our first famous example was the son of a foundry worker in the car industry, the industry in which the son would later make his mark. He earned a degree in engineering and went to work for an automobile company that later went out of business. He then worked for a larger company in the same industry. His career there is described as meteoric. He was said to be the model for the character Adam Trenton in Arthur Hailey's best-selling novel *Wheels*. He performed so well he was named head of a large division of this company twelve years after joining it. His management of his first division was so effective that he was named head of the largest division of the largest automobile company in the world.

He shortly resigned his $650,000 a year position to start his own car company, obtaining over $200 million dollars of investment on the strength of his business idea and his reputation. Between May 1981 and May 1982 his company produced over 7000 cars in the Corvette price range. He is called the first successful automobile entrepreneur since Walter Chrysler in 1925.

He is John DeLorean. Despite the subsequent bankruptcy of his company and his own personal failures, his story is the story of an entrepreneur with few peers. Had there not been the worst recession in the car industry in decades and had this entrepreneur turned over some management duties to managers, his company would probably be a contender in one of today's most competitive markets. His preparation was intense. However, he was always more a creator-designer than a manager.

Entrepreneur of the Century

Our second famous example of preparation—this time so long a period as to be almost discouraging—focuses on perhaps the premier entrepreneur of twentieth-century America. Before graduating from high school, he played the piano for money in Chicago. His experience included selling real estate in Florida, then selling Lily-Tulip paper cups. For over twenty years he sold paper cups to drug stores, factories, and restaurants. He learned to be a careful observer and he learned to sell. By observing the time consumed by variety store employees handling glasses for their food trade, he was able to sell management on using paper cups and building carry-out sales. He sold milk shake makers on the idea of using his paper cups for the first time.

He helped start a milk shake mixer company. Later he acquired and managed it and continued to be its sales force. He then became interested in the fast food drive-in in San Bernadino, California, that

ordered eight of his milk shake multi-mixers. He decided that drive-ins had a great future, and he wanted to be in on that future. After months of drawn-out negotiations, he was able to become the franchiser of restaurants like the one run by the McDonald brothers. He was 52 and had been preparing since high school.

Few entrepreneurs ever had experience more closely related to their later business venture than did Ray Kroc. And few, if any, were more successful entrepreneurs.

Other Entrepreneurs' Preparation

A pair of not-famous entrepreneurs who prepared extensively will be called Carl and Alan Aiken. Alan is Carl's son. From the time he was 10 years old, the elder Aiken was a "go-fer" for his farmer father, going for supplies and tools needed to run the family farm and repair the old machines and equipment. Carl began learning mechanical skills and self-reliance, to do himself what needed doing instead of calling a repairman or going to a garage. While continually holding maintenance-related jobs, he eventually graduated from college with a degree in English and began teaching high school.

Soon after beginning high school teaching, Carl started repairing appliances, especially heating and air conditioning units for friends and neighbors, in the evenings, on weekends, and during the summer. Fifteen years later, when Alan graduated from college with a business degree, the Aiken heating-ventilation-air conditioning (HVAC) company was developed. Carl had years of experience repairing and installing HVAC systems. Alan had worked in the business since high school, except while away at college.

So when Alan began to take over major operating responsibility for the business, he had his father's twenty-plus years of closely related experience to draw on as well as about 8 years of closely related part-time experience of his own and related college studies. Alan expanded the business and makes good money in it. He also helped his wife open a successful business.

Summary

Many people start businesses; few keep them going. In this chapter, you saw that keeping a business going, which you have started, is more likely to occur if you prepare. Preparation usually comes from part-time employment, courses related to business start-ups, full-time employment, full-time employment related to your later venture, and watching or helping others start businesses.

Exercise 3.B

After reading the following brief account of Michael Blumenfeld's pre-start-up experience and his new business, identify the main knowledge you imagine he acquired from this experience. How do you think this knowledge helped most in his business?

Michael played outfield for the St. Louis Cardinals farm club for two years, until knee problems ended that career. He began selling tennis nets from his pickup truck to tennis and country clubs in the Memphis, Tennessee, area. He and his wife mailed hand-drawn brochures to his new customers. He uncovered other items his customers needed and learned to supply them. Several years later, he had over 40,000 active accounts and mailed over 3 million catalogs a year. Sales were above $40 million, including about $8 million from thirty-two stores in the Tennis Lady chain.

Exercise 3.C

Describe your own experience at one endeavor that might become the basis of a new business. What did you do? Whom did your efforts benefit? Did you begin to develop any specialized competence? What is a likely next step to build on your experience and to move yourself closer to being able to start your own business?

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PART II

Product-Market Strategy

CHAPTER 4

Where Start-up Ideas Originate

Eureka! (I have found it!)

—Archimedes

A start up idea may be based on a product or a market. Let us start with a market idea. Market disequilibrium is a fundamental, interesting concept in entrepreneurial thinking. Disequilibrium exists when more than one price is found in a market for economically equivalent items, especially when a set of resources is valued at less than the price the market will pay for what the resources will produce. To illustrate,

> *USA Today* on January 28, 1988, carried several classified ads for Superbowl tickets. The Ticket Outlet offered tickets at $650 each. Tickets had sold by the National Football League for $100 or were actually given away two weeks earlier. This large price discrepancy illustrates market disequilibrium, and The Ticket Outlet is an example of an entrepreneurial company that anticipated the associated window of opportunity. We say there was market disequilibrium during the two-week period because either (1) at $100 each, many more tickets would have been bought than were available for sale or

(2) given the high demand for tickets, all those for sale could have been sold by the NFL for considerably more than $100 each.

Generally, disequilibrium may arise from rapid industry (demand) growth, recent exit of incumbent sellers, high industry rates of capacity utilization, recent technological changes, and from constraints on supply, such as war, natural disaster, or government regulation of supply (Vesper 1989; Sandberg 1987). To illustrate, here is what happened following a government regulation of supply (Turner 1988).

> In Bowling Green, Kentucky until January 20, 1988, minors from 18 through 20 years of age were permitted in bars and clubs serving alcoholic beverages, although they could not be served such drinks. Primarily because the city found that policing this prohibition so difficult, on January 20 the City Commission passed an ordinance barring minors from these establishments. This supply reducing ordinance created a significant market disequilibrium, since there are hundreds of college students accustomed to evening entertainment at places now abruptly barring them. The mayor stated, "There's a void that's been created. I think you're going to see some businesses fill the gap. That's what the system is good at."

In fact, that very day a number of club owners, promoters, and a marketing professor separately began plans to open new businesses to "fill the gap." A music entertainment complex, a dance club, and a weekly concert series were among the planned new businesses.

Noted economist Frank Knight (1921) came to understand the essence of entrepreneurship as identification of or seeing disequilibria and managing resources to gain pure profit (above market rates of return on investment) by supplying those markets until equilibrium was again reached.

A later economist Joseph Schumpeter (1934) also believed entrepreneurs play a key role in economies, but that role is innovator rather than "seer." He said entrepreneurs create disequilibrium by bringing about new combinations of productive resources. They bring to market new products or services, creating unmet demand (or supply shortage). Alternately, they might devise lower cost production (or marketing or financing) methods and thus bring about another (lower) price. Schumpeter saw entrepreneurs as creating disequilibria. Whether they see disequilibrium and act (increase supply) so that equilibrium is reached or create disequilibrium (until imitator rivals restore equilibrium), the temporary opportunities to start new businesses is the important idea for us. We now explore these opportunities.

Exercise 4.A

Think of two products or services you bought recently. Take a minute to think. Do you have them in your mind? Now, think of *any* ways they possibly could be changed so that they would please you more.

What you just did is one way that ideas for starting a business originate. Business ideas may be in our minds and all around us. One's experiences at work and as consumers are the main source of new business ideas. Next in importance comes the experiences of persons you will come to know in the next few years. Finally, professional idea people are always available for a fee.

In Chapters 2 and 3 we looked at predictors and characteristics of probable entrepreneurial activity. Few people have the intensity of characteristics that entrepreneurs typically have and few want to be entrepreneurs, considering costs of preparation, hard work, and risk. But, for those whose "hand is still in the game," the next step for us is to think about ideas for new businesses. Are new business ideas limited to the Henry Fords, Ray Krocs, and Stephen Jobs? Or are thousands of people also capable of coming up with many good ideas?

Studies of persons who have started businesses in the past suggest that future businesses will be started by thousands of people, each with very good ideas. We will encourage you to generate a few ideas yourself as you study this chapter. This is a fun part of entrepreneurship for almost anyone. In following chapters, we will focus on narrowing down lists of ideas — culling out fantasies and trivia — to arrive at those worth pursuing further. For many persons, narrowing down the idea list is no fun, and many would-be entrepreneurs drop out after the idea-generation stage — that is, most persons occasionally enjoy musing about getting rich by producing and selling some fantastic product. This entertainment may be confused with entrepreneurship, unfortunately.

We will examine the ideas coming from three sources. The first source is you: your employment experience, hobbies, your observations of people's wants and needs, and your observations of change. Our second source of new ideas stems from your acquaintances: people you meet in your employment, social activities, and entrepreneurship studies such as this book. Third, we branch out further and describe what institutions such as trade shows, patent brokers, and new product information service companies offer.

First New Idea Source: Your Experience and Observation

Current employment is the most practical and common source of new ideas learned and duplicated in another market.

> Karen Whitely worked in a furniture store in Boston during college and later opened her own furniture store in Springfield.
>
> David Haynes kept books for two fast food restaurants while earning his accounting degree. After college he became assistant manager, then manager, of a restaurant opened by his employer. Shortly afterwards, he moved to another city and opened a similar restaurant. Six months later, this entrepreneur opened another.

Generally, using this kind of idea generation involves learning a transferable business in one population center. Chapter 7, describing market entry, follows up on the transfer of an idea into a new market.

Students generate ideas in their college years, requiring no more than extracurricular time, available funds, and ingenious perseverance. An Indiana University student observed that thousands of dormitory residents were not pleased with cafeteria fare, and often they did not wish to trek to the nearest McDonald's or Mexican food restaurant. The demand was especially strong for two kinds of fast food late at night in the dorms. This idea, after months of research, arrangements, and initial capital, was turned into a profitable business.

Other student ideas for food, entertainment, cleaning services, and dating services as well as résumé writing, tutoring, and other education-related services have provided student founders both learning experiences and profits. Learning experience is gained more often than profit — and, early in one's entrepreneurial career, learning experiences are probably worth more.

While working you will have opportunity to see many potential new business ideas. You may spot the need for a better supply of items or services your employer uses or for products that could effectively compete with those of your employer (this is the subject of Chapters 5, 6, and 7).

Research by Cooper, Dunkelberg, and Furuta found that small, generally new businesses "varied in their degree of relationship to the previous incubator organization. Entrepreneurs from small businesses were most likely to offer the same products or services as their incubator organizations. Since a small business incubator is presumably offering products or services which could be offered by other small businesses, this is not surprising" (1985, p. 65).

Two important influences are at work. One, the founder's skill and knowledge about a particular product or service influences the choice of a new business to start. Second, because the small business previously employing the founder was presumably successful, it probably operated in an industry with diseconomies of scale; for example, the need to adapt to a local culture or climate, or high transportation costs.

Supply change is always worth watching for new business ideas (Porter 1980). *Supply change* refers to any change in production or product technology, delivery, or financing that affects the quantity, type, or price of goods and services supplied to markets. (Demand, of course, is the other side of markets.) For example, a broad change occurring in U.S. manufacturing supply now involves locating materials and parts suppliers very close to user customers. Makers of car brakes, radiators, wheels, and other components are given preference if they are close to the auto assembly plant. Many existing suppliers are too inefficient or will not move, opening the way for entrepreneurial suppliers.

> The American Sun Roof Company of South Gate, Michigan, announced its plans to build a small manufacturing plant in Bowling Green, Kentucky, to make sun roofs for the Corvette. The plans called for the plant to be completed in about eight months and deliveries to begin in about ten months after the announcement.

Even if the old supplier moves the nucleus of the new business to a new location, there will be opportunities for businesses to start or expand close to the new business.

When American Sun Roof started the business in Bowling Green several things happened. The new supplier itself needed suppliers of parts, materials, and supplies, thus creating opportunities for new businesses. Workers needed training, and secretarial assistance was required. (Temporary human resources is a major new industry.) Trucking service was needed to deliver products. Janitorial and maintenance services were needed. Often these services and parts are not available from existing businesses, and enterprising observers start new ones.

Better delivery, thinking very broadly, is an impetus for many new businesses. Fast food, one of the most enterprise-intense industries in the last twenty-five years, essentially is built on better delivery systems. Conveniently located (delivered) and fast meals still are needed in market pockets here and there. Even vitamin-packed cereals can be described as a way to deliver vitamins to persons interested in their health but not in taking pills. How many other, perhaps better, ways are there to deliver nutrition? Health?

Exercise 4.B

Conceive of two ideas to better supply a business you know about and two ideas to better deliver a product or service. Discuss your ideas and an acquaintance's ideas before going to the next chapter.

First Product or Service	Better Ideas for Supplying Main Input
1.	1.a.
	b.
2.	2.a.
	b.

Second Product or Service	Better Ideas for Distribution or Delivery
1.	1.a.
	b.

2. 2.a.

b.

A new product or service can compete with your employer's product or service if it does something — anything — significantly better or at a lower cost. These advantages will be pursued in Chapters 5 and 6.

Better financing often opens new business opportunities. Variable rate mortgages (the interest rate changes with market rates), negatively amortized loans (to keep early payments affordable, they are set below the interest cost for the month), five-year auto installments (formerly, three-years was the maximum), rent-to-own appliances, and rental furniture are all financing innovations that have opened new markets and new business opportunities in recent years. Most are responses to changes in the economy or in people's living habits. Other changes happening this year will be the basis of ideas for next year's entrepreneurs.

New technologies mesh with markets and form new industries. Major industries of recent origin and still changing rapidly (based on personal observation of the author) are as follows:

commercial seafood farming
solar power
solar heat
chemical vegetable farming (hydroponics)
database information services
home-based services of a secretarial and research nature
personal computer peripherals
education software
business software (pro shops, dairy farms . . .)
other software
portable (formerly hospital) equipment
fitness centers
health maintenance
pico (lap computers)
video cassettes
compact discs

Exercise 4.C

Discuss two technological changes that are occurring now or will occur by the year 2000. What new product or service will come about as a result?

The industries listed on page 55 and many others are in early stages of change. As they develop, many will need new suppliers and distributors because existing businesses cannot adequately support their growth. So change, and especially emerging industries, are key areas to watch if you want ideas with potential.

Complementary business ideas are also spawned by emerging industries. The recreational vehicle industry generates complementary businesses in vehicle accessories and retail service centers. Camping World Corporation is a young company, founded by David Garvin, that has grown by filling these needs. They have fourteen Supercenters across the United States, and three more are presently under construction.

Food companies sprang up to complement the microwave cooking appliance industry. Complementariness of product and service needs should be thought of in chains, each new product or service market providing links to still newer ones. Health foods are complemented by fitness centers. Fitness centers are complemented by clothing for jogging and aerobics. Jogging is complemented by outdoor vacation spots.

Exercise 4.D

Identify two complementary product or service ideas for the emerging robotics industry. Then identify another emerging industry and two products or services complementing it.

Emerging Industry	Complementary Product or Service
1. Robotics	1.
2.	2.

Product-based ideas result in new products brought about because a new technology was pursued. Market-based ideas start from a potential user's need — from demand, not supply. It often is felt to be less risky to proceed from the need (demand) to the product (supply); however, many products precede awareness of a clear need for them. The development of synthetic rubber was said to be demand pulled, whereas laser development is said to be technology pushed (Lowe and Crawford 1984).

Poroplastic was a "product" developed through a technology push at Moleculon Research Corporation in the 1970s on the supposition that it would be profitable. It would shrink controllably and release compounds for sustained periods. Uses were projected in the drug, cosmetics, toiletry, and pesticide industries. None of these markets ever materialized, and this product-based idea never found a market. Often, a product-based idea becomes so dear to its developers, but to no one else, that many dollars and years are wasted by them before the idea will be scrapped.

A *by-product* is a product-based new business possibility. For years sawdust from sawmills, as well as shavings and chips from other wood cutting and shaping operations, went unused. Now, they are profitably processed with heat and glue into strong building siding and other salable products.

This completes our discussion on start-up ideas from one's experience

except for a few notes about the legal constraints faced when ideas you thought were yours may be claimed by someone else.

Ideas derived from one's own employment experience may belong to that employer (Hofmeister and Shear 1987). Generally, as an employee leaving an employer, you can take an idea with you in the following circumstances: if you did not sign an agreement to not compete with the employer upon leaving, if the product or service can be copied by any trained person, and if products or services used were not protected by patent or protected as trade secrets. You are not permitted to use a mailing list, customer list, or other proprietary (owned) information to sell to the former employer's customers (McManus 1983).

If you learn of a product-improvement idea while employed, if you give this information to your employer, and if the employer refuses to use it, then you may be able to start your own business using it. This happened to a young man selling a pipe bending and threading machine. His recommended improvements were rejected by his employer. Subsequently, he quit his job, developed the improvements and went into business for himself.

Any general skills or knowledge learned during employment may be used in a new business to earn a living. Unprotected trade secrets (information or skill giving one or a few sellers a competitive edge) are probably usable; but, as with other areas just mentioned, an experienced attorney should be consulted before investing much time or money, to determine who owns such information. Further discussion of this so-called intellectual property, as it relates to start-ups and expansion, is found in Chapter 11 on licensing.

Second New Idea Source: Acquaintances

Let us first consider as idea sources acquaintances with whom we work and others close to us. Then, casting wider, we will examine possible business ideas from persons we become acquainted with for the specific purpose of obtaining ideas.

Extending the line of thought from one person's work experience, we find that many individuals who leave employment to start a business do so with friends. Researchers who leave IBM, MIT, and other organizations to start new businesses usually do so as partners or teams. If you find yourself in sales a few years from now, you will be able to spot weaknesses in your products or services from certain customers' viewpoints. Alone, you may not be able to do much about this need. But in talking with someone in design or assembly, or shipping, or accounting, the two or three of you may become a winning team. You may develop an improvement — better serving customer needs. If your employer does not follow up or restrict you, your team may pursue the im-

provement as a new business partnership. (This book does not discuss the techniques and pitfalls of team building. For such a discussion, see Timmons, Smollen, and Dingee 1985, Chapter 7.)

Occasionally, people with unique recipes for delicious foods go into business after friends' effusive compliments are followed by suggestions of other friends to commercialize their cooking. Many of the cookies, pies, cakes, pot pies, candies, and so on in the grocery store today began in this way. Mrs. Mamie Waters opened McCoy's Cake and Pie shop in Milwaukee because her southern dishes were "needed" in that city. You might generalize on this path to the new business based on a hobby or moonlighting job (Weaver 1973).

Frequently, people in banking or accounting positions find themselves consulting with *clients* on business problems. The problem may be a new product problem, a competitive problem, or a client who wants continuing help. In any of these cases, one may be welcomed into the business as a new partner or major investor.

Often, *inventors* are not interested in marketing their products and thus never become entrepreneurs. If your acquaintances include someone who has "a better mousetrap" but is not marketing it, there may be opportunity. In 1971 a Richmond, Virginia, man invented a safety blade for standard 18–22″ lawn mowers. The blade was about 12″ long, and on the end of it were bolted swinging cutting blades 3–5″ long. If these small blades hit a shoe, instead of cutting through, they would merely swing back. This invention was refined by the early 1970s, but for lack of a marketing push it died.

An inventive metal worker, James Jolly of Breckinridge County, Kentucky, came up with a better breakaway basketball goal to survive modern slam dunks. At the 1981 NCAA Final Four tournament in Philadelphia, his display booth was found by the entrepreneurial Gared Company of St. Louis. This company eventually manufactured Jolly's rims, after a 1985 rule change by the NCAA allowed their use by member schools.

Combining the work experience and the idea of an acquaintance plus your own business training is another idea approach. For example, an experienced cook or chef wants to open a restaurant with a business partner. Or a plumbing contractor notes a need for a plumbing supplier and wants to help such a supplier open. You may need little or no experience in plumbing supplies, as your knowledge of accounting, operations, marketing, or other business functions may qualify you to be a successful partner. Even an experienced acquaintance who does not want to enter a new business full-time would probably be willing to consult or personally contribute hours to your new venture. Whether free or for cash or an equity interest, a technically skilled person's help is a way of getting started.

Acquaintances who generate ideas can be cultivated easily. Persons will talk about their work, their ideas to improve something, or their ideas to start a business, rather extensively. Social gatherings, civic club meetings, JAYCEE meetings, Chamber of Commerce meetings, and other meeting places can yield interesting ideas.

Third New Business Idea Source: Idea Organizations

Beyond the myriad possibilities of one's work experience and beyond acquaintances are those we might call professional "idea" people. Many industries have annual trade shows and exhibitions. Here, idea producers display their latest wares or services. New lines of foods, clothes, tools, camping gear, and other items often appear here first. New services such as those offered by realtors, bankers, and health clubs are demonstrated at these shows before entering the customer market. Distributors, franchisers, wholesalers, retailers, and licensees may be sought by these exhibitors (Barovick 1983).

Patent brokers are middlemen between owners of patents, who will not commercially develop the patented product or process, and others who want new products or processes to use. If you wanted to manufacture new items in the lawn care field but did not know exactly what items, a patent broker might help you. Or if you were looking for an exclusive process to produce a common product such as medicine bottles, a patent broker might find it for you. The broker's compensation could take the form of a fixed fee from the buyer and/or seller, a royalty from the buyer, or even stock in the buyer's company. If you buy an invention, you would do well to remember that the broker is experienced and you are not. Use an attorney with patent experience. (Inventor James Jolly, mentioned earlier, found patent brokers were not very helpful in his largely unsuccessful attempts to commercialize patented items.)

Many inventors use information services to let potential business customers know of their inventions. The *International New Product Newsletter* is one such service. Published monthly since 1954, its editors claim to screen over 15,000 new product ideas a year and report on those with reasonable immediate commercial potential. One recent newsletter contained sixty-eight potential new products, including seventeen designated "special licensing opportunities." Their new product ideas are classified under headings such as automotive, chemical, and consumer.

A number of universities have new product or service evaluation services. Although these primarily are for the purpose of assisting inventors, they would pass along information from a person or company seeking newly invented products. The Wisconsin Innovation Service Center, located at the University of Wisconsin in Whitewater, will rate your new product or service idea on thirty-three criteria. These include five key areas of viability: legality, safety, functional feasibility, production feasibility, and required investment. They explain the scores given on each criterion so you have guidance to refine your product. The Center for Private Enterprise and Entrepreneurship at Baylor University in Waco, Texas, evaluates business ideas. Batelle Development Corporation in Columbus, Ohio, will evaluate potentially patentable inven-

tions. The Small Business Administration publishes a bibliography on this subject: Number 91, confidently titled *Ideas Into Dollars.*

Another new product information service is Techni Research Associates, Inc. (whose address is in the References and Notes section at the end of this chapter). Published since 1969, its *World Technology/Patent Licensing Gazette* (WT/PLG) was one of the first publications of its kind in the United States. Its primary thrust is to list technologies available for license or sale throughout the world. The listings range from high-tech products and processes to consumer products. Their sources include industry, government, universities, and private inventors. Listings include a description or abstract of the invention plus a contact name and address.

WT/PLG also contains "Newsnotes," items about licensing and technology transfer. A third service of WT/PLG is an informative and perhaps inspirational (to inventors amid many disappointments) listing of consummated licensing agreements. Still other information is published under "Meetings," a section listing relevant meetings, exhibitions, and symposia. "Books and Reports" outlines newly issued information and publications of interest to those pursuing new product development.

Listings with Techni Research of licenses sought cost $25 per insertion, plus $5 for a box number if the search is requested to be anonymous. Subscriptions cost $95 a year in the United States.

There are many other sources of new business ideas, and we cannot name them all. Stoner and Fry (1987) encourage small businesses to engage in strategic planning, including a continual search for new business ideas. They discuss environmental (opportunities) analysis, how opportunities might spring from changes in population, technology, and product life-cycle. Networking organizations, venture clubs, and the magazines, *Entrepreneur, Venture,* and *Inc.* generally focus on new business ideas, start-ups, and expansions.

Summary

New businesses are most often rooted in the founder's work experience. The future entrepreneur may begin early to observe changes in populations, incomes, and tastes. He or she may learn to monitor emerging and developing industries for opportunities for new businesses. Beyond one's own experience and observation, acquaintances and third parties who might be helpful were identified, as were printed sources. These idea sources are usually cultivated carefully by the future entrepreneur.

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Patent brokerage companies and addresses:

University Patents
875 North Michigan Avenue
Chicago, Ill. 60611

National Patent Development Corporation
375 Park Avenue
New York, N.Y. 10022

New product information services and addresses:

International New Product Newsletter
Six Saint James Avenue
Boston, Mass. 02116
(617) 426-6647

Techni Research Associates, Inc.
Willow Grove Plaza
York and Danville Roads
Willow Grove, Penn. 19090
(215) 657-1753

CHAPTER 5

Creating a Profit Margin: Differentiation Strategies

The first tale is good till the second be heard.
— Thomas Fuller

Advertisers tell us that to attract someone's attention to a product the second best word in the English language is *new*. Offering new and different gift ideas gets free national attention for Neiman-Marcus every Christmas. After exploring the concept of fitting product or market strategy to industry conditions we will describe differentiating a product and service strategy to enhance the profit margin.

Recent research has discovered interesting relations between industry (a group of rival sellers) characteristics, business strategy pursued, and performance of the new venture (Sandberg 1987). We view choice of strategy as easier than choice of industry, so we place this choice in Figure 5.1 — that is, the

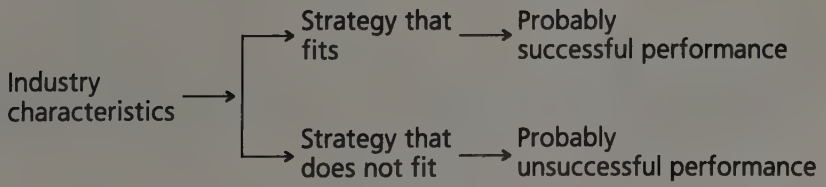


FIGURE 5.1. Strategy Should Fit Industry

entrepreneur could control or be adaptable in selection of a strategy but must follow the industry of his or her experience and interest. Thus, our model is shown in Figure 5.1.

As a would-be entrepreneur, we encourage you to first analyze your industry (the product market in which you may compete) then choose the strategy to fit it.

Performance (measured in profits and appreciation of investment) is better for new businesses whose strategies fit their industry characteristics than for those whose strategies do not fit (Sandberg 1987). Further, survival and performance of all new businesses in the early stages of industry evolution is better than for those starting in later stages. Obviously, early stage is a "temporary" situation, though it may last several years.

The remainder of this chapter and all of Chapter 6 are devoted to two ways of obtaining the most important ingredient in the new business recipe: a margin (selling price minus some definition of costs) large enough to be profitable (Vesper 1980). This chapter will focus on one margin strategy — differentiation — allowing you to charge a "high" price by offering a product or service better than your competition in some way (Levitt 1980). The next chapter will approach the margin objective with an opposing strategy — selling at a price lower than the competition but profiting by having much lower costs (Vesper 1980).

Differentiation, offering a product or service better in some significant way than the rival's offerings usually costs. One may add "bells and whistles," faster delivery, more convenient location, or other factors for a higher price. We show cost and differentiation in Figure 5.5. The figure shows these as independent dimensions, whereas in the real world they are not independent.

Figure 5.2 shows differentiation and another useful strategy dimension called *customer focus*. These call for two strategy choices.

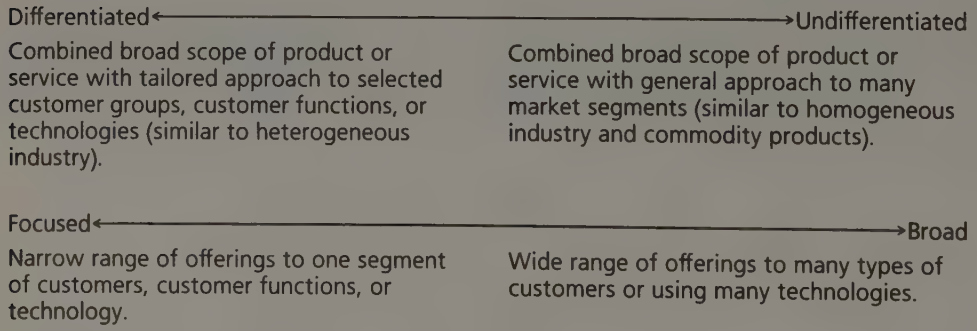


FIGURE 5.2 Two Dimensions of Business Strategy

Figure 5.3 on the next page shows the two main dimensions of an industry that should guide the entrepreneur in defining a strategy. These dimensions are homogeneity of rival's offerings and stage of industry evolution.

Homogeneity ← → Heterogeneity

Perfect substitutability of products, commodities.

Rivals products have differences that cause buyers to prefer one firm's product over another at the same price.

	Early stages →			Late stages →		
	Development	**Growth**	**Shakeout**	**Maturity**	**Saturation**	**Decline**
Growth	Below 15%	At or above 15%	Rate of growth declining	At rate of GNP	Below GNP	Negative (shrinking)
Market segmentation	Little	Some evidence	?	Numerous segments	?	Diminishes
Product design	Great change	Great change	Less change	Stabilizes	Stabilizes	Slight changes
Production process	?	Changes	Greater change	Changes	Stabilizes	Slight changes
Competitors (rivals)	?	Competitors increase	Competitors drop out	Number of competitors stabilizes	?	Weak drop out

? means unknown.

FIGURE 5.3 Two Industry Dimensions

Summaries of industry dimensions, strategic alternatives, and recommendations are shown below and displayed in Figure 5.4.

If the product-market is *heterogeneous* pursue a *differentiated* strategy.

If *homogeneous,* pursue an *undifferentiated* strategy.

If the industry is in an *early stage* of evolution, choose a *differentiated* strategy.

If in a *late stage,* choose an *undifferentiated* (low-cost) strategy or choose another industry in an early stage, if possible.

If the industry is *early-stage,* choose a *broad* strategy, not focused on specific customers.

If *late-stage,* choose a *focused* strategy.

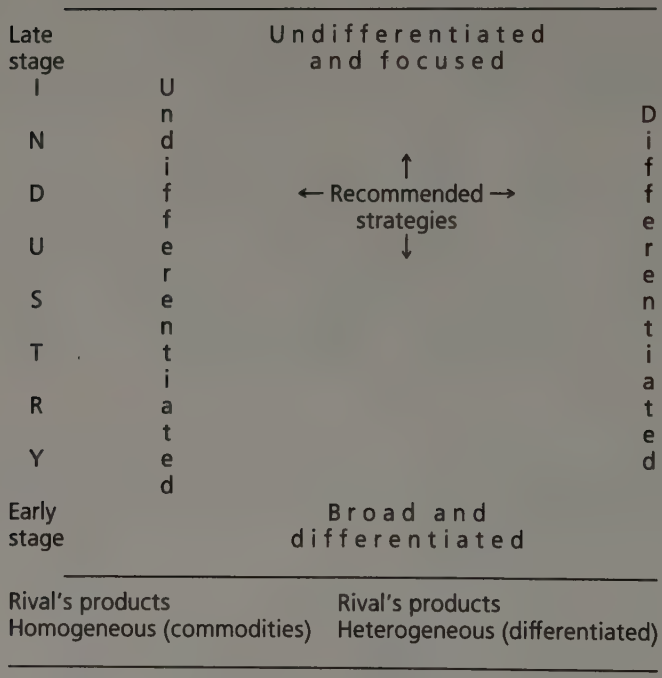


FIGURE 5.4 Fitting the Strategy to the Industry

Look at Figure 5.5. Most companies' products lie in an oval around A and C — that is, generally speaking, a price must be paid for differentiation, although in some exceptional companies or circumstances both differentiation

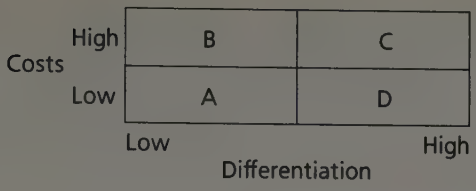


FIGURE 5.5 Cost and Differentiation

and low cost can be attained, at least for a time. Porter (1980), and later researchers who share his hypothesis, believe that companies in the A or C areas are more profitable than those in the middle. The reasons include the clarity of communicating with customers and the emphasis on cost or differentiation within the organization. Not many companies survive in the B area, because they are not competitive. The products of companies in the D area would be quickly imitated and therefore no longer different. We hasten to add, many companies stake out positions other than at A or C. Any price gap identified may provide an opening for an entrepreneur. Nevertheless, evidence suggests companies strongly pursuing the low cost or differentiation targets have an edge, thus the basis for these two chapters.

To reiterate, differentiation and lower cost are recommended by some consultants and scholars as either-or strategies. There is evidence that companies adopting one strategy or the other perform better than companies "stuck in the middle" (Porter 1980; Hall 1980, Dess and Davis 1984). If one claims to offer the best product at the lowest price, either that business is one in a thousand or the claim is inflated. Let us now illustrate these two strategies.

1. Suppose you observe that King Specialty Glass Co. makes glass face covers for watches. They sell the faces to a watch assembler for 4 cents each. While working for an eyeglass company, you become convinced that there is a market for tinted watch face covers, so that the glass would match the case or band or both. Tinting would require taking the glass "blanks" through a tinting process before cutting and smoothing — the other processes used to produce the product.

   Question: Would you be looking at a differentiation possibility, a lower-cost possibility, neither, or both? Why?

The answer we are looking for is differentiation. You may be able to profit from the idea by charging a higher price than plain glass producers charge, cover the extra cost, and still realize a profit.

2. While talking with your friend Dave, a physics grad student, you learn that lasers are being used for more and more cutting operations. You then talk to a robotics company engineer and learn that robots can be

built and programmed to use lasers for cutting glass. Further discussion convinces you that you could cut glass watch covers using a laser. If sufficient volume could be generated, you believe you could sell the covers to watch assemblers for less than 4 cents.

Question: Are you looking at a differentiation possibility, a lower-cost possibility, neither, or both?

The idea here is to substitute machine power for labor, cut the direct labor cost of producing the same product now being produced. Let us now further pursue the differentiation possibilities of starting a new business.

Dess and Davis (1984) found a panel of experts largely agreeing with managers from twenty-eight companies producing paint products on the following. The most important components of a differentiation strategy are brand identification, innovation in marketing methods, and advertising. Differentiation components felt most important by one group but not the others are new product development, control of channels of distribution, procurement of raw materials, and forecasting market growth.

The world is getting along right now without your new product or service. Why would persons decide to reduce their spending (actual or planned) for things they currently buy and instead buy your new product or service? They will not — unless you convince them your idea will benefit them significantly more than what they are now buying.

Differentiation Promise and Opportunities

The differentiation strategy to providing benefit at a profitable margin must promise buyers that your product (by which we mean product or service unless one is specified) will:

_____ do more
_____ or look prettier
_____ or work faster
_____ or run longer
_____ or come in more flavors, colors, shapes, sizes, and so on
_____ or make the buyer feel younger, sexier, and so on
_____ or withstand greater pressure
_____ or be delivered on shorter notice
_____ or be sold on easier credit terms
_____ or be installed better

_____ or be more durable
_____ or be repaired with less hassle
_____ or _____
_____ or _____
_____ or _____

than the product they now buy.

Exercise 5.A

Examine carefully the preceding list and identify products (brands) or services now being profitably sold that promise the buyer each of the above advantages. Write your thoughts in the blanks to the left.

If the next thought that entered your mind was "and each of those products started by beating then-existing products to some buyer's dollar," then you are thinking like an entrepreneur — that is, you are thinking "new," "better than current competition," and "a profitable price is possible."

Is a high differentiation strategy a simple matter of deciding to do it then sticking on a high price tag? Hardly. Dr. Land spent years and thousands of dollars coming up with the camera that would reliably develop pictures automatically. Baskin-Robbins spent big dollars and lots of time to develop the competitive thirty-one flavors and then to develop the store layout, inventory control, and other procedures to market differentiated ice cream.

Wendy's Old Fashioned Hamburgers is one of the best known companies to build success on a product toward the high-quality end of the hamburger industry. Wendy's began in 1969, about fourteen years after McDonalds. Some excerpts from 1983 speeches by Wendy's president Ronald Fay, follow. He was speaking to the Cleveland Society of Security Analysts. (The purpose of such speeches is to convince stock brokers one's stock is a good investment, thus help the company raise equity capital.) Note the concepts of margin and differentiation:

> Despite the weak economic development last year, margins for our 800 co-operated stores rose to 17.8% in the first nine months of 1982 compared to 16.3% the year earlier.
>
> There's more profit improvement ahead as we get the full benefit from our programs to sharpen operations, strengthen marketing and step up new product development . . . and amenities such as our newly designed building.

The Wendy's concept, our commitment to value and service, and our positioning at the quality end of the quick-service industry, give us excellent growth opportunities.

Types of Differentiated New Business

New businesses that succeed by premium price or differentiation strategies include the following types (blanks are explained later):

_____ New high technology producers of one-of-a-kind testing or measuring instruments;

_____ New manufacturers, turning patent protected one-of-a-kind items into high-volume items;

_____ Manufacturers, using expensive machines;

_____ Manufacturers, using highly skilled artisans or engineers;

_____ Wholesalers, carrying a very wide line (of paperware, drugs, auto parts, and so on);

_____ Wholesalers offering extra services such as delivery or credit;

_____ Service businesses offering scarce services of a high quality (towing big trucks, drilling deep wells, staying open 24 hours);

_____ Professional associations of physicians, consultants, accountants, architects, for example;

_____ Construction subcontractors offering scarce skills in electricity, plumbing, dry walling, and so on;

_____ Construction companies building one-of-a-kind buildings;

_____ Retailers of special hard-to-find items or brands;

_____ Restaurants with menus offering a wide selection or connoisseur foods.

Think of businesses in your market area, new ones if possible, that fit into each of these categories. Remember, identify businesses that offer top-of-the-line products or "extra" services and charge more than most competitors because they offer something different and better.

Most businesses that are able to charge high prices are not the "new kid on the block." Only a newcomer that offers a radically new and better product can charge a price higher than the competitor's price; an example is New Balance running shoes, another would be a fancily named French restaurant.

Exercise 5.B

You are now ready to name a business of each type described, and write its name in the blank next to its description. This should be discussed with an acquaintance.

For important reasons established businesses will often be better able to differentiate their product from those of competitors than will new businesses. Remember a product (or service) includes not only the bare physical product, such as a dinner, but how well-presented the dinner is: how hot the meat and vegetables, how cold the iced tea, how informed and friendly the waiter, and so on. Months or years may be required to develop the Cadillac of the market.

Marketing authorities say any product or service can be differentiated (Levitt 1980). If a product is advertised effectively, a perception of superiority in some aspect may be created. If dinners are served with something extra, in an atmosphere people remember fondly, word gets around that that product is better.

Excellent sources of success stories of companies starting up and their marketing strategies are *Venture* and *Inc.* magazines (see References).

Differentiated Industrial Products

Industrial products are usually commodities, bought only if they are of a certain grade or meet specifications. A brand is less important and the price more important than for most consumer products. Delivery, credit, return privileges, and other services may be the main ways these products are differentiated, not by sellers' brands.

To think further about differentiation, suppose you decide to sell paper cups and towels to hospitals, restaurants, and factories. If you sell the dispensing fixtures too and these dispensers will handle only your brand of paper items, then you may be able to charge a profitable price because a customer would incur a substantial switching cost if buying new dispensers to change paper suppliers. Of course, a rival may offer free dispensers and get back this investment later through paper prices. Or your cups and towels may lose out to

water fountains and electric hot air dryers. When you raise your price or even if you can start with a high price, any high price invites competition. Again, to charge a premium price, as a newcomer especially, you probably must have a radically different product. Substitution of an infrared heat lamp plus hot air in a hand dryer might get attention, but differentiating industrial products is difficult.

Shared Reputation and Differentiation

Another method for a newcomer to use in charging a premium price is by sharing a reputation developed in one product with a second product. Johnson and Johnson has such a strong reputation in baby products that it can transfer that reputation to skin care and other personal care products and charge good prices. Or a local steak restaurant with a good reputation may open a seafood restaurant and capitalize on the reputation of the first. There is risk, of course, in identifying a high investment brand or name with a new, untried product. If the latter stumbles, the first one suffers, too.

Differentiation Based on Location

The final possibility discussed in this text for charging premium prices is by having a location advantage. If you have the only plumbing supply in a market area, or the only seafood in an area, or the only printing shop in an area, then you have this opportunity. You have a differentiated product and can charge a little more — perhaps, enough to leave a significant profit for yourself. In location differentiation, the market probably is small (or there would already be plumbing supply, seafood, and printing), and when your volume is only $100,000 annually you must be able to charge more than if it were $200,000. Let us look now at relationships among price, volume of sales, and profit.

Reaching Profitability through Differentiation

Profit-volume analysis, also called *breakeven analysis,* is a very important step before attempting to start any business. Four factors are all closely related and all have important effects on profits:

1. Variable costs — mainly the direct costs of producing a product — such as materials, parts, and perhaps some labor costs;
2. Fixed costs — mainly the costs of space, part of the labor cost, equipment, funds, and insurance for a period such as a month or year;
3. Sales volume — the number of units you must sell in this period;
4. Selling price — the net price each unit can be sold for (an average after discounts and markdowns).

The behavior of these variables can be as varied and complex as the statements above are simplified. Although we are examining behavior of revenue and costs, this is not for financing nor accounting, but an extension of product-market strategy. Your product price is the key variable in differentiation. For now, we want to focus on selling price, paying some attention to sales volume, and *see how differentiation-based prices affect profits.*

Exercise 5.C

1. If you buy used personal computers for an average cost of $300 each, variable costs for refurbishing, etc. are $100 for each machine, you sell them for an average of $600 each, and your fixed costs are $4000 a month, how many must you buy and sell to pay all your costs?

Answer $600 − 400 = 200, into $4,000 = 20 PCs.

2. Now, notice how profit behaves when we change price. Suppose the price dropped (because your PCs were *not different* enough from others selling for $500) to $500. At 20 PCs of sales volume, how much would you lose?

Answer 20(500 − 400) = 2,000 − 4,000 = −$2,000

3. If you could offer a more convenient location, better cared-for machines, support after the sales, or a product differentiated in some other way, and could then charge $700 each, how much would you earn?

Answer 20(700 − 400) = 6,000 − 4,000 = $2,000 profit. In sum, at a price of $500 and a volume of 20 units a month, losses are $2,000. If the price could be raised to $700 because of differentiation and you still could sell 20, then profits would be $2,000.

When a 20 percent change in price causes an infinite percent change in profits, we say you have price leverage. Does price leverage work all the time? No, only if certain costs actually can be controlled while any other factors change and only if product differences can induce buyers to pay more. Further, these greatly disparate percentages will narrow as your operation grows from zero profit — that is, as the profit base grows, percent changes in profit for a given change in price will be less phenomenal.

By now, you have probably concluded that a new business can be more than lots of fun and hard work. Through enough differentiation to bring a premium price, it can provide you an income. Let us use this understanding in the next exercise to think about a business being considered by Elaine Livingston.

James and Elaine Livingston have a daughter, Patricia, who is eight years of age, and a son Hammond, who is seven. They live in University Park, an exclusive area of a northern Illinois city. Patricia works in a children's clothing store, about 5 miles west of their neighborhood. During the past ten years, she has advanced from primarily operating the cash register and straightening shelf merchandise to salesperson and buyer of upper-age (6 – 10) girls' clothing. Two other women also buy for the store. One specializes in upper-age boys' clothing and the other buys for boys and girls through age five. Mrs. Owen, the manager, approves all orders after going over them closely with the buyers. She frequently lowers quantities before ordering.

James Livingston is an engineer with a large automotive supplier in the city. They share household duties, and he admits, "There's more to it than I thought. It's actually very challenging to learn the qualities of this material or that, to organize my tasks well so that I still have time to do the things I want to do after doing my part for the family." Elaine admits that he has become very knowledgeable and efficient. He takes care of household finances and in fact recently acquired a personal computer to keep financial records. This is mostly for fun at this point he says, as no time saving is expected.

A few months earlier, Elaine mentioned wanting a children's clothing business of her own. She said she knew selling and buying and could learn the other tasks once she starts in her own store. She noticed that, as incomes generally began to increase, people were willing to spend more on their children's clothing. In fact, she believes that, during the ten years she has worked, there has been a steady (except for the recession of 1980 – 1981) increase in the number of customers wanting better clothes. She is certain their customers were buying "up" and her employer was not keeping up with this trend. During her first two years there, she mentioned this to Mrs. Owen, the manager of Ives Clothing. She had relayed to Mrs. Ives that almost daily one or more customers went away to look for "something nicer" at another store. The closest store was about two miles northwest in a new mall. That store's merchandise is priced 10 to 50 percent higher than at Ives. Owen is uninterested in Elaine's observations, remarking, "we have a very good business just the way we are."

Exercise 5.D

1. Will the strategy contemplated by Elaine fit industry conditions as far as you can discern?

2. Identify strengths and weaknesses Elaine has in starting a business. Which ones are most important?

3. Describe the following factors Elaine will need to aim for if she starts a new store selling "nicer" children's clothing.
   a. Locations to consider and those to avoid.

   b. Specific brands to buy or not buy.

c. Advertising and promotion themes to use and themes to avoid.

4. Look back at your list of ways products may be differentiated (Exercise 5.A) and your identified businesses succeeding because of each differentiation (5.B). Choose the two of these businesses you know most about and note any ideas about how you might get into each business. What preparation would be needed? Where might the business succeed? Who might help you?

Business One:

Business Two:

Summary

Differentiated strategies aiming a product toward a broad market are recommended in heterogenous markets and early stages of industry evolution. The opposite usually fits homogeneous markets and late stages. Many businesses earn healthy profit margins by differentiating their product or service. Differentiation is achieved by making the product better in the eyes of the customer than the competitor's products. *Better* can mean anything from stronger to prettier, delivered faster, installed more expertly. The entrepreneur needs to think early and long about how his or her product or service will be different from others, so customers will pay a premium, or choose the low-cost strategy discussed in the next chapter. Many companies find that certain managers are suited to differentiating strategies whereas others seem suited to low-cost strategies. Those considering starting their own businesses should consider which strategy suits them better.

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Magazines carrying stories describing differentiation:
Inc.
Venture

CHAPTER 6

Creating a Profit Margin: Lowest-Cost Strategies

Buy right and control costs.
— Charles Hardcastle, Entrepreneur

Whether your business is a supermarket, discount store, grain miller, muffler shop, or hamburger chain, if you beat your competitors' costs, your profits could be substantial. Every market has room for a new business whose costs are held below the costs of existing sellers.

At the beginning of Chapter 5, we said there are broadly two strategies for attaining a profitable margin between costs and selling price. Most entrepreneurs are suited to one strategy or the other. One strategy is to differentiate your product from your competitors' products in some way important to the targeted customer. The second way is to beat your competition by producing at costs lower than their costs. We assume that a differentiated product should be produced at the lowest cost for that differentiated product. Likewise, a lowest-cost strategy still should turn out the best product possible at that cost. The point is you need to decide whether you will emphasize differentiation, by charging a premium price, or low cost, so that even if you cannot charge a premium price you still earn a profit.

> Wheat farmers sell a nondifferentiated product. Once moisture and cleanliness (from weed seeds) are accounted for, farmer A does not differentiate his product from that of farmer B. Therefore, they will sell at the same price. Because they sell at the same price, what determines who will be more profitable? The answer is the ones with the lower costs.

Undifferentiated Product Strategy

Generally, undifferentiated products are said to be commodities. All kinds of agricultural products are commodities, as are mined products, fish, basic steel and other metals, bulk petroleum products, chemicals, and so on. In contrast to the differentiation strategy, almost any business can adopt a commodity strategy — that is, you can tell (through advertising) your potential and actual customers that most youth clothing brands essentially are the same or all hiking boots are about the same. Being about the same, the lowest-priced one is the one to buy. You may assume customers already know this; therefore, you can cut your costs even more by not advertising. Farmers, petroleum refiners, and many other pure commodity producers do not advertise their products.

If a business based on a lower-cost strategy appeals to you more than one with a differentiation strategy, you are not necessarily limited to agriculture, mining, or refining products. You can sell almost anything from soup to nuts. You are limited in the brands you sell — Mercedes does not want their cars sold with low-cost strategies, nor do Schwinn bicycles or New Balance running shoes.

Let us look at what a McDonald's publication has to say about that very successful company's strategy. As you read the quotes, look for words that suggest either a low-cost or differentiation strategy (McDonald's 1982).

> The company develops, operates, franchises, and services a worldwide system of restaurants which process, package and sell a limited menu of quickly prepared, moderately priced foods. . . . Uniform standards for quality of product, efficiency, speed and courtesy of service are advanced at all restaurants. The Company competes with other restaurants not only in price, but also by efficiently offering quality food product with speed and courtesy in a contemporary restaurant facility, where cleanliness is emphasized, and by seeking to establish and maintain a high level of public awareness through advertising.

Quotes from a Wendy's International report follow. Again, look for indications of a low-cost or differentiation emphasis (Wendy's 1982).

> The Company believes the principal basis of competition within the industry is quality, variety, and price of food products offered; however, number of units, site location, quality and speed of service, attractiveness of facilities and customer recognition are also important factors.
>
> The Company believes that its competitive position is enhanced by its use of fresh meat, its unique and diverse menu, its wide choice of condiments and the atmosphere and decor of its restaurants.

They key words relating to low cost at McDonald's and differentiation at Wendy's in the order they appear in the statements are:

McDonald's	Wendy's
limited menu	quality
quickly prepared	variety
moderately priced	attractiveness of facilities
uniform standards for quality	fresh meat
efficiency	unique and diverse menu
speed	choice of condiments
competes in price	atmosphere and decor

Perhaps, you are now saying to yourself, "I understand attaining profitable margin through differentiation and through low cost. I'm beginning to see why one must choose one or the other. However, new business strategy has not been discussed. So far we have looked primarily at two marketing approaches."

Strategies: Lowest Cost versus Differentiation

Strategy consists of choices in the following areas:

human resources,
other investments,
production processes,
product characteristics, and
marketing practices,

to achieve a lowest-cost or differentiated position in the market. If we contrast McDonald's low-cost strategy with Wendy's differentiation strategy, examined in Chapter 5, this is how they might look:

Organization practices	McDonald's	Wendy's
Human resources	More employee task specialization	Wider range of tasks per employee
Other investment	High-speed, single-use equipment	General purpose equipment
Production processes	Produce for inventory	Produce for customer order
Product characteristics	Narrow selection and choice	More customization
Marketing practices	Advertise low price	Advertise customization

Strategy is the integration of all the company's resources and actions toward competitive satisfaction of chosen product-market targets. These five main organizational practices differ markedly depending on whether a low-cost or differentiation strategy is adopted. In choosing one of these broad strategies, the entrepreneur chooses a whole package of business practices to support that strategy (Porter 1980). Would you rather start and operate a business dedicated to differentiated products (or services) or a business dedicated to the lowest cost?

Before answering this basic question, a number of factors going into a low-cost strategy must be examined. The thrust of this discussion will be: How could your business achieve costs lower than those of your competitors?

Part of the strategy McDonald's used to attain costs lower than their competitors has been presented, but McDonald's started in the 1950s. Even though their costs per hamburger are still (79¢ versus $1.39) well below Wendy's, McDonald's certainly is not now as low cost as they might be. A *Wall Street Journal* article showed that lower-cost competitors are starting new businesses in hamburgers (Galante 1986, p. 21).

> More than a dozen young fast-food companies, mostly in the Southern U.S., are returning to the days when hamburger restaurants were simple affairs. They are building their restaurants with stripped-down menus and take-out service . . . The difference in operating costs shows up in a gap of more than 40 percent between the chains' menu prices.*

The new low-cost competitors include such entrepreneurial ventures as Burger Street (Dallas), Central Park (Chattanooga), Flyers (Dallas), and Rally's (Louisville).

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Lowest-Cost Strategy Illustration: Children's Clothing Store

Now, let us turn our attention to a proposed youth clothing store (Chapter 5) and see how it might attain the low-cost position among its competitors. We follow the product from the suppliers through the store and to the consumer. First, the owner-manager buys and stocks lower-cost brands, perhaps clothing without a brand. You probably look for suppliers with whom you could do business over a long time. If you remain with the same supplier for a long period, you can save the costs of credit investigation and new negotiations required at the beginning of a supplier-buyer relation. A supplier who trusts your loyalty, even through a problem period and in the face of other supplier options, can turn that trust into lower prices to you. In return for being a loyal, preferred customer, you can negotiate price concessions. If you and your supplier trust each other, you may give him or her all the business you can, again asking for price concessions in return.

In addition to lower prices because of larger orders, the cost of processing (fewer) orders from fewer suppliers is minimal. Shipping, transportation, and receiving costs can be cut. Perhaps the supplier will inspect items going to you more closely to lower your returns and markdowns on flawed items. Perhaps the supplier will add an item now and then to compensate for an undetected slip-up on a garment. Perhaps you can occasionally delay payments without penalty, thus cutting your borrowing costs. Supplier choice and supplier relations will be discussed again in Chapter 11, so we follow our merchandise into the proposed low-cost store itself now.

What features will we see in the low-cost store? (Low-cost marketing often is by direct mail or through catalog showrooms but includes selling through stores.) First, we choose a low-rent location — not sleazy and not isolated but probably not in a fancy mall. Carpet, fixtures, and displays obviously are not chosen by a high-priced interior designer, rather the store's accessories are simple and functional.

Who works here? Not Princess Diana, nor an M.B.A. degree holder! Rather, you may employ persons from an income level similar to that of your customers. You may employ mostly part-time workers. As a result, your wage rates can be lower with few indirect personnel costs, such as pension contributions, vacations, and unemployment compensation payments.

To attract customers, your advertising would be aimed at the segment of consumers who wish to buy low-price clothing. The ads would emphasize your low prices, not fashion. When customers come to your store, they may serve themselves, further reducing your payroll costs. When a sale is completed, the clothing is placed in a low-cost bag — of paper or very thin plastic, not a textured bag with handles. When you think about the lowest-cost strategy, these suggestions seem elementary, but two essential points need underscoring.

First, when you choose the low-cost strategy for a new business, do not do it halfway. If half or even most of your efforts are toward low cost and in the remainder you go for nicer image, then one competitor will beat you on cost and another on image. An exception to this rule is when you have a monopoly because of no competitor close to you. Also, you may wish to target middle prices in certain businesses, if there is a clear gap between existing sellers' offerings. Research evidence suggests one strategy or the other is usually better than middle-ground actions.

Second, having chosen to be the lowest-cost seller in a market, many actions need to be taken to implement this choice. Our low-cost clothing store illustration introduced general rules about how to attain the lowest cost — in almost any business. We now examine low-cost choices beyond retailing businesses. After all, failure rates are known to be lower and return on investment generally higher in other businesses. In general, the benefits of choosing the low-cost strategy tend to be larger, the closer we are to the raw material; whereas differentiation tends to be more important, the closer we are to the consumer. Raw materials tend to be indistinguishable, whereas advertising and customer service can significantly differentiate most consumer goods.

Lowest Manufacturing Costs

We now systematically look at how manufacturers attain low-cost positions. You may decide this is your career niche — that is, you may pursue management within such a business and later see an opportunity to start or acquire such a business, alone or with others. Let us divide these costs into the categories used by managerial accountants and production managers: fixed costs, which are generally overhead or indirect costs, and variable costs, which are generally costs of materials and labor going directly into the product (Woodward 1976).

Lowest Fixed Costs

The greater opportunity to manage (control or reduce) these operating costs usually lies in fixed costs. *Fixed* means they remain the same whether volume of production decreases or rises. Thus, for example, a stamping machine used to produce vacuum cleaner housings costs almost the same, whether volume of housings is 300 a day or 600 a day. True, parts of it will wear out sooner if the higher volume is produced; but only a few working parts of it will do so. Further, there is a good chance it will become obsolete and be replaced before it wears out. In addition, much of the cost of any machine is financing its purchase (interest cost of borrowing), insurance costs, property tax, and floor space cost. Most of these costs are fixed relative to volume.

Though perhaps no cost is 100% fixed in its behavior, what are the costs that lean toward the fixed end of the picture? (The list is adapted from Porter 1980. This information will be used later in Exercise 6.A.)

Related to Human Resources

_____ Manager salaries and benefits
_____ Secretary salaries and benefits and space for support personnel
_____ Supervisor salaries and benefits
_____ Benefits of commission salespersons
_____ Employee wages if level workforce is maintained.

Related to Other Investments

_____ Machines, equipment, tools
_____ Floor space, building and grounds
_____ Heating, cooling, lighting, other utilities
_____ Casualty insurance
_____ Financing, interest or lease payments
_____ Supplies, phones, etc. for fixed-cost employees

Marketing Practices

_____ Salesforce cars, samples, literature, videos
_____ Advertising
_____ Sales promotions, contests
_____ Exhibits

How does a low-cost competitor control these costs? You may have the main part of the answer already — produce a large volume by fully utilizing these resources and thus attain the lowest fixed-cost per unit produced. Assuming we can sell what we produce, the key is in volume. How much volume? More!

One of America's greatest entrepreneurs was Henry Ford. His great success was from producing the largest volume, thus attaining the lowest fixed-cost per unit (spreading fixed costs over more units of product) of any competing car maker. In the 1950s, Volkswagen's success was based largely on a low fixed cost per unit, as they were able to sell millions of units of basically one car, the "Beetle." McDonald's success lies largely here.

So what are the *keys* by which a new business can enter as lowest fixed-cost producer per unit? Can a start-up, or young, small business attain lowest-cost position? We can identify keys to low fixed costs per unit. The second question is more difficult. Start-ups and young businesses must have specific advantages or their management must be smarter or both.

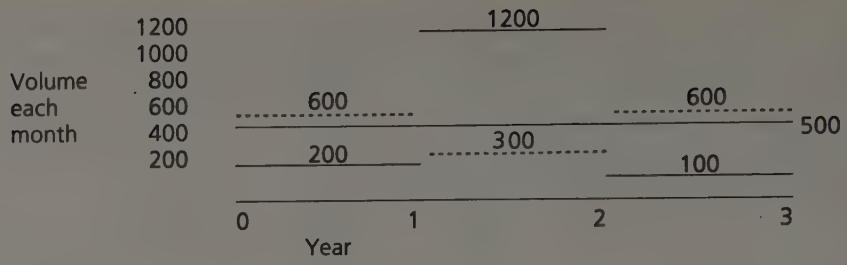


FIGURE 6.1 Production Volume

Keys one and two to minimizing fixed manufacturing cost per unit is locating stable customers and stable sources of supply. The importance of a stable volume (level over the life of the costs) can be introduced with the simple graph in Figure 6.1. Let the dashed line represent one company's production behavior and the solid line represent a competitor's production.

The graph is intended to depict two businesses, alike except for their volume of production from month to month. Each produces 18,000 units over a three-year period, an average of 500 units a month for thirty-six months. Think, however, about the differences in their fixed costs.

Exercise 6.A

Note some of your thoughts by turning back to the list of fixed costs and writing down how much, if any, you think A's costs per unit would be lower than B's (write 0 percent, 50 percent, 20 percent, and so on, for each component of fixed costs).

The size of one cost will be nowhere near the same as the size of another, within the same company, so we cannot average all the estimated percentage differences. Because B must be able to produce 1200 units a month and A's capacity need be only 600, certain of A's fixed costs will approach 50 percent lower than B's. The concept of a stable volume as it affects fixed costs per unit is worth devoting more time to, perhaps in a group discussion.

To pursue the question one step further, how does a business achieve level or near-level volume? The most crucial factor in leveling volumes or rates of production is usually the customer. If you sell to another business, the stability of your volume depends on the stability of that business' volume. Whether you sell to another manufacturer, a wholesaler, retailer, or consumer, there are some devices to stabilize your sales. Each device has a price. You should compare these costs to the costs of unstable volume and then choose the overall lower-cost device.

Lowering your price in slow periods and raising it in busy periods will stabilize your sales, as will changes in other terms of sale and inventorying practices. Basically, there are two important consumer conditions, one of which will prevail in your business. First, final consumption of the product will be stable over time or it will be unstable. Second, production may be inherently stable or it must be unstable over time. Unstable production is due mainly to seasonal production related to weather or availability of commodities.

Given the following list of manufactured (or processed) products, examine (1) the behavior of raw material production, (2) the cost of storing the raw material versus (3) the cost of storing finished product, and (4) the behavior of consumption of the final product. We believe you will gain valuable understanding of fixed-cost behavior by thinking through Exercise 6.B and writing down your conclusions. Orange juice will be used to illustrate and start the exercise.

Large equipment, large buildings, large refineries, and other capital items cost less to build per unit of juice-related capacity than do smaller ones. This is *key three* to lower costs in many businesses. Bottling companies attain lower costs by using special purpose, high speed-equipment. So do cigarette manufacturers, printers, and many others. In such a company, capital costs (previously called "other investments") are very high relative to labor costs; two or three shifts will often reduce capital costs per unit more than they will raise wage costs per unit.

Exercise 6.B

	Is raw material production usually stable or unstable?	Can the raw material be stored more economically?	Can the finished product be stored more economically?	Is the consumption of the finished product stable or unstable?
Orange Juice:	Unstable	No	Yes	Stable

Comment: The juice processor should store the finished product or "pay" the buyer to store it (through lowering and raising prices), depending on which is less costly.

Electricity: _____ _____ _____ _____

Comment: _____

_____

_____

Toys: _____ _____ _____ _____

Comment: _____

_____

_____

	Is raw material production usually stable or unstable?	Can the raw material be stored more economically?	Can the finished product be stored more economically?	Is the consumption of the finished product stable or unstable?
Textbooks:				
Comment:				
Jeans:				
Comment:				
Shrimp:				
Comment:				
Health Services:				
Comment:				
Tax Services:				
Comment:				

In addition to stabilizing volume and acting on these opportunities to lower fixed costs per unit, producing a standard product will also help. This is *key number four* to low fixed costs. Henry Ford's Model T, then later Models A and B, all in black, were standard products. Another concept related to standard products is a narrow line of products. Whether you have a clothing store or a clothing factory, you can often lower costs by narrowing your product line, perhaps to one standard product. Levi jeans did this in the early life of the company. Specialized farmers do it. Coca-Cola had a very narrow line until recently. McDonald's costs benefit immensely from a limited menu. Producing more of the same item lowers fixed costs per unit.

In all these companies, the costs of shutting down costly production processes to "change over" from one product to another would slow production considerably. Of course, this would drive cost per unit up. These companies profit by minimizing production changeover costs and employing specialized machines and personnel — *key five.*

Narrowing a product line typically also means faster inventory turnover (sales of a given item). This *sixth key* works because only the fastest-selling products are retained, the slower-selling items are discontinued.

Experience Effects on Costs

A cost factor receiving much attention in recent years is the ability of persons to *learn* to produce faster and better as they gain experience producing a certain product. So, lack of experience may be a formidable barrier to the competitiveness of a newly started business. We will explore experience effects briefly because they are important to your plans for a new business.

> How long did it take you to tie your shoe the first time? Weeks of trials and half-ties? How many times did you tie them before you reached the fastest time? Five years times twice a day?

This increased speed and proficiency of performing a task due to repetition or practice can affect costs greatly. When a business produces a standard product, that product needs less management time, engineering time, trouble-shooting time, and many other costly inputs. Whether obtaining a bank loan, repairing a machine, demonstrating a product to a customer, or any other business task, the second time you do it may require only 50 to 75 percent as long as the first time. If proficiency — how *well* the task is performed — is considered, then the output per labor (or manager) hour can also increase dramatically. Thus, fixed cost per unit declines dramatically and profit margins can widen. Does this cost saving continue? Early studies indicated that with every doubling of experience at performing a certain task, labor input could be lowered 5 to 25 percent (Boston Consulting Group 1972). The two-thousandth order to a print shop probably costs only 80 percent as much as the thousandth one of equal size. The ten-millionth McDonald's hamburger probably only required 80 percent as much labor as the five-millionth one. Learning and experience can bring down cost per unit greatly.

> What does this experience factor mean for potential entrepreneurs. First, it means you or someone in your new organization needs experience (elsewhere) before you start a business. It also means you have an uphill climb on certain costs as a newcomer. It means that you may not be able to compete head to head, with the same product in the same market, with experienced businesses. You may have to focus on a particular product for a segment of the market.

Franchising is one way to take advantage of others' experience. A new franchisee buys experience, among other things. One who acquires an existing business, particularly one using complex production processes, buys experience. You may acquire a workforce of experienced personnel as well as routine ways of doing tasks; thus, fast, proficient ways.

An important way to reduce fixed cost per unit is to mechanize or even automate the process. Why do some car wash businesses use people whereas others use machines? Why do some car manufacturers still weld manually and others use robots?

Mechanization Effects on Costs

The volume of business per period is part of the reason one manufacturer uses more labor whereas another uses more mechanization. The volume of business, the standardization of the product, and the relative costs of labor and machines all determine whether one can attain lowest unit fixed cost by substituting machine for manual production.

Figure 6.2 shows how these factors affect costs. We show cost behavior for a car wash at different volumes. When volume rises above a certain level, substitution of machine for labor will lower the cost of washing a car. Let *Af* and *Av* be fixed and variable costs of car wash *A*, without automatic equipment. Let *Bf* and *Bv* be fixed and variable costs of car wash *B* with automatic equipment. *A* uses more labor, say \$2, to *B's* \$1 per car, while equipment cost is \$400 a week for *B* but only \$200 for *A*.

If volume is below 200 units a week, costs (fixed plus variable) are lower without the machine, washing with labor. When volume surpasses 200 units a week, total costs become lower with the machine and less labor. If cars to be washed varied too widely in size, this analysis would have to be performed on

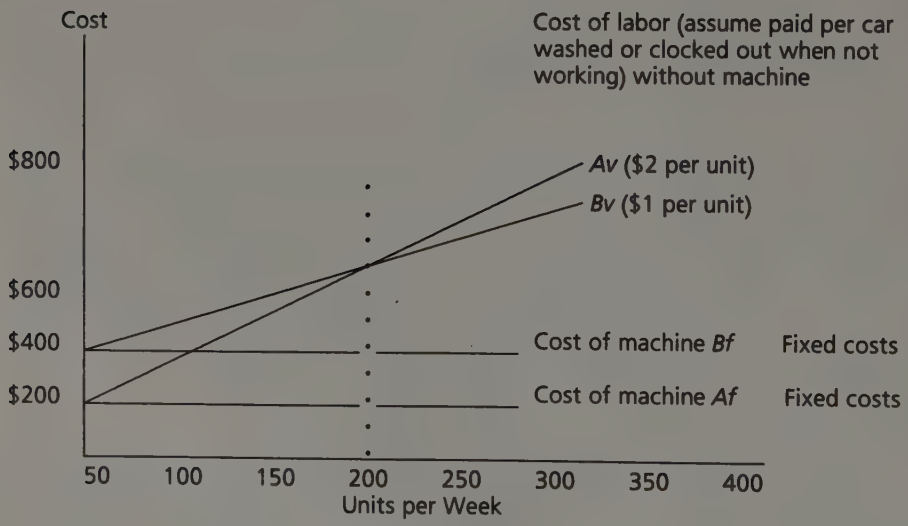


FIGURE 6.2. Some Factors Affecting Costs

each size class washable by a particular machine. Generally, wide product lines mean mechanization is less able to reduce cost per unit because a machine is not as flexible as a person. (Automation or robots, on the other hand, may be programmed to conform to the varying needs of the product on which they are working. Robots are expensive. This greater fixed cost may raise the volume level required, but may give the one robot enough flexibility to handle a wide variety of inputs or processes automatically.)

The formula for costs in situations *A* and *B* are

$$Af + Av \text{ (units)} = Bf + Bv \text{ (units)}$$

and at 200 units, total costs of *A* = total costs of *B*:

$$\$200 + 2(200) = 400 + \$1(200)$$
$$\$600 = \$600.$$

Exercise 6.C

What is the volume where costs are lowered by robotization if the robot costs $1,000 but labor cost per car drops to .50? (Situation *A* has not changed, but *B* has changed to *C*.)

$$fc + vc\ (u) = fc + vc\ (u)$$
$$____ + ____(u) = ____ + ____(u)$$

When you finish, to find the missing volume fill in

$$200 + 2(x) = 1000 + .5(x)$$
$$2x - .5x = 1000 - 200$$
$$1.5x = 800$$
$$x = 533 \text{ cars.}$$

So at 533 cars a week, you stay with machine *B*; but at 534, you go to programmable robot *C*. Of course, this situation is highly simplified to illustrate the principle that costs can often be lowered by improving the mix of machine and labor; and the best mix is determined by the cost of labor, the cost of machinery, the sustainable volume per period, and the output of machinery and labor.

You must project these costs for your competitor and your own business before starting up, and project how both costs will behave (go up or down) with volume and experience. We encourage you to try the principle of substituting machine and labor on another kind of business; perhaps, a clothes cleaning establishment.

Summary

In this chapter we stated that a low-cost strategy is one way to achieve profitability. This undifferentiated strategy is suited for nonconsumer goods to homogeneous markets, and late stages of industry evolution. A *low-cost strategy* means selecting low-cost suppliers and locations and, usually, narrow product lines. It means stabilizing production at a high volume, gaining experience benefits, and mechanizing to reduce cost per unit. A low-cost strategy, to be implemented effectively, requires a person who wants to minimize costs and is trained to do so. We are learning that certain individuals are suited to marketing and differentiation strategy whereas others are suited to the low-cost strategy. During the period of your preparation for entrepreneurship, should you choose this career, you may decide that one of these strategies suits you and the other does not.

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CHAPTER 7

Breaking into a Market

My motto is "conquer or die"; in other cases there is a middle course; in mine there is none.

— Frederick the Great

Breaking into a market already served and guarded by your new competitors is a challenge calling for aggressiveness and tenacity. Creating a new market requires these same traits. To accomplish either of these difficult feats an entrepreneur must have attractive ideas and carry them out over months or even years of hard work.

Before examining ways people enter markets, let us review a minute. So far, we have explored the entrepreneurial person and his or her preparation, the many and varied ways ideas for businesses originate, and the need for a successful business to be based on either a differentiated product or service or one with a lower cost. All these should be used as criteria to evaluate a new business idea. The criteria apply whether you have a business idea and expect others to back you, or others have an idea and ask for your backing or partnership.

One overriding question is posed in this chapter; after the preliminary issues and criteria have been addressed, the entrepreneur should ask:

> How will my business (its product or service) enter a market with competitors already in place?

Chapters 5 and 6, on differentiation versus low costs, form the jumping-off points to understand answers to this chapter's important question. We might state the problem as one of how to give customers more for their money than they now get.

Moving in Where Competitors Are Serving the Market's Needs

One way to fit a new business into an opening is to first identify existing businesses familiar to you that seem to be doing exceptionally well. They may be very busy, or they may be obtaining very high margins. These are inviting market *signals* (Mandelker 1985).

> Software Town opened in Dallas in July, 1983. They sell 800 different educational software programs, computer books and components. Approximately 700 programs are sold each month and sales the first year were $443,000. For 1985 sales are expected to grow almost 25%, to $550,000. Gross profits [margin] are running at 33%.

On the surface at least, there appears to be opportunity for another new business in this market. A high volume of sales at good margins invites rivals to enter a market. In the language of the previous two chapters, another store can quite possibly be successful here by offering something different at similar prices or by offering the same things at lower prices. Of course, this assumes that sources of merchandise are available to another store at favorable terms. In a later chapter, we will examine purchasing and supplier relations, matters especially problematic to new businesses.

Before exploring entry opportunities further, we need some background on margins. (Note, although we will talk dollars and cents, the topic is market entry, not finance.) Often when we discuss margins, we ignore inventory turnover; or, when we compare margins in two different businesses, we assume they experience the same turnover. This assumption is fine if the purpose of the discussion is to focus only on margin, costs, and pricing. If the purpose, however, is to evaluate existing businesses with the idea of possibly competing, then the whole equation (merchandise/total assets $\times$ markup $\times$ inventory turnover = return on assets) must be estimated. For example, jewelry retailing might behave as follows:

$$\frac{1}{2} \times .4 \times 2 = .40.$$

To see with numbers the role of asset turnover as it relates to margin and entry opportunity, assume that a store owner (A) owns $50,000 worth of inventory and nothing else. All other necessary items are leased. If the store had sales of $75,000 and the margin is 33⅓ percent of sales, then the inventory (and asset) turnover for the year is *one*. Another store (B) has $50,000 of inventory and sells $150,000 a year with 33⅓ percent of the margin in sales. How can this be? The inventory sold once for $75,000, then a second inventory of $50,000 was purchased and it also sold for $75,000. Inventory turnover was *two*. A fundamental relationship in business is

$$\text{Turnover} \times \text{margin} = \text{gross profit on assets}$$

or

$$\frac{\text{sales}}{\text{assets}} \times \frac{\text{markup}}{\text{sales}} = \text{gross profit on assets}$$

The store examples, in formula form, are

$$\text{(A)}\ \frac{75{,}000}{50{,}000} \times \frac{25{,}000}{75{,}000} = 50\%\ \text{gross profit on assets}$$

$$\text{(B)}\ \frac{150{,}000}{50{,}000} \times \frac{50{,}000}{150{,}000} = 100\%\ \text{gross profit on assets}$$

Why do these percentages appear high? Because in a business, assets in addition to inventory must be used to generate sales. What would happen to gross profit on assets if inventory constituted only one-half of the store's assets? GP/A would be cut in half.

What gives rise to prices and margins high enough to invite in you or another new competitor? Basically, it is lack of competition. This situation occurs under several conditions, which an entrepreneur must learn to "read." The following illustrates lack of competition in a type of market familiar to college students:

Near Purdue University, prices to alter slacks in the waist and length range from $4.50 to $11.50! One cleaner has probably 80 percent of the market and charges $11.50.

This price discrepancy is a second kind of market *signal*. This high-priced cleaner has an arrangement with the graduate dorms to do work for residents

there. The university bills residents for cleaning and alterations along with the housing bill.

Another condition with a lack of competition occurs when a product is new — it is first in the market. New products are at first offered by only one seller in a geographical area. Consequently, between the time the initial innovative seller sets up in business and the time others read the *signal*, a window of opportunity is open. If the first one or two businesses maintain low prices, that window may not exist.

We assume a third condition allowing new businesses — namely, growth in demand or growth in consumers' desire and ability to buy the items in question. Demand for a product or service does not jump from zero to "full grown" in a day. Why? Customers have to be informed, ushered past their initial fears — *educated*, in the language of salespeople.

Another *signal* of opportunity is prices that are invitingly high because existing sellers experience unnecessarily high costs. Let us say you noticed that natural gas sold to households at $.50 per hundred cubic feet (ccf) in Louisiana and $.60 ccf in Ohio. You might wonder whether costs of drilling, refining, and delivering are that much higher in Ohio or whether the difference is the cost of piping the gas from Louisiana to Ohio. New businesses often start because existing businesses are a considerable distance from their markets and thus experience transportation costs so high that the business cannot compete.

Present costs and supply quantities make production of natural gas in southern Ohio and other minor source areas uneconomical — that is to say, entry opportunities are probably not worthwhile. Any of several factors, however, could change within the next few years and give rise to opportunity to produce and sell local natural gas in southern Ohio. Can you identify these factors? Write your responses in Exercise 7.A and see how you "read" this market scene. (Suggested answers follow.)

Exercise 7.A

Changes causing local gas production for sale in southern Ohio to become feasible:

a.

b.

c.

d.

e.

f.

g.

Answers may be arrived at by looking at Louisiana, southern Ohio, and the pipeline between them. If the Louisiana gas supply is depleted, if the costs of production there rise faster than in Ohio, if the demand in Louisiana grows rapidly, if new supplies are found in Ohio, if lower-cost ways to recover small quantities in scattered Ohio wells are found, if demand grows in Ohio or other markets served by Louisiana gas, or if piping costs increase significantly, then new gas businesses may enter the market. These are seven illustrative *signals* to read to see a new entry opportunity.

Not only transportation costs but other costs may be too high in existing businesses and, thus, give rise to windows of opportunity. New companies have recently built minimills, small specialty steel mills, in the U.S. markets because the costs of existing large mills are high. Discount stores sprang up in every sizable market in the past two decades because the costs of conventional stores were high. For-profit companies are entering garbage collection, fire protection, and even correctional services because the costs of existing providers are high enough to invite new providers (Finley 1989).

Before exploring our next area of potential entry, see if you can think of two other markets where new competitors have entered by offering lower prices based on lower costs. Then think of two other markets that have potential for new entrants, where you predict new, low-cost entrants will develop within the next ten years.

Exercise 7.B

(Discuss these items with others.)

1. Two recently established cost-based businesses are
   a.

   b.

2. Two predicted new cost-based businesses are
   a.

   b.

Moving in When Competitors Are Not Serving the Market's Needs

In addition to rivals' excessively high prices and the possibility of your own low-cost-based entry, you may find situations in which a customer need is not being met well by existing businesses. Careful observation of market *signals*

will often reveal sellers or other providers of products or services who are performing inadequately. Current sellers' inadequacies to watch for include slow delivery times; lack of quality control; unhelpful, underqualified, or unfriendly sales personnel; and lack of proper handling of a customer account.

Lack of aggressive handling of clients is illustrated by the following situation, which recently came to the attention of an entrepreneur (Steinberg 1985):

> Richard Jaffee perceived inadequate exchanges of information between graduating college students and prospective employers. He talked to students at eight schools and found that many would pay $35 to place their résumés in a new computer bank he called Entry Link. He discovered that many companies would pay $150 for 25 qualified leads for a job. He plans to expand beyond the entry-level job market after two or three years. This incident shows a new business entry based on perceived customer needs not being met by existing organizations. The U.S. economy has done well by most standards for 45 years now, although there have been periods and regions when this was not true. When the economy performs well, convenience-based businesses offer excellent opportunity.*

Moving in by Offering More Convenience

Many people can afford and demand convenience more and more. Convenience Stores is a relatively new chain of stores whose name gets right to the point. Automatic teller machines (ATM) met a convenience need of bank customers. Where volume is high enough, ATMs lower banks' costs, too. Convenience not offered by existing sellers helped entrepreneurs enter markets in the following scenes:

> Long Haul Jeans, a division of Jonbil, Inc., in Chase City, Virginia, sells $10 million of full-cut jeans to truckers. (They are now developing Long Haul cologne.) These are conveniently sold in truck stops in forty-four states, although plans are to sell the cologne through drugstores and major department stores once it is established (Numata 1985).

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> Jean Ann Murdock was a single secretary with a reasonable income and not much time to buy groceries. She ordered a year's supply of frozen beef, poultry and fish from a frozen food home delivery company. She is now married so the family has more funds and an even greater demand for convenience so they continue to buy meats and fish delivered to their home. Their food bill is a little higher but the convenience is there and they feel the quality is better than that in stores. Others complain about poor quality and sales promises not met by delivered food (Schwadel 1985).*

This situation illustrates a widespread need for convenience arising in two-income households. This particular need is giving rise to new businesses that sell and deliver food in the home. The following story illustrates how an unmet need for convenience was met by other entrepreneurs (Johnson 1984):

> Fast Breaks is a new company in Bloomington Indiana, started to deliver McDonald's hamburgers and Taco Bell burritos to Indiana University dormitory residents. A survey revealed that many students would pay a dollar to have these items conveniently delivered rather than have to walk the mile to a restaurant for them. This company uses portable ovens to keep the food warm in transit. They promise and deliver in less than 20 minutes. A McDonald's franchisee in Maryland is using a renovated school bus to pick up University of Maryland students who want to ride to his restaurant.**

Convenience needs will no doubt increase further if the economy continues to do well. New opportunities will continue to open for entrepreneurs who read market *signals* then take the next step by acting in entrepreneurial ways. In addition to convenience, many other benefits will provide entry opportunity under the right conditions.

Market Entry through Product Features

An important factor in many business start-ups is freshness. Food, flowers, cigars, blood for transfusion and testing, and many other items are all worth more if they are "fresh." Freshness, of course, is determined by the time

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between production and use (which is often determined by distance), by packaging, temperature, and other factors. One successful new company provides fresh herbs to restaurants (Agins 1985).

> In 1981 an IBM plant controller took a leave of absence to develop an employment program for runaway youngsters. He and fifteen of these youths began growing mushrooms and, later, herbs in the south Bronx. Soon they had a profit-making business selling to New York City chefs. Sometimes they deliver by subway.

Although some businesses, such as herb growing, can be done by persons who have done some studying, many new high-technology companies in the health care field are started by highly trained scientists and engineers to overcome "freshness" problems. Machines to analyze blood, urine, and tissue are generally large and expensive. Thus, they are owned by central laboratories that serve hospitals, clinics, and physicians' offices within a large radius.

For faster turnaround time and the capability of keeping the items to be tested fresher, it would be more convenient if these health-care providers could have analyzer machines in-house. So, small, computerized machines are being invented; and new businesses are being formed to produce and market them. Stephen Ash, chairman of Ash Medical in Lafayette, Indiana, illustrates a kind of business entry located next to research universities around the country. Convenience is by no means the only benefit these new businesses offer.

> Ash Medical Systems, Inc., in West Lafayette, Indiana, was started in June 1983, by Dr. Stephen Ash. Dr. Ash is a nephrologist, or kidney specialist. The company develops artificial organs and implantable devices. A blood pressure and pulse monitor is one of their new products. Another is Smart Chart, a computer program to maintain a clinical chart at a patient's bedside. Bio Logic, an artificial kidney (kidney dialysis machine) is their third product. All these products are being commercialized because they provide user benefits.

Moving in by Marketing Better

New marketing methods often provide the means to enter a market. Blister pack cards (for hanging on a display fixture) sell tools, pencils, razors, and hundreds of products and have given rise to many new businesses. Timex Watch Company became a successful large-scale corporation by being the first company to sell watches through drugstores. Sometimes, new marketing methods are outdated methods brought back with a flair. New health food stores sell crackers, nuts, cereal grains, and other items from bins and barrels, the way they were sold a hundred years ago. But now these foods are promoted

to health-conscious urbanites. Often, there is a back-to-nature appeal in addition to the health-benefit promotion.

Pushcart peddling is another marketing method of the comeback variety that is spawning several new businesses. Jon Laitin (1985, p. 90), writing for *Venture,* describes new pushcart businesses this way:

> For today's budding merchandisers, pushcarts have again become a first step toward the American dream. Reintroduced in 1976 at Boston's Faneuil Hall Marketplace, the carts are proliferating at shopping malls across the country. The phenomenon offers entrepreneurs an opportunity to test the retail waters with a minimal investment, and for some the carts can lead to shops that ultimately produce millions of dollars in sales.
>
> Seasoned pushcart vendors compare the hands-on experience and assistance from mall managers to a college course in merchandising. Weekly leases, low rents, and ideal locations, they say, keep risks low and potential for profits high. At the Jubilee Market in New Orleans, where 20 carts designed to resemble streetcars offer crafts, clothing, and gift items ranging in price from $5 to $50, leasing and merchandising specialist Tina Riviere cites 'the people, the product, and the presentation' as the criteria for choosing pushcart vendors.
>
> Many entrepreneurs, including 25 vendors from Faneuil Hall, have made the transition from cart to retail store . . .*

Moving in by Focusing on a Market Segment

A major entry avenue for new businesses is called the *market segmentation,* or *specialization strategy.* In fact, this avenue cuts across many others, as will be seen directly. The story of pushcart businesses also cites the sale of designer earmuffs by one enterprising couple. Designer earmuffs were, and probably still are, directed through upscale malls, with upscale prices, to upscale buyers in cold climates.

Market segmentation is such an important marketing concept that the serious student of entrepreneurship should study it. Any college text in marketing will devote space to the practice. Simply described, market segmentation strategy means choosing a subset of a larger population of potential customers and directing your product or service (any advertising done, personal selling pitches, display, location, packaging, and price) to this targeted group. The

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focus will often ignore certain income-level persons, certain geographic locations, certain price ranges, and certain age groups to target others in each of these dimensions. Perhaps the most striking examples of successful market segmentation are by beer and cigarette companies. Think about the characteristics of persons (market segments) to whom Miller Lite and Virginia Slims are directed.

> A new business aimed at a segment of the population is Great American Puzzles. These sell at $7–$8, well above the price of the bulk of jigsaw puzzles sold by the large Milton Bradley Company. Great American Puzzles excludes the children and low income adult markets by their pricing and by distributing through gift stores and catalogs (Byrne 1983).

The aim of market segmentation is to match a specific product to a specific group of customers. You can begin with the product, such as designer earmuffs, nice puzzles, or an artificial kidney, and then target the customers. Or, you can start with a customer group then design and market a product or service to benefit that group. Entrepreneurs in for-profit hospitals observe that as the population becomes older, an even larger segment of their patients consists of older persons than was true a few years back. They are building to provide medical treatment these persons need. Entrepreneurs at Marriott (hotels) are developing expensive retirement residences for the segment of the aged who have funds.

Market segmentation strategy is important enough to new business entry to merit considerable study and thought. To think about the practice and study it further, try the following exercise.

Exercise 7.C

Describe target customers for two new products and two new services. Also, describe a new product or service for two market segments. Your ideas may sound a little "far out" because they are new and unpolished. But all new ideas are "far out" until accepted. This exercise should provide ideas for useful discussion.

New Product or Service	Target Market
1. Bio Logic, a kidney dialysis machine operable by a briefly trained patient.	
2. Mitremaker, a small jig that cuts frames and wood to any angle accurately.	

New Product or Service	Target Market
3.	New households with modest incomes, who will probably live in their hometown.
4.	Retired individuals with modest incomes, their own houses, and time on their hands.

Before leaving the topic of new businesses through market segmentation, two particular markets deserve attention (Finley 1986). One is the U.S. government, a huge buyer of products and services. Many new businesses begin by getting an order from this customer. Related segments are state and city governments and universities.

A second market segment holding opportunity for new businesses is existing companies. Consider a clothing manufacturer that dyes and cuts cloth then "assembles" outdoor coats or an alarm clock manufacturer that molds casings and assembles wind-up clocks. Each of these businesses has a main business, coats and clocks, that its management wants to be in and sub-businesses, such as buttons and clock face glass, that it may not want to be in. A new business might find success supplying buttons or clock faces to these companies. New businesses often begin by contracting with a large company to supply it with a particular item. The new business may improve on costs, quality control, or reduce management problems for the large customers (Gumpert 1977).

> One new business formed as a sub-assembly electronics firm. The entrepreneur visited large electronics firms in his area, offering to perform simple tasks such as putting screws into plugs, preparing wire for soldering, and soldering electronic components onto printed circuit boards. One large company agreed to provide enough sub-assembly work for the new business to employ 10 persons for more than a year. The entrepreneur rented a vacant garage and hired personnel. A short time later the new business had entered the marketplace and was competing successfully.*

Moving in by Seeing Under-Valued Products

An interesting new business *signal,* and very different from any explored yet, might be thought of as watching under-valued items with valued uses. We spoke earlier of the entrepreneur's need to be able to read a situation to find opportunity. Related to this is the ability to "see" high value in low-valued

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items. Arnold Cooper, an entrepreneurship scholar and consultant at Purdue University, tells of a young man who saw such value where others did not. This account is taken from a bulletin published by the National Federation of Independent Business, whose address is at the end of this chapter.

If at First You Don't Succeed . . .

John Merriam, a civil engineer, worked with a construction firm in Detroit. The firm specialized in constructing single-family housing in the northern suburbs of the city. A decline in construction activity in 1974 caused his income to decline through loss of bonuses on projects he supervised. He decided to leave his employer and began to look seriously for other employment opportunities.

A friend suggested that he consider residential demolition, which involved contracting to tear down obsolete or deteriorated housing. Existing firms seemed to concentrate on tearing down buildings as quickly as possible and hauling the debris to the dump. The friend suggested that he investigate the possibility of salvaging objects of value before tearing the houses down.

John Merriam's investigations disclosed that about 8,000 homes were wrecked in the area each year and that about 10% of these had been built with high-quality materials with real salvage value. He developed a plan to bid for the demolition of these homes and then salvage the copper pipes, electrical fixtures, hardwood floors and paneling, and other objects of value before demolition. He developed careful estimates of the time needed to do a job. He checked his estimates by bidding on one older house and demolishing it using rented equipment. It appeared that the business could be highly profitable, possibly generating pre-tax profits of $120,000 per year.

Mr. Merriam calculated that about $125,000 would be needed to start the business, including the purchase of two trucks and a used crawler tractor. Mr. and Mrs. Merriam only had $15,000 of their own and were unable to raise the additional $110,000, even though they talked to many banks and other financial institutions.

Subsequently, he modified his plans. Rather than investing in demolition equipment, he began to pay other wrecking companies for the right to go into houses first and to remove the antique hardware and hardwood paneling and flooring. The company then published a catalogue of antique building materials and sold to antique stores, interior decorators, and contractors. It has been very successful.*

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* Used with permission of the National Federation of Independent Business (NFIB).

Whereas John Merriam started his business with items others considered too old to have value, Irwin Jacobs was able to get a boost in his new business career by questioning the damage done by a fire (Antilla 1985).

> Irwin Jacobs, age 43, made his first purchase of damaged merchandise when he was 15. He bought fire damaged fabric for $1,100 and sold it later the same day for $18,000. Several years later he purchased a bankrupt boat maker and turned it into a profitable conglomerate. In response to a question by *USA Today* reporter Susan Antilla, Jacobs said, "The reason I have a knack to make money is that my father taught me to see things that other people couldn't see."

Clearly, seeing value where others do not is an important way to enter business. Some would say this perception coupled with the initiative to act on it is at the core of entrepreneurship. When you think of Mr. Jacobs's statement you are probably reminded that Chapter 1 presented self-confidence and willingness to risk to achieve as two characteristics of entrepreneurs. Did not Jacobs's fabric and boatbuilding ventures clearly reflect self-confidence and willingness to risk to achieve?

Another entrepreneur, Gary Blonder, finds values where most of us do not care to look (Curley 1983).

> Gary Blonder built Blonder's of Hartford, Inc. from his father's average junkyard into an operation making Gary worth $4.5 million. He did this by matching low-valued items with valued uses. For example, after buying a wrecked 1977 Buick Skylark for $400 he confides that he expects to sell $1,200 of parts from it within three months. He and others like him are transforming much of the auto salvage industry by selling clean, tested auto parts in neat warehouses where customers can shop in a supermarket atmosphere.*

Although wrecked cars are sold at organized auctions, another source of merchandise with potential is the U.S. government. Sometimes, one can buy from the government at very low prices. (These are as puzzling as are certain notorious high prices paid by the government for hammers, screwdrivers, and other items.) Successful bidders for equipment occasionally are able to resell such items at several times their cost. To gain access to this merchandise, you must obtain bid catalogs and sale notices, which you can do by writing the Department of Defense, whose address is at the end of the chapter.

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Summary

In this chapter we addressed the question, How will my new business enter a market with competitors already in place? Signals of entry opportunity are many and varied. We explored entering a market in which a seller is pricing attractively high and a market in which we can offer something extra, entering by focusing on a segment we can readily benefit, and entering by seeing values where others do not. These entry avenue categories lack clear boundaries — they overlap — and there are other avenues yet. However, the major avenues seem to be those described here. Sources of further information and added perspectives are in the references below.

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Further information and perspectives on breaking into a market are found in:

Department of Defense, Bidders Control Office, P.O. Box 1370, Battle Creek, Michigan 49016, has bidders application forms.

National Federation of Independent Business, 150 West 20th Avenue, San Mateo, California 94403. The NFIB Research and Education Foundation publishes materials useful to prospective new businesses as well as small businesses. Much of the material is free.

Venture, Entrepreneur, and *In Business* are three magazines publishing stories on how new companies are started.

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Wall Street Journal and *Forbes* also include stories on new ventures.

CHAPTER 8

Sales Planning and Forecasting

For the entrepreneur, selling is an almost Zenlike experience.

— Victor Kiam

This chapter focuses on a narrow problem within the field of marketing. The entrepreneur's first marketing tasks are to carefully plan to sell and forecast sales.

The planning and preparation described in this chapter help solve the single most urgent problem you will face as an entrepreneur: how will you induce people (creditors, suppliers, and others) to "invest" in your business, instead of in other investment alternatives, when you *do not even have a business*? The entrepreneur must have money to start a business, yet he or she needs a business to obtain money. By having a business, we primarily mean having sales. Therefore, this chapter describes ways to market the new business concept and the preparation needed for this necessary task.

An entrepreneur who can demonstrate a level of obtainable sales can enlist the support of suppliers, creditors, advertisers and distributors, investors, and professional and management persons. If these parties are astute — if they know their markets, and you must assume they do — then they will not be

impressed by drawings of a new product, by a building, by permission and licenses to do business, nor even by a place of business. They will be impressed by sales prospects. By *sales prospects* we mean promises, orders, or better yet a sale and a repeat order. We cannot overemphasize the importance of establishing the credibility of your product or service with customers. Virtually every resource the entrepreneur needs can be accessed if and when sales are assured.

Assurance is the key idea on which all investments of time, merchandise, and money are based. All "investors" want to be assured that their investments will yield a profit. The other side of the assurance coin is risk. Look at sales preparation as risk reduction. In addition to developing your idea into a competitive product, discover problems that might prevent sales or reduce them. As you reduce your sales risk, you will feel better about your own investment in the new business and you will find others willing to invest to help get it started. Collins (1985) cites a marketing research firm that became a successful venture capital firm, using its sales research expertise to convince financial investors it could pick winners among start-up consumer product companies. This account illustrates the potential power of sales preparation and forecasting. Our first variable in sales forecasting is newness.

The problem of sales assurance is more uncertain the more new elements are in a proposed business. We will get a perspective on the sales preparation lying ahead by first examining the newness of different types of start-ups. Figure 8.1 illustrates the newness concept and the risk, and suggests preparation required to offset that risk.

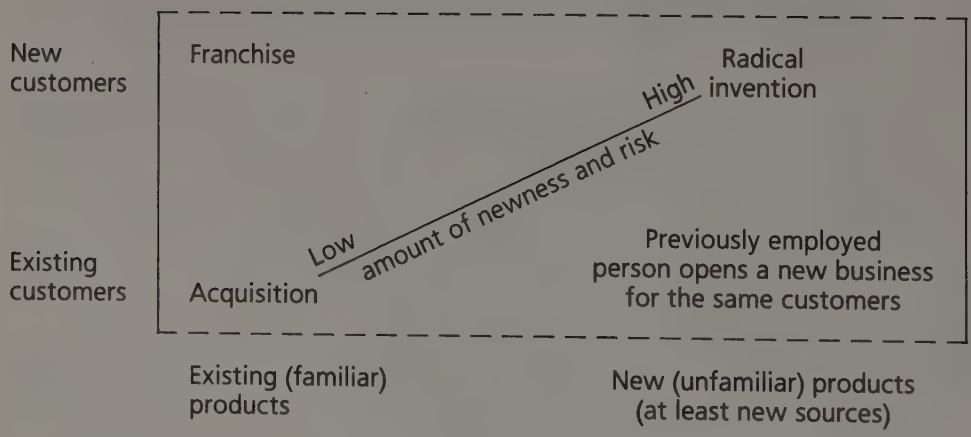


FIGURE 8.1. Newness Affects Sales Forecasting

Newness of Products or Service

Sales forecasters find that predicting new product sales is the most difficult forecasting they do (Sales Executives Club of New York 1984). A survey of a large sales executive club found that smaller (and presumably newer) companies found new product forecasting less accurate than did large companies. Survey results showing these differences are

Accuracy of forecast	Small (newer) companies	Medium companies	Large companies
100%	0%	0%	0%
90–99%	5.7	14.0	20.8
70–89%	34.5	35.9	57.5
50–69%	26.8	31.3	16.0
Less than 50%	28.4	18.9	10.2

Among smaller companies, what gives sales forecasters the most trouble? In order from most mentions in a survey (Sales Executives Club of New York 1984) to least mentions, the factors are

Judging size of market	34.6%
Competitor with new similar product	23.0%
General state of economy	17.3%
Judging share of market	15.3%
Lack of cooperation from dealers and others	13.4%

From New Product Idea to Market Research

A radical invention, such as television, portable calculators, or gasahol, possesses the greatest sales risk of any type of new business. Not only are the product's field performance and user benefits undemonstrated, but users are unknown. Who might buy and use the radical new flexible blade for lawn mowers described in Chapter 4? Would it be older persons, families with children, lawn-care businesses, or teenagers mowing lawns on Saturdays? How would you educate them to the blade's benefits? Which group would you start with? The blade never became profitable because these questions were never

answered, and so credible sales forecasts were never developed and funding was never acquired. Nova Concepts' tamper-evident, child-resistant vial closures have progressed through a beginning sales stage and many of the preceding questions are being answered as of this writing. Problems of consumer acceptance and competitor behavior still loom ahead.

In the mind — the imagination — of the entrepreneur, a creative process brews. It consists of two kinds of ideas at the beginning: product ideas, as discussed in Chapters 4, 5, and 6; and competitive market entry ideas, as discussed in Chapter 7. Our focus now must be on how to get from this brew of usable ideas to a testable new business. You might visualize our task as filling the missing step in Figure 8.2.

Entrepreneurs speak of hunches or gut feelings that a product will sell. Figure 8.2 is an analysis of that feeling. You need to break down the missing step into components — take it apart and look at it. Its source is usable product ideas. What are the features or dimensions of the best new flexible, hinged mower blade, for example? Marketing specialists break this problem into several dimensions, called the *marketing mix* (Cohen 1981). This mix consists of product, promotion, position, place, and price:

Product:	What is its length, material, weight, shape, color, package size, thickness, and cost?
Promotion:	To whom would it be promoted? Who would promote it? Would the promoter use advertising, promotions, personal selling?
Position:	What position will it occupy in the market? Will it be a safety blade? Will it cut and vacuum cuttings well and be positioned as the performance blade? Will it be an exclusive blade, available only on high-priced new mowers and at their dealerships? Or will it be closer to the convenience end of the scale and be available at all hardware, discount, and department stores? Will it be branded or positioned as a commodity item?
Place:	Would it be sold only through dealerships or would K-Mart, Wal-Mart, and others carry it? In what areas will we use manufacturer's reps or our own sales force to reach those locations?
Price:	Based on the production and marketing costs, what is the minimum profitable price? At what volume? Are competing prices well above our floor price? Do we want an initial "market penetration" price, low enough to induce consumers to switch to us?

On the right, our missing link connects to a testable market. What is a testable market? Still using our flexible blade for illustration, potential *market segments* should be identified. Think carefully about who might be interested in the blade. You must talk with potential users, retailers, and any consumer behavior experts you can corner. After extensive informal research, you may perhaps conclude that young, upper-middle-income professionals are likely to

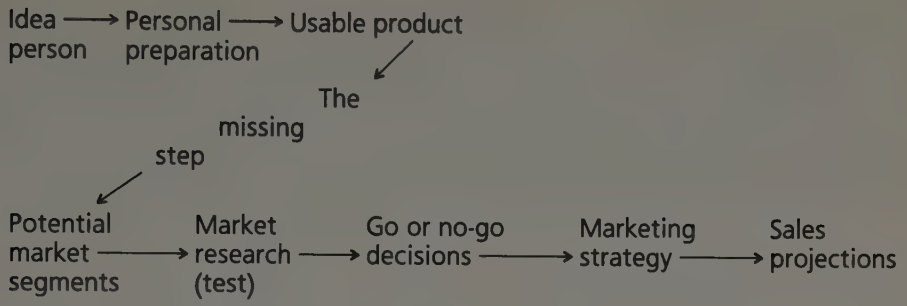


FIGURE 8.2. The Missing Step

be "educable" to this blade. When buying a new mower or having one maintained, they can perhaps be convinced to request this safety blade.

You might call on a few dealers in better brand mowers and try to sell them on the idea of installing fifteen or twenty of these blades (free) on their customers' mowers, with the customers' permission, of course. You would prepare a questionnaire that would help you detect the impressions the users formed about the blade. You would need to have the dealer get customers' names and addresses when the blades are installed. When the customers agree to participate in this user test, the dealer sets up an appointment for you and the customer, perhaps one month after taking the mower home. When composing the questionnaire and using it in an interview, you must carefully determine what information to seek. You will want to learn what benefits and disadvantages the users-buyers perceive in the new blade, compared to the product they were using. Overall, do they feel it is better than previously used blades and if so by how much? Would they be willing to pay more for it? If a conventional blade were $6.00, would they be willing to pay $8.00 for this one? How about $10.00?

The results of this kind of research will be a main factor in deciding whether to pursue the business. If the decision is to pursue the business, much can be learned from this kind of research about the direction to take next. For example, "position" choice will be clarified as well as promotion choices and pricing.

Two Cases of Sales Preparation

For a change of pace, take a test. Suppose you possessed a new type of alarm that could be installed in homes. Upon detection of smoke, heat, or an intruder, it would create a very loud pulsating horn sound inside and outside the house. The whole system could be set prior to the family's absence ranging

from an hour to several weeks. Thus, it would help protect the house and contents during a grocery shopping trip or a vacation. With the electric eye turned off, it functions as a fire alarm. It is expensive, costing over $1000 to install in a 2000 square foot house and more in a larger house.

These steps were taken by two professional managers forecasting sales for the alarm intended to become the basis of a new business:

1. Obtain names and addresses of everyone living in three upper-income neighborhoods.
2. Write them letters asking when they will take vacations.
3. Identify the value of the house.
4. Identify the value of specific items in the house.
5. Ask how much they would pay for a described alarm system.
6. Explain who you are, where you live, and why you are conducting the survey.

Exercise 8.A

Cite specific reasons you feel the preceding research design would or would not be effective in forecasting sales.

1.

2.

3.

4.

Cooper (Louis E. Weil, Jr., professor of management, Crannert Graduate School of Management, Purdue University) tells of two men starting a business to assemble and sell a fishing lure. While reading the following account, judge whether their test marketing was appropriate and note any improvements they could have made.

> After experimenting with various lure designs, Mr. Ellings, a lawyer, fashioned the Blue-Oreno lure and found it effective for catching bass and trout in his home state. Similar lures retailed in several types of stores for $1.99 to $5.25. He fashioned a display card and suggested a retail price of $1.79. About the middle of the fishing season, Ellings and a partner, who is a realtor, called on the manager of the largest of a chain of hardware stores. They struck a deal with him to display and sell their lures. Working separately the next two days, the partners induced the managers of twenty-six other stores to handle the lures. By the end of fishing season the retailers sold 2,000 lures. Mr. Ellings and his partner talked with store managers and occasionally fishermen about lure-buyer attitudes and behavior.

Exercise 8.B

1. Was their test marketing appropriate? Why or why not?

2. What improvements do you feel should have been made? Explain.

3. Will the actions of Ellings and his partner achieve the three goals of a market research design?

Our evaluation of the alarm system research is negative. First, probably no more than one-fourth or one-third would open your letter. Then, of the few who began reading, a small fraction would go past the part where you asked when they will vacation. The request for valuation of items in the house would lose most of the remaining. Of those who said they would pay x dollars for the system, few actually would part with the money when the time came. In contrast, the Blue-Oreno test marketing was sound. It built on the knowledge and facilities already in place. It was gradual, so that feedback was used to reduce risk. It used the complementary skills of the partners.

The alarm system market research would probably result in several calls telling the researcher to mind his own business, a call or visit from the local police to see if the entrepreneur runs an organized theft ring, several returned questionnaires with advice on them, and perhaps 1 to 2 percent useful questionnaires. The latter assumes we had enclosed a stamped self-addressed envelope! By contrast Piehl (1979) describes a low-cost, perhaps free, effective customer survey done by a Small Business Institute for a new business. You may be able to use this service by contacting a Small Business Institute, usually through a Small Business Administration office. The alarm system research project was actually attempted by two professional people trying to become businessmen. They had no research success and abandoned their business plans shortly thereafter. By contrast, the Blue-Oreno test marketing was appropriate.

We have described useless market research and useful market research and given reasons for the rating of each. It is time to move to test marketing, bringing us a step closer to these goals: (1) go or no-go decisions, and if go, with what marketing mix; (2) skill in selling the product in the form and position we finally decide upon; and (3) credible projections of sales levels.

Test Marketing

Test marketing is based on the concept of gradualism. Why move into any high-risk situation quickly, if we can instead move in gradually, receiving information and adjusting our efforts as we move? In test marketing we want to simulate a later full-scale market choice of customer type and product-promotion-position-price characteristics.

Depending on resources, you should vary promotion, position, and price comparing one test market result to others, then collecting buyer acceptance results. Thus, we reach goal 1: go ahead or wait, and if go, then what marketing mix to use. As part of test marketing, we gain experience and thus can gain goal 2: marketing skill. By multiplying the sales results of the test marketing project times the appropriate number of comparable territories and time periods (with adjustments for season, experience, and so on), we reach goal 3: our sales projections.

Thinking back to our missing step, what better name can we now give to it? It starts with a usable product idea, moves through a marketing mix, and connects to potential market segments. Call this linkage your *market research design* (MARD). Of course, this design is a plan of the way your research and test marketing will be done. Again, depending on your resources and the risk elements in the new venture, more or less time, effort, and money should be invested in research.

Methods of Forecasting New Product Sales

Established marketers forecast in a four-stage process, part of which is useful for a new company or new product. All the steps are for a specified product, a specified geographic area, and a specified time period. The first step is estimation of the total market potential: maximum sales if all sellers exerted maximum selling effort. Step two is estimation of the expected total market sales by all sellers. The third step is estimation of the maximum sales by one's company if it exerted maximum sales effort — that is, the company's market-share potential. Finally, the sales forecast is the level the company expects to achieve, given its intended level of marketing effort. A sales forecast is the main objective, but it is better performed by starting with market estimations. These methods are described in most marketing texts and provide a useful background for the task facing the new company or new product.

Small companies use a number of different methods to forecast new product sales, most of which are available to a new company. In order of mention in a Sales Executives Club of New York (1984) survey, the relevant forecasting methods are:

We use our own research facilities	40.3%
Our salespeople estimate the potential market	38.4%
We use an outside research service	10.9%
We ask distributors (or retail outlets) to estimate consumer response	10.9%
We figure rate at which item will be bought as substitute for another that serves similar needs and for which sales patterns are known	7.7%
We study response under simulated purchase conditions	5.7%

Of course, an established company can better afford the risk of not forecasting new product sales than can the start-up company. One large, consumer-goods sales agency states that their product managers do the research on new products. A useful concept of the entrepreneur is that of product manager. In fact, being a product manager in an established company is ideal marketing experience for a budding entrepreneur.

Observations from the Sales Executives Club of New York for the new product forecaster are:*

> Your forecasts will contain more personal opinion or educated guess the more new the product is.
>
> Concentrated markets, such as the industrial field, are easier to identify and reach and therefore, to accurately forecast than are consumer markets.

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Many forecasts of new product sales are too high because the seller allows insufficient time to prepare the market for successful introduction.

Having actual samples of the new product to show prospective customers is usually the best way to get a good feel for its acceptance.

These cautions are not to dissuade your entrepreneurship, but to inform you about specific hurdles you face and suggest ways to overcome them.

The following steps are typical and perhaps ideal in new product sales forecasting, according to the Sales Executives Club:*

Step 1. Estimate potential for new product by historic analogy, substitution studies, or other methods.

Step 2. Probe prospective users and middlemen to gauge their reactions.

Step 3. Go into limited production based on findings in above steps.

Step 4. Test actual use of product to gauge user satisfaction, and make any modifications that seem needed.

Step 5. Do late-stage testing using carefully selected sample markets.

Step 6. Keep constant check on purchase patterns once product is launched.

Forecasting by analogy, substitution, and the probing of prospective users will be illustrated by a compact discs example. When compact audio discs first came onto the market, their marketers looked closely at the historical consumer-acceptance rate of video cassette recorders, over the first three years of their life. This information helped marketers predict the market for compact discs. Three years into the disc market, the trade association, Recording Industry of America, Inc., figures showed cumulative CD sales exceeded VCR sales at the similar period. A substitution study to forecast CD sales would observe the process and rate by which CDs are substituted for audio cassettes and records. Projections would be made from these observations.

Step 2, probing prospective users, starts with a group of persons chosen from most likely (prospective) users. They are then given the new product (in this illustration CDs and players) and asked to use it for several days, after which they are asked to compare the product to one they now use or to evaluate the new product on selected criteria.

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Three methods used to forecast sales potential are described by Urban and Hauser (1980). First, using an "intentions" approach, consumers are asked to estimate the likelihood of their buying the proposed product or service. An "intent scale" questionnaire is used, such as the one on page 122 illustrating research on a diet service.

Check the Most Appropriate Statement Below

_____ I definitely would use the diet service described.

_____ I probably would use the diet service described.

_____ I might use the diet service described.

_____ I would not use the diet service described.

One study found that for frequently purchased consumer brands approximately 75 percent of the "definites," 30 per cent of the "probables," and 25 percent of the "mights" later actually chose their indicated product. Suppose these percentages described your product category. Suppose further the proportion of respondents answering definitely, probably, and might were .05, .15, and .30, respectively. Then, before allowing for unavailability and unawareness, the probability of purchase by your target market would be:

	Intention scale responses	Responses and actual purchases	ISR times RAP
Definitely	.05	.75	.0375
Probably	.15	.30	.0450
Might	.30	.25	.0750
Proportion of target market expected to purchase equals			**.1575**

Suppose three mutually exclusive designs or "packages" are being studied. Then, the research questionnaire might be set up in the following manner:

> If (clearly described, pictured, priced) options one, two, and three were each available, which would you likely choose? Check one space on each line below.

	Definitely not choose	Probably not choose	Might choose	Probably choose	Definitely choose
Option one	___	___	___	___	___
Option two	___	___	___	___	___
Option three	___	___	___	___	___

These responses would be helpful in entrepreneur's go or no-go decision, and if a go decision, then whether to go with only one option or with more. Of

course, if affordable, actually placing more than one alternative on the market would yield invaluable comparison information.

A useful alternative to the intention scaling formats is the probability scale. Here each category is the respondent's estimation of his or her probability of purchase. For example, after a description, price, and, if feasible, a demonstration of a CD is presented, you ask:

> Considering your alternatives for home entertainment, what is the likelihood you would purchase a CD? Check one of the following spaces:

Almost certain	(99 out of 100)	____
Very sure	(9 out of 10)	____
Quite probable	(8 out of 10)	____
Probable	(7 out of 10)	____
Good possibility	(6 out of 10)	____
Fairly good possibility	(5 out of 10)	____
Fair possibility	(4 out of 10)	____
Some possibility	(3 out of 10)	____
Slight possibility	(2 out of 10)	____
Very slight possibility	(1 out of 10)	____
Almost no chance	(1 out of 100)	____

Studies show that, although actual purchases do not equal prior stated probabilities, there is a linear relationship. If stated probabilities are on one axis of a graph and actual purchase probabilities are on the other axis, a straight line will best fit the plotted points. Urban and Hauser (1980) cite examples with actual data.

Retailers, such as store managers, can make or break a new product. These persons can give the same kind of prior feedback as consumers. Retailers need to see the product in use, the suggested retail price, their discount, and generally to be convinced they can profit by substituting the new products for products currently on their shelves.

The new store, warehouse, or service business is an attempt to sell persons items they are already buying from someone else, or perhaps an item promising to perform a function currently performed by another product. Often industrial salespeople who switch employers or start their own supply company will be able to entice several previous customers to accompany them to their new business.

New retail shopping malls and new businesses within them are built on the assurance that customers will abandon their downtown or out-of-town stores in favor of the new stores. Retail research data are available to help

predict the amount of source switching one can expect of buyers. Research models are also published in books on retailing and on market research (Parasuraman 1986). The entrepreneur wanting further guidance on estimating such new sales is encouraged to examine these resources.

Impact of Location on Sales

Location and distance from seller are important determinants of much buyer choice behavior. Convenience stores are so labeled because they sell merchandise that persons will buy from whoever offers it at the most convenient location, means of use, and hours. Asphalt and other bulky (in relation to price) materials will usually be purchased from the closest seller, assuming price, quality, and service are competitive. Proposed convenience stores, asphalt plants, and all other businesses where location or distance is critical, should obtain maps from local governments. They should then plot the location of prospective buyers and estimate the probable purchases of each one.

New service businesses for which maps and census data are currently finding strong usage to help estimate sales include banks and emergency medical centers. Twenty-four-hour branch locations are developing in banking and medical treatment at about the same rate. (Recall the discussion of the convenience trend from Chapter 4.) Maps and traffic data must be studied, not only to see where prospective customers and competitors are located but to see customers' frequent routes of travel.

Of course, speculators who think they can see into the future a few years predict where population and traffic will increase. Then these persons acquire property and hold it for a profit. So, the new business venturer will not easily find popular locations at affordable prices. Government bodies concerned with road building, planning, zoning, and development can help the entrepreneur discover a location that may be affordable because of current low traffic but future high traffic. Sales analysis and the other foundations of a new business are not achieved overnight and often entail years of effort.

Statistics tell us that wholesale businesses are more profitable and fail less often than retail businesses. Location is a critical sales predictor for most wholesalers. Many have to locate on a railroad or river, whereas others can locate wherever trucks can enter and exit easily. The transportation cost of incoming and outgoing items must be competitive. A map showing prospective customer businesses (industrial, retail, or other wholesale) and competitors is often helpful in projecting sales levels. The importance of location in attracting customers to a new business is directly related to costs of transportation and inconvenience. Location is more important to the sales of a new business, the more loyal customers are to their current source. As described in Chapter 2 on personal preparation, if you develop loyal customers over years of selling for

one business, a number of those will remain loyal to you if you open a new business offering reasonable prices and desired products, even if you do not have the best location.

Role of the Channel of Distribution

We will now examine major marketing efforts; then we will be ready to analyze a case involving major start-up marketing decisions. After we have decided the characteristics of the product, how best to promote it, and its targeted position and price, we still must decide how to move it from here to there — that is, how to distribute it. We must select and induce marketing intermediaries to help us.

Primarily two influences determine the distribution methods most appropriate. First is the availability of marketing resources. The more marketing resources we have, the more we will be able to do our own brand advertising, sales, promotions, personal selling, storing, transporting, and distributing. Second, a small number of targeted customers makes doing it yourself more feasible. Most start-up businesses have limited marketing expertise and personnel and limited budgets. Thus, if you were going after any sizable number of final customers, for example for most consumer products, retailers have to be used. Imagine trying to sell a new fruit-flavored cold drink mix without advertisers, wholesalers, and retailers.

Without consumer advertising, prospective customers will certainly not be aware nor interested. If consumers are not interested, then retailers will not give you the valuable shelf space now used by Kool-Aid and other established brands. If retailers are not interested, then why should wholesalers buy your product? We call the promotion based on consumer advertising the *pull approach*. If done well, the product may be pulled through the channel by the consumer asking the retailer, who asks the wholesaler, who asks the producer.

Should you decide to create consumer demand, you will need money for advertising. You should count on pricing the product high (for an adequate profit margin), branding it, and differentiating it in the consumer's mind. This may be done in a small local market by a new small company, with adequate up-front finances.

Alternately, a low-cost strategy might *push* the product through the channel by offering deep discounts. You spend minimally and give the intermediaries the profit margin necessary for them to promote the product. A wholesaler who knows you are advertising and promoting a product heavily might handle (buy) it for a 20 percent markup on cost. (The wholesaler actually sees this as a $16\frac{2}{3}$ percent discount off the wholesale selling price. Cost + .20 Cost = Selling Price becomes C = SP/1.2 = .$83\frac{1}{3}$ SP). But a wholesaler who knows he or she will have to devote time and money to promote your new

brand and still risk low sales will expect a larger margin, say 25 percent on the wholesale cost (20 percent on the retail selling price) or more.

The retailer will look similarly at a new product. As part of the wholesaler's or retailer's promotion effort, either may insist on selling it under a so-called private brand. The manufacturer gives up control when the product must be pushed through the channel. You no longer have much power to make decisions on promotion, position, or final price.

Determinants of Use of Outside Marketing Specialists

Figure 8.3 depicts the relation of the two factors determining the need for outside marketing specialists by the new venture.

The other major determinant of our need to use others versus marketing the product ourself is the *number* and location of product users. This factor influences the marketing resources required. What kinds of goods go only to a small number of users per producer? Perishable items such as bread, which must be kept fresh, offer small producers an opportunity to compete in small markets. Bakeries can sell and deliver directly to local restaurants, grocers, and convenience stores because large, centrally located bakeries would lose product freshness if they covered wide territories. Industrial products (used by other businesses) typically sell to a smaller number of customers than do consumer products.

If you manufacture military defense hardware, you have only one to four users: the Department of Defense, and possibly the Air Force, Army, Marines, and Navy. An OEM (original equipment manufacturer) sells to one or a few manufacturers of, for example, cars or trucks. In these situations, little outside

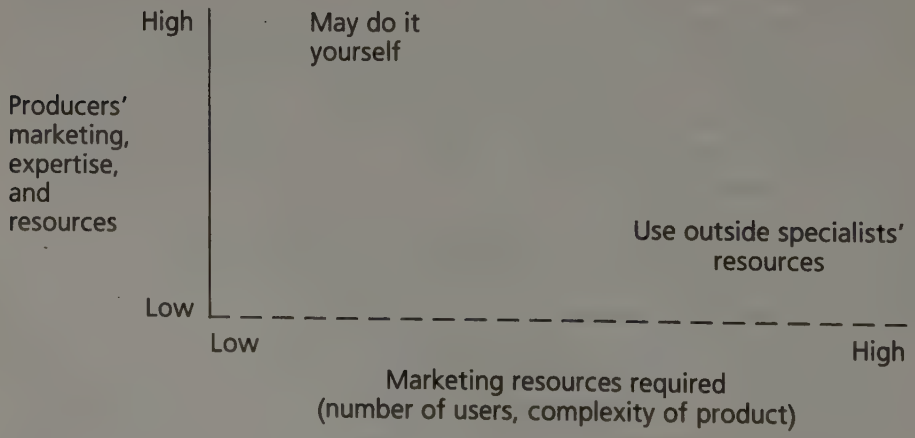


FIGURE 8.3. Use of Outside Marketing

marketing help should be needed, at least on a sustained basis. *Complex* products such as computers, aircraft, or robots, need to be marketed by a party that can install, adjust, and maintain the product. That party often is the producer. Even a new seed corn may require on-site evaluation of soil and climate conditions by the developer. Hills and Star (1985) found marketing is extremely important to the success of new ventures, and after-sales service for complex products is an important promotional factor for new firm success.

Among the several disadvantages a new business often faces, there is one potentially strong advantage. New is news. News is publicity, and publicity is even better than advertising. It is "objective," hence more credible. Parsley Patch (see the Business Plan of Case One at the back of the book) gets much valuable publicity through magazines, newspapers, and even this book! A marketing research project often can do double duty as a free opening promotion (Annett 1979) — that is, the researcher can create market awareness in the researched product.

We left marketing of new retail store businesses until last because in many ways it is less of a problem than the producer's problem. Also, much good reading material is readily available. The SBA (address at back of book), retailing textbooks, and trade magazines are useful.

An old and valid summary of real estate investing is applicable to retailing as well: "The three most important things are location, location, and location." Actually the importance of location is most true for convenience goods (that people choose based on their convenience) and least true for specialty goods (most differentiated so the customer will go out of the way for a preferred brand).

Advertising is also critical for many retailers. For this reason, you are at a disadvantage if you have only one store in a media market served by two stores of a competitor. The competitor can devote the same percent of sales to advertising as you do and "cover" an audience with twice the ads that you send. Likewise your rival's supply costs will likely benefit from supplier economies of scale. Your strategy may be to concentrate as many stores in a media market as does the competition. This may mean going to the small town or neighborhood and using media (such as neighborhood newspapers, inserts, coupons or flyers, or billboards) that point clearly to your location.

Entrepreneur magazine tells how a retailer grossing $250,000 a year in sales can mount a strong advertising program with 5 percent of the sales, or $12,500 (1985).

26 weeks in a community newspaper 2-column-by-5-inches deep	$1,560
Transits ads on outside of two busses that pass by your store, a year	960
Inside bus ads in 20 busses	480
10,000 pieces of direct mail including production	8,000
Free-lance advertising and layout time by a professional	1,500
	12,500

Summary

We first discussed the importance of sales for securing support from suppliers, advertisers, creditors, and investors. The start of a new business is essentially the start of sales. Entrepreneurship has been equated with risk taking; the main risk is that sales will not materialize. Low sales is a function of the newness of product or service plus the newness of customers. Someone who acquires a business has little sales risk; someone who develops a new company to sell a new product takes the most risk.

Small companies forecasting sales of new products use their own staff, including salesforce. Sales forecasting methods include analogy, substitution, and the forecasts of the middlemen. An "intentions" questionnaire, a choice among alternatives, and a probability scale are useful ways to reduce the uncertainty facing the new seller. An establishment's sales are powerfully influenced by its location, which may need to be convenient or close to the customer. Between new product ideas and sales projections many steps are taken: personal preparation, usable product ideas, identification of potential market segments, market research, and assessment of marketing skills. In the middle of this process is the development of the new product itself, including physical and performance specifications.

Poor sales preparation and useful sales preparation have been illustrated. The role of the channel for distribution is greater when more marketing is required and when the new company has less marketing expertise. Finally, location and advertising are of special importance to retailers.

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CHAPTER 9

Who Will Supply You?

Supplier goodwill is as important as customer goodwill.

— Anonymous

We first want to establish the importance of purchasing to the success of the budding business. To a new import business that buys finished goods from other countries and resells them in the United States, purchasing is extremely important. Purchases may be 70 or 80 percent of all costs. In any business that competes on price, purchasing is where competition begins. If you compete by selling specialty items, such as top-of-the-line cameras or craft items, then purchasing is the basis of most competitive advantages you may attain.

Do other kinds of new businesses find their suppliers critical to their success? In manufacturing, purchases typically account for 40 to 60 percent of all costs, so suppliers' prices are not important in the same way as they are in wholesaling or retailing; if purchases represent 80 percent of total costs and the price of purchased items rises 10 percent, then total costs rise by 8 percent. If only 40 percent of costs are from purchasing and those prices rise 10 percent, then costs rise only 4 percent. Manufacturing is likely to be in the latter circumstance. In manufacturing, the quality control and dependability of delivery often are prime purchasing considerations.

If you want to sell differentiated products, you face searches for uncommon materials and parts with which to build the product. If you compete on price, then any interruption of materials or parts that may shut down your production becomes intolerably costly. However, if price competition is keen, then you cannot afford to overstock these items either.

Mary Holman began a commercial craft business by constructing decorative items in the garage and selling them. Soon she opened Craftown, a store in which she purchased and retailed craft supplies to craft hobbyists. Mary observed that purchasing stock was a considerable problem for other retailers she talked with at trade shows and by phone. So, two years after opening a retail store, she, joined by her husband Bobby, opened Century Crafts, a wholesale business. She credits buying with being a key to the success of the new business.

Mary conceived of a particularly profitable buying idea. She would find and buy and item sold as a commodity in one market and resell it as a specialty craft item. Wire, which could be bought for pennies as a hardware commodity item, could be marked up 200 to 300 percent and resold as a craft item. (In the language of economics, Mary identified a market disequilibrium, since more than one price was found for economically equivalent items.)

Having established the importance of purchasing for the new business, we turn to an analysis of the basics a start-up business must achieve in securing materials, parts, and services most favorably. First, what does *most favorably* mean? What purchasing objectives are likely to be especially important to the start-up business? Included are price (including discounts), delivery, terms of payment, and other objectives. Second, what leverage opportunities might your new business have available to meet those objectives — the most favorable purchasing? Finally, how do you go about aligning purchasing objectives and opportunities to have a competitive advantage? Choice of suppliers, relationships with them, and negotiation are important to the success of the new business.

Purchasing Objectives for the Start-up Business

Four main purchasing objectives will be (1) terms of payment, (2) quality control, (3) dependable delivery, and (4) price. The order of importance of these factors will vary with the capital of your new business, whether you are in a new or mature market, whether inventory storage is economical, and with your business strategy. The later exercise with the *Thomas Register* helps you learn how to identify and contact suppliers with whom you can achieve relationships to fulfill purchasing objectives.

Terms of Payment

The chapter on financing (Chapter 13) discusses trade credit — paying your suppliers thirty, sixty, or more days after receipt of goods. The costs of such credit are described and calculations are illustrated. You may obtain free or low-cost credit from your supplier, using one of the levers described in the next section. An established supplier is a likely source of this "financing" because he or she (1) has much to gain by adding you as a customer and (2) has less to lose in the extreme than a bank; for example, if the borrower has to repossess goods, they are worth more to the supplier than to a bank.

You may find it useful to compromise a little on price to obtain concessions on payment terms, but you probably should not lower quality control standards for any concessions. Quality control standards need to be established in the beginning and strictly maintained, since your new business, because of its newness, has a unique opportunity to benefit from word-of-mouth recommendations and media publicity. You cannot afford any negative experiences by your customers, and so you cannot afford defective parts or materials in your products. How do you ensure quality materials and parts? There are many aspects to this control problem, the most important being choice of supplier.

Quality Control

If you choose a supplier who manages defect-free shipments, then your own quality control problems will be manageable. If incoming shipments contain defective items, then you must inspect 100 percent, which is costly and not 100 percent effective, or you can set up an acceptance sampling procedure and achieve whatever level of quality control you pay for. Acceptance sampling means you decide the shipment sample size, product attributes to be tested, and sample proportion that must pass for the entire shipment to be acceptable. Formulas are available that, given certain assumptions about distributions of attributes about a mean, tell how large a sample is needed to predict with a certain level of confidence that defective items do not exceed a given proportion of a shipment. (John Groocock, vice-president of quality at TRW, Inc., discusses the costs and returns of purchasing's role in quality in his 1986 book, *The Chain of Quality*. Chapter 6 of his book is on incoming inspection, and Chapter 7 is on the quality of purchased items, for those needing thorough knowledge in these areas.)

J.M. Juran is an American who has been instrumental for many years in bringing Japanese quality control to world competition levels (Juran, Gyna, and Brigham 1974). Most business professors in statistics operations can help you set up procedures for ensuring quality control of incoming items as well as for the processing of items. Choosing high-quality suppliers and requiring

high-quality standards is better than trying to detect defective items. This is true whether your new business will be retailing, manufacturing, or service.

You might be tempted to think that quality control is important only toward the differentiation end of the strategy continuum and that competition on price and cost can include less attention to quality. Some managers presume that differentiated products, with the latest bells and whistles, are synonymous with high quality, whereas price competitive products can include defectives. Low-price but quality controlled import cars beginning with the VW Beetle should dispel this notion. A recent study of twenty-two paint manufacturers found that those pursuing low-cost strategies emphasized quality control more than did those pursuing differentiation (Dess and Davis 1984)!

Delivery

The third objective is dependable delivery, which may mean a regular delivery — for example, every Tuesday by 9 o'clock — or it may mean short lead times — for example, calling in an order to your vendor and depending on it to arrive by the following noon and to include the right items.

Regular delivery will be most important to you if your own operation is the stable production of a uniform product, such as standard baked goods, paper items, or other staple items. The need by bottling and boxing operations for regular delivery of uniform bottles and boxes is stronger than that of most for regular shipments, because bottles and boxes tend to be bulky and so the user needs to avoid storage.

In contrast, if your business makes custom products, you will have especially strong needs for dependable short lead-time delivery. Printing shops, custom cabinet makers, automobile repair garages, and construction contractors cannot store most materials for their operations because the variety is so great and the usage so irregular. If you are starting this type of business, you must build close working relationships with suppliers so they will give your frequent, even small orders high-priority attention.

> The magazine *Purchasing* is published for corporate purchasing agents, assistants, and managers. You might first learn about new materials, products, or services through this source. *Purchasing* also monitors market conditions leading to general price changes. Buyer's or seller's market conditions also affect delivery times and these times are reported, based on industry surveys.

Price

Price is the fourth purchasing objective for the start-up business. Whole books are written on how prices are determined, the role of price in a market economy, price elasticities, and so forth. Perhaps the most basic concept to grasp here is that, when more products are brought to a market than there are buyers, the price falls; and when demand exceeds supply, the price rises. These two

situations are termed buyer's and seller's markets. Actually other factors change from a buyer's to seller's market, such as quantity discounts, return and allowance privileges, and terms of payment. By learning to read purchase market conditions you can estimate your ability to negotiate favorable prices and other factors.

> In the 1970s, when Ted Turner and other entrepreneurs were starting superstations (usually unaffiliated TV stations broadcasting to surrounding metropolitan areas, which then found new audiences through cable companies), he purchased programming cheaply. More recently the demand for old movies and TV series has bid up their price and largely lost Turner his cost advantage. This loss prompted Turner to search for replacement sources and led him to purchase classic films by purchasing MGM.

Continuity of supply may be especially problematic if you are dealing with a new or little-known supplier. For example, one buyer survey cited in *Purchasing* (Dowst 1975) magazine found the proportion of buyers buying some materials overseas increased from 21 percent to 45 percent. Not only are overseas sources likely to be less well known than domestic sources, but the transportation problems and currency exchange rate fluctuations further reduce the certainty. A new company in Nashville, Tennessee, installing fancy woodwork in new homes faced the need for high-quality wood with carvings to differentiate the product. Their solution was to establish a small plant in Taiwan where expert wood carvers work for a fraction of the cost of similar work in this county.

Although local purchasing may increase your goodwill with bankers, customers, employees and others, converting this goodwill into the dollars and cents critical to the survival of your new business may be difficult. Businesses in wood products, electronics, clothing, and other areas rely on overseas producers for many items because of their lower prices.

Exercise 9.A

Locate a *Thomas Register of Manufacturers* and from it answer the following questions:

1. What are the three ways information is indexed?

2. Who do you think uses this publication?

3. Describe three separate situations in which it might be used and steps you imagine would be followed in each situation.
   a.

   b.

   c.

Opportunities to Obtain Favorable Price and Terms

If your product is new or new in your region, then you may have to offer introductory pricing, and likewise you may negotiate for introductory pricing from your supplier. This practice is called market building and applies as well to your potential suppliers as to your business. Introductory pricing can be an investment.

Another price negotiation factor is the fact that a supplier's new sale—incremental volume — often incurs little incremental cost. The supplier's total costs may be largely capacity costs and not greatly affected by small increments in volume that only fill unused capacity. Learn about your potential supplier's business. What is the supplier's capacity utilization situation, particularly his or her ability to reduce costs per unit through added sales? How can you induce the supplier to pass along part of that reduction to you?

A supplier who feels discriminated against, because of race, ethnic membership, or simply being a new business, might be a very competitive supplier. According to a report by Watkins in the *Wall Street Journal* (1987), minority businesses often do more to get customers: "Some people are still shocked to see what we do," says Mr. Crump, whose company had 1986 sales of $1.2 million. "We still have to go an extra step to prove to people that we're capable."

Another factor to consider is altruism. Can you, the budding entrepreneur, appeal to the altruism of the established supplier? Many of us are willing to unselfishly help others on occasion. The start-up of a promising new business may be such an occasion. If the potential supplier is a successful entrepreneur, you may be in luck, because such people are often a source of help — advisory, financial, and otherwise — to budding entrepreneurs. This is not to say you can expect to exploit any supplier to earn easy money. There are enough unplanned and shabbily implemented new businesses to make all legitimate businesspeople wary. Nevertheless, with honest tact you can secure help from certain suppliers.

Does being honestly tactful and appealing to altruistic motives mean acting poor and needy? Situations differ but you should probably act and appear honestly the way you are. Bankers have been accused of lending only to persons who do not really need money. Do businesspeople grant concessions, including trade financing, only to budding entrepreneurs who are and appear well financed? Because no solid research has been done on the question, you should dress, furnish your office, and select your car appropriately to your means. These items should be neither so rich nor poor as to attract attention, but they should be functional and tasteful. Your aim will be to convince a supplier that you will be a profitable customer, yet you need help getting started.

Further Notes on Purchasing

Purchasing practices affect inventory and are affected by inventory objectives. A summary of the relationships between purchasing practices and inventory levels follows:

High levels of ordering costs are associated with a larger inventory.

Greater quantity discounts are associated with a larger inventory.

Higher stockout costs are associated with a larger inventory.

Greater order lead time variability is associated with a larger inventory.

Notice that these four separate factors can lead to higher inventory levels. Stated another way, higher levels of inventory help solve four problems faced by companies. However, when consulting with expanding businesses, the author observed that lack of cash flow is often due to poor purchasing practices and consequent excessive inventory.

A development among many U.S. corporations in recent years is to give more formal attention to matches between the corporation and its environment, particularly its industry. An industry is a group of rival companies selling similar or closely substitutable products or services. An important aspect of your new company's industry is its age.

Although a new or young industry poses opportunities, mostly in sales and marketing share, it also poses significant purchasing problems to the start-up company. The first companies in an industry have no established suppliers from which to choose. Locating high-quality, defect-free parts, materials, or services is often impossible. Your purchasing ingenuity may be the most significant difference between you and your rivals.

One last comment about being in a new industry is needed. If you develop special competence as a purchaser you may be of value in the selling side of your fledgling business. Appreciating customers' difficulty of sourcing (buying) certain items may lead you to work with customers who would help establish your new business.

Consider the (now mature) mainframe computer industry. In the early growth years, IBM found supplies of chips so inadequate they invested heavily in the chip supplier Intel Corporation to assure IBM a dependable supply of these needed components. When Ray Kroc was first building McDonald's, in the then new fast-food industry, there were no capable suppliers of paper products, potatoes, or needed restaurant equipment. Part of McDonald's success came from working closely with suppliers to upgrade these items.

Exercise 9.B

Interview, in person or by phone, two persons who have started or expanded a business within the past five years. Ask the following of each person.

1. Rank your purchasing objectives (quality control, terms of payment, dependable delivery, price, and others) and briefly explain the ranking.

2. What change in purchasing (processes, priorities, or suppliers) in your business experience has been most important?

Summary

Depending upon your type of business, purchasing may pose opportunities and threats as significant as any start-up efforts. Businesses typically spend from 40 to 60 percent of their sales dollars on purchases of parts, materials, and supplies. The main objectives when purchasing for your business will be consistently high quality, dependable delivery, favorable terms of payment, and price. Positioning to achieve these objectives will help assure the future of the new company. Being a start-up or expanding business and buying from established businesses may allow you to obtain deals not available to others. There are purchasing related costs you can manage, but in so doing you may find yourself with excessive inventory. Buying from inexperienced suppliers requires patient cooperation but may achieve profitable results.

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PART III

New Business Structure Choices

CHAPTER 10

Franchising

More millionaires have been created this way than any other.

— Andrew Kostecka

Promoters of fraudulent business opportunities and franchise deals fleece the public for more than $500 million a year.

— Investor Alert

Could these quotes both be referring to businesses such as McDonald's, Wendy's, Hertz Rent-A-Car, Midas Muffler, Athlete's Foot, or 7-Eleven? Are the quotes saying franchise millionaires get their wealth through fraud and fleecing?

The first quote is attributed to Andrew Kostecka, an official of the U.S. Department of Commerce (O'Donnell 1984). Kostecka is an unabashed booster of franchises such as those just listed and the thousands of other legitimate franchises in the cities, towns, and roadsides around us. The second quote is a caution we pass along from *Investor Alert,* a publication of the Better Business Bureau and the North American Securities Administrators Association. As their names suggest, these organizations act, among other things, to protect the good names of most businesses from the fraudulent and near-fraudulent practices of get-rich-quick schemers.

Over one-third of U.S. retail sales are made by franchises. Franchises have probably been the fastest growing type of business since the corporation was given legal status. It is estimated that by the year 2000 more will be bought from franchises than from all other forms of business.

Main Franchise Questions

Exactly what is a franchise? Are they all basically the same or very different? Should an entrepreneurial person be interested? Why do many work so well that their growth has been phenomenal? What is a franchise agreement expected to cover and to what benefit? Where can one obtain more information beyond this chapter?

What Is a Franchise?

A *franchise* is a contract between a party having the right to sell goods or services, called the *franchiser,* and a second party interested in selling those goods or services, called the *franchisee.* Almost always the contract specifies a brand or trademark, a location, and amounts of money payable by the franchisee for the franchiser's proprietary name. Particular contract provisions are presented later.

Franchise originally meant "free," a privilege or right not required to be purchased. The voting franchise means the right to vote. Cars were among the earliest items sold through franchises, with no fee being paid. These contracts were agreements between manufacturers with rights to names such as Ford and Chevrolet and independent businesspeople who became dealers. Needless to say, "free" is not part of business franchising, although "right" is a central concept. Contract provisions spell out the rights of each party.

The franchiser's lawyers write the franchises or contracts. The second quote at the beginning of the chapter was caution number one. Caution number two, if you become a franchisee, is that the other party's lawyers wrote the contract! They wrote it with their interests first in mind. An analysis of the recent conflict between franchisers and franchisees is available from the author (Finley 1990).

Are Differences among Franchises Important?

You probably have at least one friend or acquaintance who is a franchisee. Suppose you talk with him or her about the contract. Are all other franchise businesses likely to be about the same? No, the differences are important. Let us approach these differences by noting some types of franchises. Later we will investigate contract provisions and main differences from one agreement to another.

One type of franchise is called a *celebrity franchise.* Mickey Mantle and Minnie Pearl were celebrated names when franchising was in its take-off years. These persons' names helped sell franchises — that is, investors were willing to pay money to celebrity franchiser companies, for two reasons. Certain fans of these celebrities wanted the association with the famous. Also, these investors felt that consumers were more likely to buy from a celebrity store. Name recognition, a key step in selling brand items, was certainly easy if your store and roast beef were named Roy Rogers. But athletic or show business success does not guarantee your country cooking, fried chicken, or roast beef will be better than other fare on the market. Also, celebrations and celebrity or star status inevitably fade, as do most celebrity franchises.

Hot concept is the name given to a second loosely bound type of franchise. Difficult to define, this type generally offers something not as common as fried chicken. Care and cleaning of furniture are examples. Sports car rental and a rack on which to display one's cap collection are examples. Gourmet cheeses and (appropriately) weight loss centers were once called *hot concepts.* Sun tanning parlors also fall in this group. As star franchises may fade, hot concepts may cool. This is not to say you cannot earn good money in these businesses. If their popularity strikes us as probably short-lived, two points must be considered. First, why not get in on a hot concept while it's hot and make money. Then, if it cools, get out? Second, Monday morning quarterbacking the marketplace is anybody's game — that is, calling an industry a temporary thing is easy after it declines, but knowing today what will sell and what will not sell tomorrow is nearly impossible.

A *conversion franchise* is a type of arrangement whereby an independent business converts to a franchisee covering its entire business or a certain line of products. ERA is a national real estate business franchiser that provides its name, an informational network, and operating guidance to established local real estate companies for a fee. The local independent business converts to a franchise. ERA's main competitive concepts are its seller- and buyer-protection plans. Part of the fee paid by the franchisee is used to insure appliances and other items in the seller's house for a period while the house is listed for sale with an ERA franchisee. Century 21 is another conversion franchiser in real estate brokerage.

In the construction industry, Carrier, for example, operates through conversion franchises in that an agreement is signed with one or more dealers in a market area. This agreement conveys the right of the dealer-franchisee to sell Carrier air conditioning equipment free from competition by other Carrier dealers in that territory. Actually two or more franchisees may be in the same market, but whatever number is agreed upon becomes a restriction on the franchiser. The franchisee in turn agrees not to sell equipment directly competitive with Carrier. No fees are paid, but the essence of a franchise is present, a contractual right to buy and sell a branded product. Conversion franchises supposedly benefit from the successful business experience of franchisees, who converted from related businesses.

Exercise 10.A

1. Call a conversion franchise and ask what feature of their franchise is most pleasing.

2. What would they most like to change?

Franchises are grouped by the Federal Trade Commission (FTC) into product and package types and business opportunity venture types. These two types are regulated by the FTC. Product franchising is the distribution of goods or services with a franchiser's trademark, accompanied by assistance and control by it, and a fee received from a franchisee. Brushes, cosmetics, and *Encyclopaedia Britannica* are sold this way. Package franchising has the same contractual characteristics but refers to a bundle (package) of goods and services such as fast-food stores, tax services, and other places of business.

Business opportunity ventures, as defined by the FTC, sell goods or services supplied by the franchiser or a party contracted by the franchiser at outlets or locations (stores, point of sale racks, vending stations) secured by the franchiser and with compensation to the franchiser. Certain distributors, rack jobbers, and vending machine route operators are typical franchisees of this type. The FTC regulates product and package franchises and those of the business opportunity venture type. Franchises are continually being investigated by the FTC and are subject to extensive rules (McManis 1988). Disclosure requirements are the main regulation. No endorsement is present nor even a stamp of inspection or approval by the FTC.

Franchises are also classified by the type of company sponsoring them, called the *franchiser*. The earliest franchises were sponsored by manufacturers

and wholesalers. Later ones were initiated by franchising companies, who may neither manufacture nor wholesale anything. All three types offer numerous new business opportunities.

Manufacturers sponsor dealers in their automobiles, petroleum products (service stations and bulk plants), tires, farm and other heavy equipment, appliances, paint, furniture, shoes, and other products. The franchisee-dealers often agree to carry specified levels of inventory, price at manufacturer suggested prices, meet sales quotas, and not sell competing brands. In return, they obtain exclusive territorial rights, often some forms of management assistance, and credit. They pay no initial fee or percent-of-sales fee. Often originating in the 1920s or 1930s, they are not thought of as franchises but dealerships, though they possess the features making them franchises and afford opportunities to start or acquire a business.

Wholesalers may also distribute through franchisees. IGA is a wholesaler-sponsored franchise chain of retailer-owned grocery stores. Ace Hardware is a franchise chain. Western Auto belongs in this category. Western Auto stores are owned by local managers who get much help from the wholesaler-franchiser, Western Auto Supply Company.

Entrepreneur magazine is the source of our last classification of franchises. The system of grouping franchises in *Entrepreneur* follows the nature of the product or service, much as does Standard Industrial Classification (SIC), widely used by business people. *Entrepreneur's* categories give us a good feel for the range of franchises doing business:

amusements and recreation
automotive
beauty and health
building products and services
clothing and accessories
computers
educational and training programs
fast food
food, retail
home furnishings
hotels and motels
income tax preparation
insurance services
maintenance products and services
photographic products and services
real estate

restaurants
security products and services
travel agencies
miscellaneous retailers
miscellaneous

This product or service grouping is further subdivided by narrower product categories. The importance of the right product or service to successful franchising is commonly accepted. A quote from a professor, researcher, and authority on marketing success in franchising is appropriate:

> What you really need is somebody who is fanatical about a product or service, not somebody who is fanatical about franchising.
> — *Roger Blackwell*

Exercise 10.B

Locate "The Franchise 100" in the latest year's December issue of *Venture*.

1. What type of business dominates these fastest growing franchises?

2. Choose any two franchises in the same line of business and compare them. What might account for differences in growth of new units?

3. What might account for differences in fees?

4. Why do you suspect the royalties differ?

Franchising requires effectiveness at selling a product or service. The earlier product-service groupings suggest that if you are interested in franchising, you should pay attention to the product or service and choose one you enjoy and have a talent for selling — not just "go into franchising."

Should Entrepreneurial People Become Franchisees?

What characteristics of individuals (see Chapters 2 and 3) fit best with franchising? Exact answers do not exist, but insights have been gained.

A recent article on franchising in a popular magazine, entitled "No Entrepreneurs Need Apply" (O'Donnell 1984), suggested franchisees are not entrepreneurs. The franchiser's power over the franchisee and the dependence of the franchisee for key ideas and for the initiative to develop a market for the product or service are reasons we might not place these business people high on the entrepreneurial scale. As contract provisions will show later in this chapter, a franchisee often marches in lock-step with others to the franchiser's tune.

Further insight into the franchisee as entrepreneur comes from the supposed lower failure rate of franchisees compared to independents. The Commerce Department recently estimated 5 percent versus 80 percent failure rates. Although these statistics are incomplete and unclear, clearly franchisees are not as likely to fail as are new independent businesses. A main cause of failure of all kinds of newer businesses is lack of enough capital to operate on until profits

are achieved. One study of franchisees compared to independent businesses found the former invested $110,000 on average, whereas the latter invested only $57,000 (Knight 1984). This finding suggests franchisees are able or willing to invest more, and we know that one benefit of the larger investment is more security.

We refer to our thesis in discussing types of franchises — namely, not all are alike. Some franchisees are quite entrepreneurial and others less so. A franchisee who searches out a ground-floor opportunity and bets the house on it is different from the one who searches for an established operation and invests a portion of his or her wealth in it. The first situation is much like the business start-up, whereas the second situation is much like managing a sure operation while following instructions, even though you may have money invested. Franchising is discussed in this book because it is a very popular way of starting and expanding a business.

What do franchisees have in common, and what are ideal franchisee characteristics? They want to be "in business," not an employee. They (80 to 90 percent of them) have no previous management experience in the business of their franchise. Perhaps three-fourths have no management experience prior to their first franchise. (We stick by our recommendation, in Chapter 3 and implied in Blackwell's quote — that is, to gain work experience in the business of your intended franchise.) New franchisees are much like those who first acquire businesses, they have some funds but little managerial know-how. Both groups pay for management know-how and some proven ideas or products.

In the view of franchisers, the ideal franchisee has robust health, will work cheerfully in the business for long hours, and is cooperative. He or she has capital to start the franchise (at least one franchise) with enough left over for emergencies. There would be no smears on his or her reputation nor misconduct that would reflect negatively on the franchiser. This profile is not particularly entrepreneurial. Rather, it sounds like someone you would like to invest in your business and then work in it, which is what a franchisee usually does.

Why do people become franchisers, and what are the benefits to the franchisee? What have many of these contracts contributed to businesses, many of which have grown dramatically and continue to grow?

From the Franchiser's Perspective

Think about Ray Kroc, entrepreneur and franchiser extraordinary. He was an unusual man — unusual in his need for achievement and in his relentless thirty-year drive for it. He liked the food business and believed in the future growth of fast hamburgers. On the latter point he was lucky — the so-called lighter foods, vegetables, grains, chicken, and fish are growing in popularity now and beef is not so highly favored as when he started. Kroc pursued his

business ideas intensely. Day and night, weekday and weekend, he thought and talked them. He invested everything he had or could get to make his ventures succeed.

Once a business started, he invested himself in it, from selling the product to sweeping the place clean. He worked out all the little product and service flaws and glitches, so efficiency surpassed all competitors. He found recipes people came back for, and he learned to maintain tight quality control. In sum, he developed a faster service of good food and for a lower price, a rare and valuable package. So where does franchising come in?

Why did Kroc, and the other lesser franchisers, not obtain venture capital for the great "package," open several company stores, and later "go public" to get funds to open still more stores? It is said that franchising is a way of financing, so why are franchise fees and royalties used to finance expansion instead of venture capital and the conventional markets for new debt and equity? Before answering this, also think of franchising as a way of staffing and compensating.

Could Ray Kroc have trained restaurant managers to produce and sell meals as effectively, if they had been salaried employees? Could he have planted them in communities, where they would stay and become involved in civic and charitable activities, as effectively if they were on fixed salaries? Perhaps the staffing benefit of franchising, to the franchiser, is of more value than the financing.

Now let us think of successful franchising as a combination of financing and staffing a better business idea. The franchiser can get funds through front-end fees and royalties on sales while reducing the need for investment by having the franchisee finance the land, building, inventory, and working capital for sales outlets. The franchiser, unlike the securities salesperson is selling something very tangible. When you invest as a franchisee you get not only pieces of paper evidencing contracts and ownership but your own land, building, business, and the chance to become rich. This is heady stuff for many individuals who have felt tied to faceless salaried jobs in who-knows-whose company.

Note again that the franchiser's staffing needs are addressed in the process. While recruiting and qualifying investors (weeding out the unqualified), the franchiser is also recruiting and screening key "employees." Of course, franchisees are not employees, but they are substitutes and are better than employees in certain respects. Not better people but often more intent on operating successful businesses. This desire to operate a profitable business is linked to the franchisee's considerable investment, often over $100,000 including borrowed funds, plus the fact that profits are his or hers to keep. Franchising can be an attractive financing arrangement and an attractive solution to staffing and compensation requirements.

Almost nothing has been written on the staffing and incentive compensation aspects of franchising, but we feel this is as important as the financing aspect. Linking pay to performance is a powerful influence on work behavior.

Top managers are paid partially in this way. Others in the work force of a few progressive companies share company gains and losses; but, in the vast majority of employee-employer relationships, the link between pay and performance is not strong, is arbitrarily changed from time to time, and is frequently confused. The franchisee, on the other hand, is paid directly by the revenue source, the customer. Anything the franchisee does to affect revenues or costs will appear in the next paycheck. The franchisee has confidence in that. No one stands between the revenue and the franchisee's pay, to determine how much will come to him or her. This is a kind of entrepreneurial independence. Does it work? Our observations are that the average franchisee works longer hours, makes better decisions, and runs a more effective business than a counterpart employed for a salary.

To successfully sell a business idea to franchisees, benefits provided must be convincing. These benefits are the first business ingredient to sell. Many benefits are provided initially with the agreement, and still others are provided as ongoing services. The most common ones, based on Knight's 1984 research, follow.

Typical Initial Franchiser Services and Potential Benefits

1. *Recognized trademark.* Gives the seller and product-service credibility and gives the consumer confidence.
2. *Operating manual.* Tells the often inexperienced franchisee how to set up and conduct each activity needed.
3. *Management training program.* Substitutes for lack of experience, gives new franchisee hands-on practice, skill, and confidence.
4. *Store design.* Is tested for structural qualities and consumer appeal.
5. *Site selection.* In retailing three main keys to success are location, location, and location.
6. *Lease negotiation.* Favorable rate and terms can mean the difference between profit and loss.
7. *Market survey.* Reduces the risk of low sales and loss of investment.
8. *Equipment package.* Is tested to assure efficient operation and quality control, may be available at a reduced cost because of franchiser's volume buying.*

Whereas these are potential benefits a franchiser provides a franchisee initially, other benefits should be continually available.

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* Russell M. Knight, "The Independence of the Franchisee Entrepreneur," Journal of Small Business Management, April 1984, pp. 53–61. Used with permission.

Ongoing Franchiser Services and Potential Benefits

1. *Availability for advice.* An experienced specialized consultant at little or no cost, may help solve sales and operating problems.
2. *Advertising and promotion.* Quality better than independent business can create, national media may add credibility, nationwide locations give a traveler confidence.
3. *Information bulletins.* Franchise can inventory high-selling items, improve techniques as learned in test markets and specialized laboratories.
4. *Regular operating assistance.* On-site management help to solve problems or implement innovations.
5. *Centralized purchasing.* Volume discounts may be passed on, quality control starts at purchasing.
6. *Market research.* May identify profitable product line additions or price changes.
7. *Refresher courses.* May train franchisee employee to operate and sell in owner's absence.
8. *Inventory control.* Offered to probably less than one-half of franchisees.
9. *Bookkeeping.* (Not just training) is offered to some franchisees.*

These lists of franchiser services and their potential benefits to the operation are not provided in all businesses. They are listed in order of their likelihood of being provided according to a study in Canada by Knight (1984). There is no reason to think these practices would differ significantly in the United States.

So, who should become a (package) franchiser?

One who has a unique and very successful business that can be replicated by others.

One who also wants desperately to expand that business fast but lacks the funds and staff.

One who has the organizational talents to plan, follow through, and control operations of a large number of franchises.

One who can sell potential franchisees on these ideas.

At this point, we return to our discussion of franchise relations, but first a story.

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* Russell M. Knight, "The Independence of the Franchisee Entrepreneur," Journal of Small Business Management, April 1984, pp. 53–61. Used with permission.

The Midas Touch

Midas Muffler is one of the most successful franchise operations in the United States. Their relations with franchisees are typical in some respects but atypical in others. The franchiser typically advertises nationally (or whatever the market potential is) and charges 3 to 5 percent of franchise sales to cover this cost. Local advertising is usually the responsibility of the franchisee, although the franchiser may help with print and broadcast ad materials. Likewise national promotions probably will be performed by the franchiser and local ones by the franchisee. Midas gets a 10 percent royalty, but we are told 5 percent goes to national advertising and 2½ percent to local advertising, and these ads are handled by the franchiser. Phil Whitney is perhaps a "typical" franchisee.

Phil Whitney had an undistinguished college career for two years after which he went to work for his uncle in a car dealership. There his "education" took a turn toward seriousness; and after not too long as a garage employee, he decided to complete his degree from Western Kentucky University. On finishing the degree, he had no great opportunities but soon became manager of an automotive department in a Woolco store.

During his year there, Phil and his wife began to feel that a business of their own would be attractive. Because of his experiences in the garage and managing a leased automotive department of Woolco, he wanted to be in a car business. He looked at a transmission franchise opportunity and was not attracted. Then he approached Midas and soon was managing a "store" for them. It was a company-owned store that had not been run well. He was not given much help managing it. It was sink or swim and he learned to swim — to order, price, sell, install, and do the paperwork — mostly on his own. After a year, he decided to open his own Midas store.

Luckily, he was able to come up with $40,000 of family money. A bank then loaned the other $50,000 needed for his building lot, building, inventory, franchise fee, and working capital.

The first year was difficult. Other automotive people in town were amazed. "You really pay Midas all that money do you? Isn't this really their store? Did you really invest your own money in this operation? We're going to sell mufflers, too, so you will never do enough business to pay Midas and get a return on your investment."

But most of the money that franchises send to Midas is invested by them in advertising, training, and other support services. The franchiser advertising plus a well-run store began to increase Phil's volume. Time became his ally as he learned more each month about building volume and operating efficiently. Today, eight years after

opening his first business, he still has only the one but is pleased with it. He employs six people and works fifty-five hours a week himself and makes a good living.

Mufflers have faced a no-growth market and stronger competitors for a few years now, but Midas saw this coming long ago and over the years developed business in shocks, brakes, and front-end work. Phil has confidence in the Midas people. He compares the adding of lines by Midas to McDonald's addition of menu items and breakfast, as their hamburger market saturated with sellers.

Phil's automotive experience and interest were keys, he feels, to his success in his franchise. (Research shows, however, that most franchisees do not have experience in related business.) Midas never inflated claims nor withheld negative information from him. He says they gave him the right help with a good product and service. Would he become a franchisee again, or would he go independent if starting today? He says he would franchise. Would it be with Midas? "Yes. I can work with them. We have disagreements occasionally but we are positive toward each other." Phil has studied the option of a Nashville location for his second store. It would cost almost three times that of his present store and probably would not return the profit margins, but it would be a profitable store, Phil and Midas believe.*

Typical Franchise Provisions and Comments

Because the contract is the heart of a franchise — a franchise is a contract — we now look at typical contract provisions beyond each party's contributions outlined earlier.

1. The franchisee may be guaranteed a territorial exclusivity. This exclusivity restricts the franchiser from competitive selling in the specified territory and from granting another franchisee rights to sell in the territory. The franchisee may have the right to build a second outlet in the territory and, if she does not, exclusivity may be lost.
2. The franchisee agrees to diligently operate the franchise (cannot just speculate in franchises, holding for resale).
3. The franchisee may be required to sell specified items, including some not desired, and prohibited from selling all others or conducting any other business (insurance, for example) out of the franchise place of business. The requirement to sell items not desired is causing litigation. An up-to-date attorney should be consulted if such a requirement appears in a franchise you become interested in.

* Used with permission of Phil Whitney.

4. The franchisee may be prohibited from engaging in any other business, anywhere.
5. The length of agreement and termination terms will be specified. This clause is deceptively important. The franchisee may benefit from growth in the value of the investment only to lose it to the franchiser. Again, an attorney should ensure that the language of the contract will protect the franchisee's interests. You do not want the franchiser to be able to buy your $100,000 investment for $50,000 at the end of the agreement.
6. The franchisee is required to follow, without deviation, building plans and operating procedures. (These restrictions have been used by unscrupulous franchisers as justification to terminate the operation and bring it into franchiser-owned status. Yet, protection of the uniformity of work processes and of the franchiser's appearance in the market can be very important.)
7. The franchisee keeps the premises in the best state of repair and cleanliness. This may entail more expenditure than the franchisee would otherwise make.
8. The franchisee may have to buy some or all items from the franchiser. This may be the best source, but it may be a costly, burdensome requirement. Litigation has arisen over this matter.
9. The franchiser services, such as enumerated earlier, may be promised but not delivered as promised. This is an area causing contention between the parties.
10. The franchisee's payments may not be clear and new ones may be added during the term of agreement.
11. Limitations on transferability of the franchise may be total. It may become a "nonnegotiable security."
12. Improvements in the local operation by the franchisee may become the property of the franchiser.

Franchise agreements should be previewed closely by an experienced attorney because they are lengthy, complex agreements. The franchiser and the firm's lawyer generally have much more experience with such contracts than the franchisee and the franchisee's lawyer. Further, as the courts have noted in A.S. Rumpel v. Hyster Co., 1957, the franchiser-franchisee relationship is usually very unbalanced. Considerable money and possibly a lifetime of work are at stake.

Is the agreement negotiable or is this a take-it-or-leave-it offer? Certain items clearly are negotiable, such as the period of the agreement, territory covered, and which items may be purchased on the outside. The franchisee may be told that all items are nonnegotiable. Actually, this depends on how strongly the franchiser wants the franchisee. Generally, more established, large, success-

ful franchisers need a particular additional franchisee less than the new franchiser trying to "go national" and establish a trademark in the consumer's mind. The latter is more likely to negotiate on a range of contract clauses.

After studying the contract with your lawyer but before sitting down with your potential partner-franchiser, you might wish to list the matters most important to you. Note the provisions you want and how they differ from the contract provisions. Also note provisions less important to you that you would be willing to concede in some way. Negotiation is more likely if the other party gets something of value when asked to give up something of value. For example, you might get a reduced fee for year one in exchange for an increased fee in year two. This could help you past the most difficult time of any new business: the first year. If fees are required by law to be the same for all like franchisees or if the contract says they must be the same for all franchisees, then other items might accomplish the same ends. Would a free experienced employee for the opening month be very valuable to you? You might negotiate this in return for the promise to send one of your experienced employees to another new franchisee later. An example of negotiation is a bulk oil and gasoline franchisee acquaintance who negotiated a purchase price whereby the entire property would become his if he operated successfully for a stated number of years. He is now experienced, independent, and wealthy.

Summary

A franchise is an agreement between a franchiser, who owns a product or service name, and a franchisee, who pays for the right to use that name. The agreement may include the period of time, territory, assistance to the franchisee, fee and percent of sales payments, and many other items. Package franchising is a means for a franchiser to expand rapidly and for a franchisee to start a business with fewer uncertainties than if independent. Financing and staffing benefits accrue to franchisers. Care and diligence should be exercised by each party to select a fitting partner. Conflict between the parties is not uncommon. Information is available from the government and franchise associations in addition to franchisers and franchisees.

References and Notes

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McManis, C.R. 1988. Unfair trade practices in a nutshell. The Nutshell Series. St. Paul, Minn.: West.

O'Donnell, T. 1984. No entrepreneurs need apply. *Forbes* (December 31): 124, 128, 130.

Sources of Franchise Information:

Better Business Bureaus can warn of "fly-by-nighters" in any type business. Material is also available from the Council of Better Business Bureaus, Inc., Arlington, Virginia.

Chambers of Commerce have information on local businesses and where to get further local and state information.

Dunn, D. H., (ed.). 1985. The nuts and bolts of investing in a franchise. *Business Week* (January 28): 105–106. This article appeared under the regular column "Personal Business," which contains advice on investing and personal finances.

Entrepreneur magazine, by Entrepreneur Inc., 2311 Pontius Avenue, Los Angeles, Calif. 90064. The annual franchise issue has information on over 1,000 franchisers and an indexed rating of 500.

Inc., *Venture,* and *Franchise* magazines all devote space to franchises.

International Franchise Association, Washington, D.C., represents approximately 480 franchisers. It lists member franchisers and can supply some information about them.

Justis, R. and R. Judd. 1989. *Franchising.* Cincinnati, OH: South-Western. This book is a comprehensive treatment of the subject, with cases. Justis is director of the International Franchise Center at Louisana State University, Baton Rouge.

Magazines and newsletters in the industry of interest, such as *Restaurant Business* or *The National Petroleum News* provide information.

North American Securities Administrators Association can provide information on protecting your investment in a franchise.

State Departments of Commerce give information about franchise and other kinds of business opportunities in that state.

The *Wall Street Journal* has an informative weekly column on small business. Occasionally franchising is reported, as on October 22, 1984, when Teri Agins, a staff reporter, wrote "Owning franchises has pluses, but wealth isn't guaranteed" (October 22, 1984): 29.

CHAPTER 11

Start-up and Growth through Licensing

Agree like finger and thumb.
— Anonymous

In 1876 William Orton, president of Western Union Telegraph Co., made perhaps the worst decision in American business history. He rejected an opportunity to purchase for $100,000 all patent rights to the telephone from Alexander Graham Bell and his associates. Telephone technology became one of the most valuable properties in the world. Although understanding of intellectual property has increased in the last century its greatest uses may lie ahead. Licensing appears to have far greater potential for entrepeneurs than is being realized.

This chapter first describes intellectual properties, those often available for purchase or licensing, then licensing agreements. The steps in the process of protecting and transferring intangible properties are discussed, followed by comments on inward licensing as an entrepreneurial strategy.

Thanks are expressed to Brian L. Smith, an attorney practicing intellectual property law in Nashville, Tennessee, who helped write this chapter.

Intellectual Properties and Their Licensing

To understand licensing, we must first understand what may be licensed. Tangible property concepts are readily understood and recognized; that is, physical objects of ownership and the ownership rights protecting the owner's use of a car, boat, or house. Intangible property concepts allow for the licensing of rights, though these are similar to rental rights of tangible property. One basic concept of property is the owner's right to exclude others from its use. We now examine this and other rights of patent holders.

The basis for U.S. patent law is found in the Constitution, which gives Congress the power to "promote the Progress of Science and the Useful Arts by securing for limited times to Authors and Inventors the Exclusive Right to their respective Writing and Discoveries" (Article I, sec. 8). This is now a seventeen-year exclusive right giving scientific research a considerable profit opportunity. It also encourages the introduction and promotion of many inventions to the marketplace because the capital launching them is protected. Patents are awarded in the following classes: manufacture (article or product), process, machine, composition or matter (drugs, alloys, etc.), and certain types of plants (Russell 1950). A "way of doing business" (not a process) is not patentable. The drive-in theater patent has been held invalid for this reason.

Most simply, a patent license agreement specifies the use of a particular patent, owned by a licenser and to be used by a licensee or licensees. At the other extreme, a license agreement may include transfer of many patents plus licenser training of many licensee personnel and other investment in establishing licensed operations. Most naked patents would have little commercial value. Only through product and market development is value attained. This development can be performed by either the licenser or licensee. In chemical and pharmaceutical industries, where licensees are often large corporations already skilled in production and marketing, the licensees may develop the product.

Often companies in developed economies reach license agreements with licensees in other countries whereby the licenser supplies product and marketing know-how. For example, Lord Corporation, of Erie, Pennsylvania, licenses rights to formulas; specifications for components, equipment, and products; manufacturing processes, quality control procedures, and other technical information to companies for production and distribution of adhesives in India, Pakistan, Sri Lanka, Nepal, and Bangladesh. The trademark CHEMLOK is licensed along with this know-how.

If information is not patented or not patentable, it may still be a trade secret. Information is likely to have legal status as a trade secret if it is known only within the firm and not within competing firms, the firm pursues means to protect the information from disclosure, and the information is valuable to the firm and its competitors (Stern and Eovaldi 1984). Courts have ruled as trade secrets certain blueprints and specifications, cabinet designs, customer lists,

and other information. Agreements between a firm and its employees to prevent the information from reaching competitors are enforceable. A firm may realize value from a trade secret either by using it to develop and sell a product or service or by selling the information.

The law regarding licensing of trade secrets is not always clear. Patent policy says that, if an idea is in the public domain and is not patentable, copying is permitted. However, the Supreme Court indicated (Aronson *v.* Quick Point Pencil Co. 1979) that licensing and royalty agreements based on trade secrets may be enforceable even after the ideas come into the public domain.

Trademarks indicate the source of products, and their value derives from buyers' belief that the product is of a certain quality. Protection against infringement of a trademark may be easier than protecting a patent. Trademark licensing may be a compliment to patent licensing or may stand alone. Trademarks have an indefinite life and, if the mark is respected, a high potential value. Part of realizing that potential value lies in ensuring that the products bearing the trademark are of consistent quality. Trademarks were a central part of our franchise discussion in Chapter 10.

Copyright rights may provide one of the most solid legal foundations for licensing intellectual properties. By statute, these rights exist when an original work of authorship is "fixed in any tangible medium of expression." Simply put, when the artist's pen leaves the page, the typewriter key leaves a tangible mark on paper, or a songwriter's song is recorded — presuming the work is original — the author's copyright exists.

The five exclusive copyright rights that reside in the author of such an original work are (with some exceptions): (1) the exclusive right to copy or reproduce, (2) the exclusive right to distribute, (3) the exclusive right to display publicly, (4) the exclusive right to perform publicly, and (5) the exclusive right to prepare derivative works from original works.

Copyrights may be the single most important intellectual property to enjoy rights of protection and licensing, covering as it does such works as books, choreographed dances, computer software, fabric and wallpaper patterns, fine art prints, photographs, and video reproductions.

Right of publicity gives a celebrity rights to profit from the commercial exploitation of his or her name, likeness, or image. "Characters" are licensed when a licensee purchases the rights to reproduce a character, make a product in its shape, or use its name to exploit buyer awareness. This awareness has presumably been built up over a period of media exposure. Mickey Mouse is the classic character. The classic celebrity is Elvis Presley, whose estate realizes millions of dollars a year by licensing out the right to use the "King" 's name, likeness, or image to sell a wide array of merchandise.

> Whereas Spring Air Mattress Company licenses *in* the right to use Vanna White's name to promote its Spring Air bedding products, it licenses *out* to Jamison Bedding, Inc., and others the rights to manufacture and distribute these products.

Licensed merchandise was said to be a $27 billion market in 1983 (ITT tries to bring back Raggedy Ann, 1984). This is called the *hottest growth industry* of the 1980s, and the Licensing Industry Merchandisers Association estimated retail sales of officially licensed products at $34 billion, $40 billion, and $54 billion in 1984, 1985, and 1986 (Grimes and Battersby 1985).

Exercise 11.A

Consult a business law text or a lawyer then describe how protecting intellectual property differs from protecting tangible personal property or real property.

License Agreement Topics

Main license agreement issues are parties, agreement as to product or process, market exclusivity, obligations, lump sum and royalty compensation, and reversion of rights to subsequent discoveries or inventions. *Parties* refers to the licenser and licensee, and the agreement first identifies their operations and locations. Products, processes, or technologies transferred are then identified. Exclusive rights in a market (territory) may be negotiated. Before doing so, the licenser would want up-front compensation, minimum royalties, or other assurance that the licensee would pursue production and sales toward profitability by the licenser. A long term (e.g., ten years) may place unacceptable restraints on the licenser, and a short term may not allow the licensee to recover front-end costs of production and marketing.

The agreement obligates the licenser to take necessary steps to transfer (perhaps including training time by licenser personnel and so forth) the technology to licensee and also protect it from use by others. The licensee is usually obligated to vigorously pursue income accruing to both parties.

Compensation may be any combination of fixed fees (payable initially or later) and royalties, with or without minimums. The agreement specifies when, where, and how the compensation is to be paid and audited. Finally, provisions may be made for ownership of product improvements, contract default, and for resolution of disputes not settled by the parties. Settlement may be by an arbitrator or laws of a certain state or nation.

Steps in Protecting and Transferring Rights

The first steps in *protecting* an invention involve determining that it is within a class afforded statutory protection, then commissioning a competent patent attorney to conduct a preliminary search in the U.S. Patent and Trademark Office records to see if the invention appears distinct from prior patents. If the preliminary search yields desired results, a patent application may be filed. Valid patents must still be defended in court if infringement is suspected.

There is a legal requirement that a copyright registration be filed before an infringement suit can be brought. If the registration is filed before an infringement occurs or within three months of first publication, then the patent or copyright holder is entitled to an election of remedies and may recover attorneys' fees plus court costs — important in determining whether an infringement suit is advisable. Copyright registrations are relatively simple, and there is a public policy of making the process simple and the forms readily available so that the many authors and other creators of copyrighted properties can properly protect themselves. Aside from registering these rights, authors should place the copyright notice on every copy of the work beginning with the first draft or rough sketch of the work.

Trademark rights do not depend upon registration in Washington, D.C., or any state. Proper adoption of the mark and actual use in commerce create common law rights in the mark. Although registration is advised for substantive and procedural benefits, the most important step in protecting trademarks may be selection and first use of the trademark. Choosing and using a new mark has definitive legal considerations, aside from advertising and marketing considerations. The process is for marks to first be used in commerce, then state and federal registrations to be filed.

"Rights of publicity" properties reside in the individual, and, under the general common law theories, virtually nothing must be done to protect these rights. The courts are in conflict over whether the right of publicity will survive death and inure to the benefit of the heirs of the person if the right is not commercially exploited during the life of or shortly after the celebrity's death. A celebrity's name, stage name, and other "trademarks" can be registered as servicemarks in certain states and the U.S. Patent and Trademark Office. This step is needed to protect and license what may be developed into property valuable to the original owner, as well as to an entrepreneur whose products it helps sell.

These procedures to protecting exclusive rights to certain properties can be lengthy, costly, and uncertain. For these reasons, secret products and processes not easily copied may not be patented at all — the inventor having more faith in secrecy than in legal protection (Helms 1986).

Whereas protecting by use or registration is usually the first major process in *transferring* intangible property rights, the second major step is securing

information on possible partners. The initiative leading to a license agreement may be taken by the future licenser or licensee but more often is by the licensee. Therefore, we briefly describe where information can be obtained by the entrepreneurial company wishing to produce and sell products or services patented or registered under another's valuable name.

From this point forward, we will often divide intellectual property into two classes: patents, copyrights, and trade secrets (know-how), and trademarks and rights of publicity (know-who). This distinction was not useful in the legal protection discussion but will be in the commercial arena of transferring rights.

Directly approaching a company producing and selling only in another country is one option for a small licensee. Also, likely large companies' research and development personnel are canvassed for unexploited products or technologies. Small companies may become licensees of large companies' R&D spin-offs if these inventions are not of interest to the large company. Celebrities, many with names usefully attached to merchandise, can be found in every city with a recording studio, sports franchise, television studio, winning college team, and so on.

Exercise 11.B

How is the transfer of intellectual property similar to and different from transferring tangible property?

A Strategic Role for Licensing?

Following Porter's (1980) competitive strategy model, the growing company should identify its internal strengths and weaknesses as well as its external opportunities and threats. According to Chrisman, Hofer, and Boulton, "a strategy describes the fundamental characteristics of the match that an organization achieves among its skills and resources and the opportunities and threats in its external environment that enables it to achieve its goals and objectives" (1988, p. 414). Either correcting weaknesses or competing only in ways that circumvent them might be added to the concept of strategy.

A strength of certain small companies is intimate knowledge of and relations with narrow or local markets. Good relations with distributors and the local labor supply may be important parts of this strength. The main weaknesses are likely to be financial — poor balance sheet and cash flow— and difficulties in R&D. Most smaller companies fall within the type labeled *unit/batch* by Woodward. According to her classic 1965 study, "Strategically, unit/batch production firms tended to emphasize new product development, whereas mass production firms emphasized process efficiency to reduce product costs" (Nemetz and Fry 1988, p. 628). These researchers concur that manufacturing flexibility, the ability to switch from one product to another, is one of a company's most important means for coping with environmental uncertainty. Though the company with smaller growth may include an inventive entrepreneur or team, it is unlikely to have the resources to competitively develop new products.

Little is known about the marketing, financial, or product roles of know-how licensing in these companies. Slevin and Covin found no clear agreement or disagreement in entrepreneurial firms with the statement, "We use product or process patents and/or copyrights to provide a competitive advantage" (1987, p. 96). However, more high- than low-technology firms agreed.

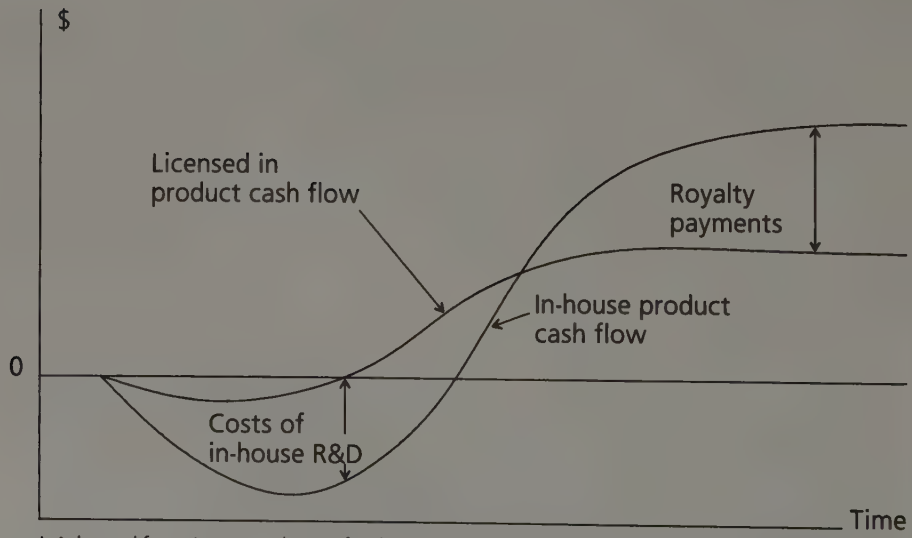
Use of copyrights, trademarks, and rights of publicity may be of more value as marketing tools than use of patents for product innovation, as indicated by agreement with the following statement by Slevin and Covin's questionnaire respondents: "We emphasize the building of brand image/identification" to deal with competitive uncertainty. The licensing manager of Hillerich and Bradsby, of Louisville Slugger baseball bat fame, describes the typical license inquirer as a small to medium size company with a good but unknown product wanting an entree. For example, whereas the name Johnson on a sweatshirt would not help get a foot in the door of a retail company, the name Louisville Slugger would. Many new or small companies, with weak financial and marketing capabilities, cannot afford the costs and risks to internally develop new brand names or images, but they also do not know how to use external sources.

Threats to this type company are legion, but most threatening may be rivals bringing improved or lower-priced products to customers to increase their market shares. The Slevin and Covin study just cited found clear agreement with the statement, "We emphasize new product/service development." This data, the Lowe and Crawford (1984) study, and our own observations lead us to conclude that many entrepreneurs, although recognizing the strategic benefits of new products and known names, find themselves unable to reap those benefits. Licensing in (i.e., purchasing licenses), may provide an opportunity for certain companies to exploit their market knowledge and skill, gain a market position in the face of larger rivals, and skirt their weaknesses in capitalization and R&D. Licensing in has been found to typically provide less negative cash flow and earlier positive cash flow than in-house product devel-

opment (Lowe and Crawford 1984). They also found companies licensing in to establish a market position earlier. These comments can be restated by saying that licensing in is a way to reduce uncertainty, which is a central challenge to the entrepreneurial company.

Arnet Corporation, formed in 1983 in Nashville, Tennessee, illustrates use of licensing in to reduce uncertainty. Their industry, small computers, has very short product life cycles. This means R&D needs in the areas of user demand, engineering, and the development of software and hardware are beyond Arnet's capacity. So Arnet contracts out specific projects. Intellectual property rights created by contracting parties are often purchased or licensed in by Arnet for use in new products or sublicensing to others.

If the small company can license in a proven product, rather than research and develop a new one, it shifts away considerable product risk. Licensing in increases the supply of available products and reduces the dependency on narrow in-house capability. The company can concentrate on production for its narrow or local market. By licensing in a product already having come through the stages of product and market testing, the licensee may achieve stable sales quickly. By avoiding significant R&D costs the company's cash flow should be much stronger. These factors are considered in Figure 11.1.*



* Adapted from Lowe and Crawford's *Innovation and Technology Transfer for the Growth Firm.* 1984. Used with permission from Pergamon Press.

FIGURE 11.1. Comparison of Cash Flows from In-House R&D with Licensing In

Which Partner? What Compensation?

While the know-how licensee scans information sources to arrive at a suitable product or process, licensers evaluate potential licensee companies. As a prospective licensee, one probably will be evaluated primarily on three factors: financial capability, production facilities and skills, and market access. Organization cultures should be compatible as well, because those persons involved in negotiations and implementation of the agreement must work together in a spirit of partnership, trust, and cooperation toward their mutual advantage.

The main considerations for selecting characters, trademarks, or celebrated personalities to license *in* include,

1. Recognition of the character (trademark, name) among prospective product buyers.
2. Liking of the character by these persons.
3. Carry-over of liking the character to wanting the product (this carry-over is also called *fit*).
4. Continuing promotion of the character by the licenser.
5. Distinctiveness of the character.
6. Effect on the licensee's target image.
7. Exclusivity rights.
8. Costs to license in the character.

Recognition and liking value derive from a combination of media exposure (advertising, role in newspaper cartoon strips or TV programs, and so forth) plus inherent appeal and fit, the first two of which are usually short lived.

Know-who (trademark or celebrity licensing) fit is obtained by careful initial choice. If a personality name is licensed (or endorsement secured) and that personality subsequently engages in unpopular behavior, the licensees' image is tarnished. The perspectives of several leading retailers on selling licensed products are reported by Gill (1987).

A number of factors influence the optimal split of compensation between up-front fees and royalties. These two components may be traded off to optimize the parties' risk preferences. (Risk preferences are based partially on the parties' cash resources.) No fixed fee and a high royalty percentage means little licensee risk but considerable licenser risk. High fees and low royalties shift the risk to the licensee. Tax considerations and currency exchange con-

trols often weight in favor of either fees or royalties. Fees are favored where up-front costs of developing transferring the property are substantial.

The certainty of the product or process and its market (sales) influence minimum royalties. More certain sales, of products in a later stage of market development, mean the licenser should trade minimums away for higher percentages whereas the licensee wants lower royalty (percentage) and will accept higher minimums. Minimum royalty amounts, or escape clauses in the event sales do not materialize, should probably be demanded by the licenser if exclusivity is granted.

The licenser of property wants protection against illegal use but may find monitoring markets costly or impossible. A licensee normally wants to protect the patent as well, to avoid market competition. Licensing partners may be chosen more for the expected protection than for short-run profits.

Exercise 11.C

Identify a new product with little market awareness whose acceptance suffers from lack of awareness or credibility. Then identify a well-known person, character, or trademark that might be licensed to promote sales of the product to the advantage of the licenser and licensee.

New product:

Well-known name:

Despite potentially important advantages to companies from licensing, little is known about whether small companies engage in licensing in or out.

After conducting a survey in the United Kingdom, Lowe and Crawford (1984) estimated only 5 to 9 percent of companies license either way. A U.S. study of eight new businesses found, "All the firms use external technology to innovate" (Gatewood, Hoy, and Boulton 1987, p. 555), but little is known about their specific practices or needs in this area.

Can Marketing Consulting Companies Help?

The right marketing consulting firm could be helpful in overcoming certain barriers. Marketing/Trademark Consultants, La Jolla, California, and New York City, helped Hillerich and Bradsby (Louisville Slugger) break into the business of licensing out its trademark. A consulting company would normally be able to do the following:

1. Identify prospective partners from data files by type of business;
2. Market to these parties the opportunities with a licensee;
3. Promote licensees through booths at trade shows;
4. Negotiate agreements, including provisions for monitoring the quality control of products or services sold, ongoing licenser advertising and promotion of the name, and licensee sales of the product and royalties payable.

Exercise 11.D

1. Reconsider the product and the well-known name you proposed in the previous exercise. What barriers do you imagine would be encountered by the small company with the as yet unknown product trying to team up with the known name?

2. What steps should the entrepreneur take to overcome the barriers you predict? (Turning the whole matter over to a consulting firm is not an option, unless you are wealthy.)

Summary

Protection of patents, trademarks, trade secrets, copyrights, characters, and rights of publicity are important to the owner. Using certain of these intellectual properties of others by means of licensing may be profitable. Main considerations in the license agreements are product, exclusivity, obligations, and fee and royalty compensation. Roles that licensing can play in an entrepreneurial strategy include market penetration, stabilizing cash flow, and skirting weaknesses in R&D. Care must be used in selecting intellectual property to transfer profitably, and use of an experienced attorney is recommended.

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CHAPTER 12

Acquisition Finding and Structuring

When a bank wants to extricate itself from a situation, the investor can often pick up a bargain.

— Arthur Lipper III

In Chapter 7, we described market openings or cracks between competitor offerings into which a new business might fit. In this chapter, we are still concerned about how a company fits into its markets, but now we consider acquiring an existing company rather than starting a new one.

Acquisition Decision Process

First, we should try to answer two questions:

1. Who should acquire instead of starting from scratch?
2. What circumstances favor acquisition instead of start-up?

Should you acquire a business or start from scratch? Primarily, the choice depends on whether you have a unique product or service idea and are determined to pursue it or just want to own a profitable business. Mo Siegal became fond of herbal tea before getting into his own business, Celestial Seasonings, Inc. Presumably, he wanted to own a company based on herbs. Because few companies were producing and selling herbs, the chances of acquiring one were slim indeed. Ray Kroc, on the other hand, wanted a business with a high profit potential. Probably, he would have gone into the computer business instead of hamburgers if a money-making computer opportunity had come his way. However, his experience narrowed his realistic chances of success to supplying or producing within the broad food or beverage industry. Kroc acquired his first McDonald's from two McDonald brothers rather than starting the restaurant.

Let us assume for a few minutes you do not have a narrow idea of what business you want to be in, but you feel you do want the frustrations and rewards of being in business for yourself. Will you wait enough years to get experience as described in Chapter 3? Or, will you want to move quickly? Individuals without experience in a particular type of business are advised to acquire experience by acquiring a going operation. Actually there are three broad options that logically fit on a scale and can be approached as follows:

> If I have no business experience, I should try to acquire a successful company whose personnel will remain.
>
> If I have limited business experience, then franchising might make sense for me.
>
> If I have wide, intense experience successfully starting and operating businesses, then I can start one without great risk.

You may be thinking that, "acquisition requires big money, especially to get a successful company, and as I will never have big bucks before business ownership, I can never hope to acquire one." Actually, acquiring a business may require less personal capital than starting a new one. This point has to wait for discussion until later in this chapter and in the chapter on financing.

> While reading the preceding paragraphs, we hope you began to think that acquiring versus start-up depends mostly upon the following:

1. Your willingness to own any business versus an insistence on a particular kind of business
2. Your need for others' experience or only your own

Our second question was, What circumstances favor acquisition instead of start-up? We now examine circumstances other than your experience, financial condition, and preference for a particular kind of business. First, you may not have narrow preferences about the kind of business to be in, but you may have a narrow geographic preference. Few if any attractive businesses may be available in the city or town of your choice. When a business is available for sale and no other businesses are available, this fact probably will raise the price. Conversely, the fact that others are not bought and sold often means that the present owner may not know what the business is worth. This could be in or not in your favor. The point is that the market for businesses is worth learning about if you have an interest in starting by acquisition.

An owner who has no other acquisition transactions to observe and evaluate, may price the business based on what it means to him or her, which may be a fortune. But if you are a good salesperson or if the current owner especially likes you, then you may get a very favorable "price." (Actually the words *buy* and *price* are too simplistic to convey the complexities of most acquisitions, but we will use these terms because they are common.) Where the market for businesses is inactive and the market price is not well known, there is a greater chance that a given price will be too high or too low. In other words, there is risk here beyond the many other risks of getting into business.

Another circumstance affecting the acquire or start-up choice is a particular business that may be available to you. As part of your thorough entrepreneur preparation, you may have worked in a small business that is soon to become available. Often key employees get first chance to acquire a business the owner is relinquishing. Another circumstance, very common in earlier times and still happening here and there, is the passing of a business from one generation to the next. Farms, retail businesses, small factories, and others continue beyond the career of the owner in this way. (Primogeniture is the practice whereby the oldest son inherits the family farm or business. Many businesses in traditional cultures were acquired in this manner. Additionally this practice started many other sons in search of new businesses! In Colonial America, Virginia exported native second and third sons whose entrepreneurship helped start businesses and states to the west.)

Finding Acquisition Candidates

As with so many questions about business, "How do I obtain leads toward acquisitions available?" has no single, simple answer. Suppose you have been in business as a manager in New York City, working with executives, investment bankers, and venture capitalists. A broad path to finding leads can be suggested. On the other hand, if you are the country cousin, 20 years old, and your parents are workers in a small company in a small town, then your task is far

different. Actually, if you are in a position similar to the latter one, you probably need to prepare extensively (see Chapter 3) and gain at least a few contacts like those of the first person.

Developing communication with the business world usually comes before finding acquisitions. Every animal, including humans, has a number of ways of communicating with the environment. Some are called the senses, some feelers, some communication channels, some contacts. We cannot hope to cover all the ways persons have learned about acquisition opportunities. We will describe major ways that seem to be helpful to the most persons, starting with contacts.

Over a period of years, starting in college or even high school, become acquainted with businesspersons. By the time you are ready for your own business, if there comes such a time, you may know two or three bankers, a stockbroker, an attorney who does some business practice (incorporation, tax planning, contracts, bankruptcies, and so on), realtors who deal in commercial and industrial properties, owners of small businesses, and similar others. You may have begun reading the "business opportunities" section of newspaper classifieds. Perhaps you have even attended a number of liquidation of business auctions.

So, if the time comes to consider acquisition opportunities, let the word out. Carefully, in a nonurgent manner, let all your contacts know you are interested in getting into business for yourself. Many persons fantasize about going into business and are not taken seriously. Assuming you have been serious in your work and in business dealings, persons will take seriously your interest in acquiring a business. Some will go out of their way to help you.

Business communities, persons you communicate with, are in some sense fraternities or clubs. Not everyone is welcome. Many are. Newcomers are expected to "pay their dues," by working hard and suffering a little at first. Established members help certain prospects in and help them once they are in. The popular term now for breaking into business circles and using them for information and assistance is "networking." We suggest you build a network of communication channels, contacts, and mutual support. Putting the word out is part of networking. It is not just a one-shot effort, but rather is to be reinforced and followed up periodically. We can identify most likely helpful acquisition finders together with comments on each, in a short list:

> Bankers, especially those working with small businesses or in commercial lending, have direct contact with acquisition candidates and good networks; but they may want you to buy a failing business to whom they have loaned heavily.
>
> Stock brokers and venture capitalists may know of companies wanting to "go public," but that are not ready; they may have clients who want to sell out and invest in stocks and bonds; and they have good networks.

Attorneys, especially ones serving small business clients, are likely to know early if clients will sell out, may know early of bankruptcy situations where businesses are available at low cost, but may owe their first allegiance to the existing (seller) clients.

Realtors who specialize in commercial property (if you are interested in a retail, wholesale, or service business) or in industrial property (manufacturing or mining) constantly seek to list businesses for sale. In larger market areas they specialize even more, and they do charge a substantial commission that is partially passed to the buyer in a higher selling price; but "your" realtor may owe first allegiance to the seller.

Owners of small businesses, especially those nearing retirement age or in some other personal circumstance conducive to exiting the business, will listen to offers even if their business is not on the market. They charge no commission. You know what the person you are talking with wants.

An interesting source of acquisition candidates is ads in your local paper, the next larger metropolitan newspaper in your area, and even the *Wall Street Journal.* An ad in the *Indiana Business Journal* (1985) was unusual in that an owner offered several businesses for sale (ad by Salesway, P.O. Box 663, Indpls. IN, 46206). Reading ads of businesses for sale is definitely a shotgun approach in one sense. Businesses of all sizes, conditions, and types will be listed. Some will be priced at ten times their worth. But this source is a rifle approach in another sense. Only businesses for sale are listed. Of course, many of these are listed by realtors or brokers, but with others you can talk only to the owner. (There is great risk when buying an unknown business from an unknown person, and this will be explored further in the next section.)

Trade publications, such as by a restaurant association or thoroughbred breeding association, will often carry announcements and ads of businesses for sale. These are influenced by those inside "the club" (restaurateurs and racehorse owners) and they will often be able to sell to a person not in that business for terrific prices. You should know the business or know the person selling it.

A sure enough shotgun approach to finding an acquisition is to place a business wanted ad. Expect offers of a wide range of "opportunities"! By carefully wording the ad, you can screen the candidates. You might specify a size range, broad type of business, down payment limit, or geographic limits, or all these. As is apparent, finding and screening out uninteresting prospects are not usually separate processes. When you put out the word, the persons you talk to know whether you are interested in acquiring a General Motors or a Mom 'n Pop grocery store, so they will screen for you. When you use paid mediators, they can screen for you. You screen ads by others and you write your own ad carefully to screen readers. We might think of "finding" as

including first-level screening. Next comes efforts concentrated on screening, which we can call *second-level screening.*

Screening out the Uninteresting

We have already mentioned as screening criteria the type of business, range of price and terms, location, and condition of the business. Because we seldom get exactly what we want in life, let us think about tradeoffs briefly. Screening criteria must often be traded off against each other. First, however, you might be able to identify businesses you would not be in at all. (I would not own or operate a yearround business in North Dakota. There are North Dakotans who would not be in business where I live.) Because we are thinking of owner-operated businesses, location may eliminate many businesses early.

Of the many criteria you may set for yourself, let us focus on only one more: condition of the business. Think of a continuum illustrated by a line, with descriptors at each end.

Losing money by the bucketfuls	Very profitable, strong cash flow
Owes more than it owns	Has no debt, excellent assets
Cannot pay bills	Pays bills quickly
Has lawsuits filed or pending	Is free of any legal suits
Declining sales	Growing sales
Has poor reputation with customers and suppliers	Enjoys excellent reputation with customers and suppliers
Has a high-wage contract with a hostile work-force	Enjoys a low labor cost and is a preferred employer

Having shown some extreme conditions businesses may be in, we quickly add that few businesses are in these extreme positions. But two points are worth considering. The buyer must decide how much he or she can and is willing to pay for a business toward the right of this continuum and how he or she trades off a low current profit rate, for example, against a good reputation with customers? What if customers like the business because it is selling 20 percent below the competition but also 10 percent below its cost? Customer loyalty may be very short lived once prices are raised.

On the first point, paying to acquire a company in good condition, not only will the good company yield financial and satisfaction dividends, but its chances of surviving the next few years are great. In contrast, the weak company will surely drain its owner; the owner must have "deep pockets." Even worse, chances are considerable that this company will then fail, even with infusions of funds! Failure happens to the most capable of managers, as the

following events show, but failure is not permanent, any more than success is (Klein 1977).*

> Indeed, before his troubles with Forms Corp., Mr. Hayt was the very model of the small-town-boy-made-good. His business career began at age 16, when he went to work as a part-time apprentice printer for a publishing company in Parsons, Kans., where he grew up. By the time he was 21 he was production manager of the firm, and two years later he and two friends each put up $3,000 to strike out on their own.
>
> Their company, Va-Co-Hy Business Forms Inc. [taken from the first two letters of each partner's name], started life with a single press in a storefront office in Girard, a nearby southeast Kansas town of 2,600 people. Within a half-dozen years the company had sales of more than $3 million, occupied a shiny new plant and employed more than 200 people, making it Girard's largest employer.
>
> [Sometime later . . .] They had become the regular recipients of takeover offers from larger companies, and that year Mr. Hayt and his partners decided the time was ripe to sell. [And sell they did, whereupon Mr. Hayt became president of the company he and his partners formerly owned. But he did not like this job.]
>
> So he began looking around for a way to get back into business for himself. It turned up in 1971. Pfieffer Business Forms Inc., a six-year-old firm here in Spring Grove, was in trouble and was looking for a buyer. The company had lost $151,000 on sales of almost $1.5 million the year before, but its "growth pattern and assets looked good to me when I talked to the owners," Mr. Hayt says.
>
> He recalls, "They'd recently acquired some assets of another forms outfit, and I figured that the additional sales would put the company into the black. I met with Pfeiffer's creditors, and they said they'd go along with me if I took over, so I went ahead. The problems were there for anyone to see, but I guess I didn't want to see them. I thought I'd be a hero and turn the place around."
>
> So Mr. Hayt sold his LVO and Ennis holdings for about $400,000, less than half their worth when he got them, and put $100,000 of the proceeds into Pfeiffer, changing its name to Forms Corp. From the first, things went badly.
>
> "I found an organization that was totally sick," he says. "Morale was low from the janitor on up. Orders that looked good on paper

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were losers in practice. There was no cost-accounting system, so it was impossible to tell which parts of the business were profitable and which weren't. I was running around in circles trying to get a handle on things."

[Shortly . . .] By mid-1973, things were so bad that Mr. Hayt called in an attorney and an accountant to sort them out. "We had a meeting, and the lawyer said to me, 'Doyle, you're bankrupt.' I said, 'Who, me? No way. I'll work things out.' He explained Chapter 11 to me and recommended I try it. He said that if I didn't, my employees would lose their jobs, my creditors would get practically nothing, and I'd be out in the cold.

[A year after reorganizing itself under Chapter 11 bankruptcy, the company began earning profits. It later began paying its tax and creditor obligations.]

The extremely weak company is best left for bankruptcy courts or for a deep-pocketed, highly skilled "turnaround" manager. These companies are low cost to the acquiring turnaround artists and post interesting challenges. Some businesspersons have earned reputations for turning around sick companies.

Likewise the extremely strong company may be a poor buy. Does this statement surprise you? Acquiring a company is something like buying a car. When would you buy a Mercedes 300? Although the 300 is a great car, an economy-minded car shopper would see $40,000 as too much for even this car. Extremely good companies, like cars, excite people. Sizable companies that are extremely good, particularly those with profits growing rapidly, are called *growth companies* or *glamour companies*. A dollar of annual earnings of these companies may cost $20 in acquisition, whereas a good company can be bought for, say ten times annual earnings.

An answer you should consider to "How much should I pay for 'good condition'?" is: if you are inexperienced, then acquire only a company in reasonably good condition. If your experience is less than that of the current owner, then the company's performance may well drop before turning up. The price of even a good company may fall quickly in certain circumstances, offering an opportunity to an interested buyer. According to Simon (1985), when an owner-manager dies unexpectedly, there is often a liquidity crisis because cash is needed to settle the estate and pay taxes and anxious creditors. The business may face loss of new credit because of the uncertainty about the company's future. If family members are not qualified to take over the proprietorship, it may be liquidated or sold on short notice. Only the liquidation value would be realized in most cases. For example, Noblesville Casting, Inc., a company that may have faced liquidation, was acquired and turned around by the key employees and others.

In 1981, the foundry and castings industry was hurting from high costs and increased competition from Asian and South American companies. TRW Corporation, owner of Noblesville Castings, was losing money on it and wanted to sell. The managers and other investors bought the company, finishing the deal in October 1983. With wage concessions from the union, new equipment, new products, and new customers, the newly acquired company became profitable in about six months. They still were not paying dividends as of early 1985, but many persons were benefiting.

The second point, "How do I trade off performance in one area against another?" might be looked at in comparison to your own talent or specialized skill. If low sales seem to be the key problem and you have reason to believe you could raise sales, then this company might be the one. If you have neither experience nor great skill in sales, then be honest with yourself. Likewise, if costs are out of line and this seems to be the source of other problems, ask yourself, "How do I perform as a cost cutter?" As with all self-assessment (see Chapter 2), honesty is as difficult as it is important.

There are no quick answers to questions raised by good-poor condition companies. But better to go in with eyes open, asking the main questions, than to be shocked after purchase by surprising conditions.

Valuing Acquisition Candidates

The objective of this last stage of examination before negotiation can be summed up as how to predict the cash flow of the business. Exactly what is cash flow? For our purposes the projected cash flow from a business is:

> Sales minus direct cash costs minus administrative cash costs minus financing cash costs minus profit taxes minus loan payments equals cash flows.

Unless cash flow will pay for the company in five to ten years plus provide you with a livelihood, would you want this business? Lest we oversimplify, a company growing rapidly uses cash, and so your return must wait until the growth slows or you sell the larger company.

A few notes about projecting these items on a candidate are needed. Start with recent data from company records and tax returns. Obtain assistance from an accountant. Then, project the future compared to the past and present. If the candidate business is in good operating condition, then the accounting records probably will be current and complete. Many small companies in poor condition lack good bookkeeping. This adds to the uncertainty

facing a buyer — and to the risk. Reasonably, an owner of a strongly performing company would ensure that records were kept to show that good performance, whereas the owner of a company in poor condition and performing poorly might be tempted not to keep accurate records. Unless you have training or experience in accounting, paying for professional help to evaluate the condition and performance of the company is encouraged. (Appendix A explains financial condition and performance separately and shows how they are related.) The following questions are those one should ask to help predict changes in cash flow likely with ownership transition.

Sales

Will *sales efforts* be more effective than under previous management? How so? More products — if so, when? More salespersons — if so, when?

Will *competition* be more or less effective in the future than in the past? What evidence is available?

Will present *customers* be able to buy as much of our product?

Will there be as many of them? If our customers sell to other customers, do those downstream customers appear strong?

Direct Costs

Will *productivity* (output per labor hour) be higher, the same, or lower in the near future? What do employees expect?

What will happen to *labor costs* per hour worked? What do employees expect?

Will costs of *materials* and *parts* go up? How much? Will better *machines* or *equipment* be required? At what cost?

Administrative Costs

Project insurance costs, payroll taxes, property taxes, licenses, other taxes. What about fees to attorney, accountant, others?

Project salaries, commissions, bonuses, and other. Be honest about how much you must take out of the business.

Financing Costs

(Include *lease* and *rent* payments here because the alternative to leasing is borrow and pay interest.) What will payments be?

What will *interest* payments be, including those on existing debt and on new debt incurred to acquire the business?

Income Taxes

What will the profit likely be (sales minus above costs and minus depreciation)? What *taxes* must be paid on these?

Payments

Identify payments for acquisition of the business, whether notes or other payments.

Once you have projected sales minus cash costs and payments, the net figure each year is to be related to the amount of cash required to get you into the business. Assume for now, you will have all the ownership. To relate future cash inflows to a present cash payment, we must take time to develop the concept of net present value (NPV), which is discussed further in Appendix B. We are going to see how it works and how it helps arrive at a value of an acquisition candidate.

Although a detailed presentation of valuation of a business is beyond our intentions here, overviews of four methods follow. First is the *present value method.* From this valuation process will come a number approximating the economic or financial worth of a business as a potential buyer sees it. We start with the time value of money.*

Suppose you project a company will yield a cash flow of $8,000 (plus your earned salary) a year for four years, and then you think you would sell it for $100,000. What is it worth now? Let us say your investment could earn 12 percent elsewhere at comparable risk.

The present value of the first $8,000 is $8,000 divided by $(1 + .12)^1$, or 1.12	=	$7,143
The present value of the second $8,000 is $8,000 divided by $(1 + .12)^2$, or 1.254	=	6,380
The third year's $8,000 is presently worth		5,694
The fourth year's $8,000 is presently worth		5,084
And the $100,000 projected at the end of year four is presently worth		63,550
Thus, the company's worth is about		$87,851

* If money is worth 10 percent annually, invested or borrowed, then $1 now = $1.10 at end of year 1, that $1.10 is worth $1.21 at the end of year 2, and so on. This we get by $\text{principal}_0 + \text{interest}_1 = \text{principal}_1$; $P_0 + I_1 = P_1$; where I_1 is (principal)(rate)(time) or $I = Prt$, and because time or t is 1, it can drop out of the term. Thus, $I = Pr$; $P_1 = P_0 + P_0r = P_0(1 + r)$; $P_2 = P_0(1 + r) + I_2 = P_0(1 + r)(1 + r) = P_0(1 + r)^2$; and $P_3 = P_0(1 + r)^3$. In other words, an amount of money in hand now will be worth $(1 + r)^n$ times the current amount at the end of n years. And an amount coming in at the end of year n is presently worth the amount divided by $(1 + r)^n$. $P_0 = P_3/(1 + r)^3$.

A basic principle of valuing future income is that the greater the risk, the greater the discount rate (the interest rate equivalent, such as the 12 percent in the illustration at the base of page 183). If you could earn 10 percent on a risk-free investment (a savings account well insured or a government security) and if this candidate company appears to warrant a 2 percent risk premium, then 12 percent is a good rate to use in valuation. Most small businesses are risky enough to call for a 5 to 10 percent risk premium or more, in addition to the risk-free factor.

Discounting $8,000 a year for four years plus $100,000 in the fourth year at 15 percent gives a present value or worth of	$80,020
At 20 percent we obtain only	68,940

These numbers show how risk enters the valuation process. Our suggested approach, then, to finding the maximum worth of a business to you is

1. Project cash flow for any chosen number of years.
2. Project a value at the end of the chosen number of years (accuracy is not critical, as it is several years in the future).
3. Discount these figures, at the current risk-free rate plus a risk premium consistent with the risk of your type of business, to find a "present value," or cash value.
4. If you are sure you strongly want this business and you can afford it, adjust the present value up by a personal factor. If you find the business only acceptable, adjust the present value downward.

In addition to the adjusted present value method, other popular methods warrant an overview. They have merit, and in fact the seller may use one of these methods. When negotiation time comes, you will want to understand the seller's thinking.

Second and closest to the above present value is an *earnings multiple method,* wherein you multiply the average of recent earnings by a factor. What factor? Depending on earnings growth, the market multiple of profitable companies' earnings ranges from two to twenty. Most small, stable companies will sell at four to six times their annual earnings, after a manager's salary. If the manager-owner spends sixty hours a week in the business, does most of the work, and the business has his or her name, then its value to a new owner may be only two or three times its earnings. Use of the earnings multiple method requires you find the earnings and selling price of comparable businesses and divide their earnings into their selling price to determine their multiple and thus what the multiple should be on the business of interest.

A third defensible method of valuation is to price the *assets,* then *add* a percentage for *goodwill.* One specialist in valuing companies for sale says start

with the fair market value of fixed assets, add the inventory at no more than cost, 80 to 90 percent of receivables, and for goodwill add a percent of profit. On the profit before the owner's salary that percent addition will be zero for low-profit businesses up to 150 percent for high-margin businesses. Dun and Bradstreet or Robert Morris publications will show average margin percentages for many different lines of business. These "business ratio" publications may be found at most banks and business libraries. This method dodges the question, "What is the fair market value of fixed assets?" A realtor-appraiser familiar with the type of business may help on this question, too. In fact, for a fee, you can get an appraisal of the market value of a company.

This method, pricing at the market value of the company, is fine; and you may not expect to buy below market value, presuming you can find that value. Unless the seller seriously wants you to have the company, which occasionally happens, why should the seller not try to obtain market value or more? By *market value* is meant the price at which similar companies currently sell. An independent appraiser will make a skilled effort to determine this amount. The seller must trust the appraiser or believe that the appraisal is plenty high, else the seller will ignore the appraised market value.

Book value, our fourth method of valuing a business, is the accounting value of assets minus liabilities. Additionally, goodwill would be called for if the business is profitable. Book value of assets needs some background discussion. When fixed assets (machinery, equipment, building) are purchased, they are not expensed but capitalized — that is, because these items are used to produce revenue over a period, for example, five years, to charge their cost against this year's revenue would cause this year's profit to look too low and next year's profit to look too high. So, when a company buys a five-year machine for $10,000, it simply records an exchange of $10,000 for a machine and no expense occurs. At the end of each year, $2,000 of expense is charged against income of that year. The part of the $10,000 not expensed (depreciated) is the book value of this asset. Now, back to our valuation process. A company may have assets on its books at zero book value and they may be "worth" their purchase price! Inflated prices for new equipment together with careful maintenance of a company's existing equipment cause this to happen. Conversely, a machine may be on the books at $50,000 and be worth only its salvage value. Obsolescence and lack of maintenance cause this.

So, book value as a valuation method is full of problems, of which we looked at only the main ones. Why even consider it? Because book value is there on the accounting books in black and white, everyone knows how it was arrived at. The seller may feel it is what has been invested in the business; the buyer should understand book value primarily because the seller may use this amount plus a figure for goodwill as the asking price. In practice, a mixture of methods is common. We will demonstrate a valuation mixing book value of current assets, market value of fixed tangible assets, and present value of expected incomes from goodwill plus "normal" profit.

Valuation Example

Recent balance sheets and income statements for the hypothetical business of Home Furnishings, Inc., follow (Finley and Hays 1988). Net income for the years 1984–1986 totaled $93,000. Home Furnishings, Inc., was organized in 1967. In 1972, after five years of marginally profitable operations, the corporation acquired land and constructed a new building in a rapidly growing area of the city. The owner believes the real property of the business has appreciated substantially in value over the past thirteen years. The corporation's primary products are furniture and carpeting, but it also sells other home furnishings, such as wallpaper. The company has been considerably more successful in its new location. Table 12.1 show the firm's income statement for 1987 and 1988. Table 12.2 shows balance sheets for the same years.

Sam Sellers, age 60, owns 100 percent of the outstanding stock of Home Furnishings, Inc. Sam is interested in selling his business and has been talking with Brad Beyer, a prospective purchaser. Both Sellers and Beyer are interested in consummating the transaction, but they have differing views regarding what the business is worth.

Sam Sellers believes his business is worth $393,250, derived as follows. He estimates the land is worth $50,000; the building thereon, around $200,000; and the fixtures and equipment, $50,000. He discounts the accounts receivable by 10 percent, leaving a value of $135,000. Assuming the inventory has a value equal to its cost, the value of the assets is $759,000. After deducting

TABLE 12.1 HOME FURNISHINGS, INC., INCOME STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 1988 AND 1987

	1988	1987
Sales	722,000	704,000
Cost of sales	440,000	432,000
Gross Profit	282,000	272,000
Other Expenses:		
Operating, except depreciation and interest	189,000	186,000
Depreciation	12,000*	11,000
Interest	18,000	19,000
Total	219,000	216,000
Income before income taxes	63,000	56,000
Income taxes	12,000	10,000
Net income	51,000	46,000

* Fixed asset requirements are assumed to be approximately equal to depreciation. Thus, cash flow and net income are assumed not to be significantly different for purposes of our discussion.

TABLE 12.2 HOME FURNISHINGS, INC., BALANCE SHEETS DECEMBER 31, 1988 AND 1987

	1988	1987
Assets:		
Cash	35,000	28,000
Accounts receivable	150,000	140,000
Inventory	280,000	275,000
Prepaid expenses	9,000	8,000
Land	25,000	25,000
Building	150,000	150,000
Furniture and equipment	125,000	115,000
Accumulated depreciation	(65,000)	(53,000)
Total	709,000	688,000
Liabilities and stockholder's equity:		
Accounts payable	120,000	125,000
Other current liabilities	116,000	136,000
Mortgage payable	175,000	180,000
Common stock, $10 par	100,000	100,000
Retained earnings	198,000	147,000
Total	709,000	688,000

the liabilities of $411,000, Sellers arrives at a net tangible asset value of $348,000. He is convinced an appraiser would substantiate his estimates.

Sellers next calculates the goodwill, or intangible asset value. The average annual net book tangible asset value over the past five years was $193,000, and he estimates the average return on assets of similar businesses to be 15 percent. On this basis, an average return per year would have been $28,950. He subtracts this amount from the actual average earnings over the past five years, $38,000, and arrives at excess annual earnings of $9,050. He capitalizes these excess earnings at a rate of 20 percent and arrives at $45,250 as the estimated goodwill. Adding the net tangible asset value of $348,000 and the intangible asset value of $45,250 leads Sellers to conclude that his business is worth $393,250.

Brad Beyer wants to value the business by discounting expected future earnings. Beyer plans to operate the business, and to him the value of the business is based on its ability to generate earnings. His review of various financial information about Home Furnishings, Inc., indicates that the company has followed conservative accounting practices and that salaries paid to the owners were reasonable based on services rendered. Beyer is thus satisfied with the quality of the earnings and believes that good management can gradually increase the income of the business. He concludes that transition problems will keep earnings at the $50,000 level for 1988 but that they will increase at the rate of $4,000 per year for the period 1989–1992. For 1993 and thereafter, he estimates earnings at $70,000 per year.

Beyer determines that the current risk-free rate of return is around 7 percent. He adds an 8 percent risk factor and a 5 percent factor for lack of marketability to arrive at a discount rate of 20 percent. His risk factor for illiquidity is low because of what he considers the excellent quality and location of the facilities. He concludes that 20 percent is an appropriate discount rate for the risks associated with the business in question. He then determines that the business is worth $286,374, calculated as in Table 12.3.

Because Sellers and Beyer are far apart in their initial estimation of the value of the business, completion of the transaction will require considerable negotiation. In this respect, each party should understand how the other party arrived at his estimated value, in order to point out any weaknesses in the calculation.

In our example, Beyer may contend that Sellers has assigned excessive values to the assets. Beyer must also recognize that the real estate may have greater value for uses other than in the current business; and if such is the case, Sellers is justified in insisting upon an amount that represents the true market value of the property. Beyer may also object to the manner in which goodwill was calculated by Sellers. Because earnings have been relatively stable, suppose Beyer reconsiders the risk and marketability and thinks 17 percent is an acceptable discount rate.

Using his present value approach, but with a lower risk factor, the business is worth approximately $342,000. Beyer might start with a 20 percent discount rate but realize that 17 percent, and a consequent higher price, are justifiable.

Sellers may argue that Beyer is underestimating future earnings or that the discount rate applied is too high. Using different assumptions, Sellers may arrive at a considerably higher valuation of the business using the discounted

TABLE 12.3

Year	Forecasted earnings	Discount factor *	Discounted earnings **
1988	$50,000	.833	$41,650
1989	54,000	.694	37,476
1990	58,000	.579	33,582
1991	62,000	.482	29,884
1992	66,000	.402	26,532
1993 on	350,000*	.335	117,250
TOTAL			$286,374

* The $350,000 forecasted earnings figure represents the estimated earnings for 1993, and each year thereafter, of $70,000 discounted into infinity ($70,000/.20).

** From the present value table using 20 percent rate, or dividing forecasted earnings by $(1 + r)$ to the n, where r is discount rate and n is number of years until earnings are received.

earnings approach than did Beyer. A substantial difference in the bid and asking prices of the buyer and seller is not unusual. Each party attempts to get the best deal possible, and the likelihood is that the buyer's initial offer is less than he or she is willing to pay. Likewise, the seller's asking price may be more than he or she expects ultimately to receive.

Valuation Conclusion

To conclude the valuation discussion, both the asset valuation and the discounted earnings approaches to valuation of a business have merit. The use of quantitative approaches provides objective bases for initial estimations of the value of a business. Ultimately, the price that a buyer and seller agree upon is highly influenced by their negotiating skills. After determining their initial positions, numerous factors may affect the bargaining. For example, how is the transaction to be structured? Is the buyer paying cash or is the seller financing a portion of the price? What is the current economic climate? How strongly does the seller want to sell or the buyer want to buy? Is the buyer acquiring the assets or the corporation's stock? What tax factors are relevant to the proposed transaction?

Both the buyer and the seller should consult experienced attorneys and accountants before entering into an agreement. These advisers may note a number of items that should be considered by the parties involved before concluding an agreement.

Exercise 12.A

Locate a business that is for sale, either from the classified ads, a banker, or another source described early in this chapter. Call or visit the seller and learn the asking price. Was this price arrived at via any of the four methods explained above? Is it a reasonable price? Why? What is being sold, just tangible assets or more?

Negotiating the Acquisition

Our next acquisitions topic, after valuation, is negotiation. Clearly, the typical owner will want all he or she can get for the business and the buyer will want it for as little as possible. This statement is not to imply greed nor stimulate argument by the parties, but understanding this fundamental fact helps the buyer not get "taken," by sales statements such as "You're just getting started and I want to help you," when the seller is really asking twice the worth of the business. Nor should the seller get suckered by such buyer statements as "You mean so much to this business, it probably will not make any money once you leave, but I am willing to give it a try," then the offer to buy is only half the worth of the company. Buyers and sellers of investments such as diamonds, real estate, horses, and businesses are in an arena where value is difficult to determine objectively. Thus, caution is in order, especially for the inexperienced.

Exercise 12.B

A number of rules for negotiating follow. Make a brief notation by each one as to why it might be recommended for negotiating. What assumption underlies each rule? These rules and your notes should be discussed with an interested acquaintance.

1. Before negotiation, win the seller's friendship and maintain it.
2. Write a proposed price and terms before the other party does.
3. Send an agent to negotiate, at first at least.
4. Arrange the meeting on your territory.
5. Beware of the seller who talks continually.
6. Bring a team to the negotiation.
7. Offer less than you are willing to pay.
8. Understand the terms preferred by the seller.
9. Know the business or know the seller.
10. Ask questions with "yes" answers, then ask for an important concession.

Negotiating is a skill. As with playing basketball or writing software, it is a skill that can be fully developed only by practice. Because most persons who acquire companies do so only once or twice in a lifetime, practice is not feasible. So careful attention to rules suggested by experts, and perhaps simulations, can help.

A general rule in any negotiation is to know and respect the other party. An individual selling a business has certain feelings about the business.

Does the seller feel affection and pride, even though selling?

Does the seller look at the business from a purely economic perspective?

Is the seller disgusted with it?

If you make an offer he or she considers low, will this insult and possibly anger the seller?

Where is the seller's irritation threshold?

Can you bargain with this person, possibly even wear him or her down? Or was the seller's first price also the last?

If you can get a feel for answers to these questions you can negotiate better. Also, if you can simulate a negotiation session, you will develop a feel for the art and increase your ability here. Place yourself in the role of the buyer: collect your information, plan your strategy, and test yourself with a friend. Then be the seller and go through a negotiation again. Perhaps, one person will be the prospective buyer and another an agent such as the attorney. Other persons in a group could collect information and help plan the strategy.

Structuring the Acquisition

Part of negotiation is deciding what you might give and what you might get. Money is by no means the only value used to acquire companies. Notes (promises to pay), stock in a new company formed to buy this one, a consulting contract to the seller, and royalties on sales — all these are possible substitutes for cash. Likewise, you may acquire the entire corporation, its stock "lock, stock, and barrel." Or you may acquire only selected assets, all assets, or assets and selected liabilities. The name for these choices is *structuring the acquisition.*

If a buyer has cash or can obtain it at a reasonable cost (see Chapter 13), then paying cash makes some sense. If the seller agrees to finance you at the same interest rate the bank or your best source charges, then you might still consider how much the seller would drop the price for cash.

Installment notes payable each month or each year are often used for part of the payment, after an initial cash payment. These should be timed to match the seasonality of the business, if seasonality is significant. Agriculture businesses and Christmas-related businesses often experience high revenues a particular month of each year. Accordingly, payments are often annual, at the end of that high-revenue month. This simply saves bothersome small short loans at the bank.

Using the acquired company's cash flow to pay for the company is not a new idea, and there appears to be a growing number of acquisitions of this type. The new term is *leveraged buyout,* or LBO. This leverage is based on borrowed money.

We identify three sources of the popularity of LBOs: selling corporations, those who buy out, and dealmakers. First, many large divisionalized corporations became that way by borrowing (too much) to buy smaller businesses. These corporations need substantial cash to pay debts. An LBO is an opportunity to sell off a self-contained business without damaging the remaining businesses.

Second, middle managers in sizable corporations often are languishing in a condition of little incentive to aggressively pursue profits. Consequently, the business performs poorly, having unproductive assets, bloated costs, and making only the easy sales.* The business will be worth more behind the leadership of a newly entrepreneurial team. The opportunity for an employee to become an entrepreneur is the reason this discussion is in the text.

One observer calls these mid-level bureaucrats a huge pool of frustrated middle managers (*Business Week,* 1984). Our intrapreneurship chapter further describes their condition and alternate ways corporations can unleash middle managers' energies without resorting to an LBO.

A third source of LBO popularity is dealmakers. These are investment bankers, venture capitalists, and attorneys who have found, in fees and commissions, a new source of income. Thus they promote LBOs.

The *Wall Street Journal* (1984) cites additional reasons for the current popularity of LBOs:**

> As with so many other investment schemes, LBOs are driven in part by federal tax laws. By borrowing heavily against corporate assets to buy out other shareholders and take a company private, a small group of managers or investors can take advantage of liberalized depreciation rules in the tax code. As a private company, they have no need to show earnings for public shareholders, so they make fullest use of nontaxable depreciation allowances. The enlarged tax-free cash flow is used to service and retire the large debt incurred during the buyout.
>
> This kind of creativity has certain merits, and particularly so in cases where it makes it possible for talented managers to, in effect, become entrepreneurs. Entrepreneurs often take a different view of the world from professional managers. For example, they may have

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* The September 15th issue, page 1, carries an informative story on improvements in management typically following an LBO.

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a stronger belief in property rights and in managing for a long term, two attitudes that are useful in preserving a free, capitalist system.

For tax purposes, you might form a new corporation to buy the company on installment instead of buying it personally. The acquired company may be able to pay funds, as it generates them, to the new corporation with which the new corporation could pay the seller, all with less tax obligations than if the buyer personally pays the seller. If a new corporation is formed, then the seller might accept part of that stock as payment for the company. However, minority stockholders of small companies are not in good positions, so the seller may not be interested.

As to what is acquired, the simplest and most desirable arrangement for the buyer is to buy only the assets he or she wants. Presumably, these include only those assets used to generate sales and, of these, only those that fit into the new owner's plans for the future of the business. Inventory may include unsellable items. If certain product lines are to be dropped, then machines for their production would be only of liquidation value and better left with the seller. Often a corporation accumulates pieces of real estate, cars, and other assets not used in the business. The name of the business is an asset that may or may not be worth much. If the name is the seller's name, would you, as buyer, wish to use it? Probably not after some transition period. Which assets to buy may become part of the negotiations. You can offer to buy the assets you want at good prices but pay little or nothing for others, not saying they are worthless but simply that you cannot make full use of them. If you finally acquire all assets you may save several hundred dollars by identifying those not useful to you and pricing them separately from the remainder.

The next increment you might consider is buying assets plus only specified liabilities. It should be clear that you are not buying the corporation but only that part specified in the contract. The reason for this precaution is that certain liabilities may be contested as to amount, or worse yet, there may be liabilities you do not discover until later! Invoices and bills can get misplaced; and in small companies with unorganized accounting procedures, obligations often turn up at various times and places.

Another way of buying part of a company is to buy only part of the stock. Of course, this is done thousands of times a day as persons buy shares on exchanges, over-the-counter, and from secretaries of small corporations. The difference between acquiring a company, as we have been discussing, and buying shares as investment is that in the former case the buyer intends to manage the investment. If you buy less than 50 percent of the voting shares of a corporation and the rest of the stock votes as a block, then its holders can exclude you from any management voice if they choose.

So, if you intend to manage the company, you must own or control enough stock to control the board of directors. Being a minority stockholder in

a small, closely held corporation may give you little but the fun of ownership. The corporation does not have to pay dividends. In fact, it can pay officers, consultants, and others to the point it does not even earn profits. Your only recourse in this situation would be to file suit, and this would be more messy than remunerative. Therefore, if there are to be one or more minority stockholders, then their interests should be protected by up-front agreements specifying limits on salaries, fees, and requirements for dividends. Provisions for repurchase of the minority shares should also be considered.

Other provisions needed in stock or corporation acquisitions, called *clauses,* are

Representations and warranties: that the assets are owned free and clear and that liabilities are fully stated.

Escrow account: taken from the purchase price, placed in a bank to reimburse the buyer for uncollectible receivables, nonstated liabilities, and other named contingencies.

Noncompetitive agreement: that the seller will not compete in the same line of business within a specified radius within a named number of years.

Acquisition agreements are often detailed and complex. An experienced attorney is needed to help with this agreement.

Exercise 12.C

Write a 200 word essay titled, "Why I Would Prefer to Start (Buy) My First Business."

Summary

A person who finds an appropriate business for sale at a reasonable price and terms may avoid many start-up difficulties and risks by acquiring it. However, limited availability of businesses for acquisition narrows the potential entrepreneur's opportunities greatly. The process of and sources for learning about acquisition opportunities includes networking; reading printed ads; and questioning bankers, attorneys, venture capitalists, realtors, and business owners. The criteria by which to screen acquisition candidates include the financial condition of the business, its reputation with customers, and the buyer's personal values. Acquisition candidates can be valued by projecting sales and costs, present-value procedures, an earnings multiple concept, or asset and

goodwill pricing. Negotiating the acquisition is likely to result in a more favorable price and terms. Structuring the acquisition is agreeing on what assets and liabilities to buy and agreeing on what combination of cash, notes, and other assets to give. An escrow account is suggested, from which the buyer draws in the event of named contingencies.

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CHAPTER 13

Financial Resources: How Much Money Will You Need and How Will You Obtain It?

The information requested by funding sources minus that provided by business owners stunts the growth and prosperity of many businesses.
— Paraphrase from James W. Henderson

Will the business start in a sizable store, office, or factory? Or will it begin at home, either in a spare bedroom or the garage? Will you purchase sizable amounts of machinery, raw materials, and other inventory? Or can you subcontract (outsource), lease required machines, and buy or produce only to fill orders, thereby avoiding finished inventory? Answers to these questions determine how much financing is needed by a new business.

Will you or your new business have collateral to substantiate your promise to repay debt? Will you or your business have a "track record" to comfort the lender? Will you have customer orders in hand when you approach poten-

tial sources of money? These questions influence how the new business obtains financing.

How much financing and what sources are the main areas to be addressed in solving what may be the most complex problems of a new business venture. Financing a new business is, in a sense, more difficult than financing General Motors because, as an old banking proverb says, "money will easily be loaned only to one who can prove he does not need it." A budding business may have no such proof.

Financing start-ups is a challenging problem. Henderson (1988) wrote an entire book, *Obtaining Venture Financing,* covering financial planning, costing, and sources. How do we treat this complex problem and its procedures in only one chapter on new business? We followed three rules in writing this chapter:

1. Discuss financing of service, sales, and manufacturing types of new business.
2. Present the material chronologically as far as possible, from pre-start-up to a going business.
3. Refer the reader to Appendix A and references for background accounting and finance materials.

The vast majority of businesses fit into one of three broad types, and the financing needs of each type is different. The types are service (car wash, for-profit school or health clinic, dry cleaner, accounting, data processing, banking, plumbing, restaurant, recreation services); sales (retail store, direct sales, wholesale); and manufacturing (factory; also utilities, mining, and farming fit best here insofar as financing is concerned). Despite the differences in particulars, the questions can be answered broadly for all three types. The question of how much financing for each type of business can be answered as not much, sizable, or potentially huge. The question of how you will get it can also be answered broadly: use savings and personal credit; use these plus inventory for collateral; or use these plus plant and machines for collateral. These points apply primarily to pre-start-ups. With this overview let us look more closely at financing a sales business. The needs of service and manufacturing businesses will be noted when they differ from sales in financing requirements.

By the time you begin to consider financing, you need to be familiar with the cash budget, the balance sheet, the income statement, and pro formas. If you are not, or if a review sounds comforting, then you will benefit by studying or reviewing Appendix A before going on.

Sales-Supporting Assets

A business needs financing to support sales. This principle is fundamental yet not well understood by many otherwise informed entrepreneurs. Our first topic is determining the assets needed to support sales. The success of a sales business will rest primarily on the items from which its customers can select. Thus, the main need for financing is so that the new business can purchase and inventory items. A sales company cannot skimp on inventory — that is its business.

If your sales business is retail, then you may sell for cash. If you sell large-ticket retail items such as clothes or appliances or if you sell anything wholesale (to other businesses), you will not get paid in cash. Your pay will be only a promise to receive cash later, and these "receivables" must be financed. Somebody has to own them. You, their owner, can borrow against them or sell them. Either way you will incur costs, depending on the paying practices of your customers. Of course, you will not have receivables before start-up; but at the end of the first two months of credit sales, receivables financing needs peak. One authority claims that one should expect to invest at least two months overhead plus two months worth of labor and material costs in order to begin operations. And don't forget that it takes about two months to launch a cash flow cycle. This period, when sales have occurred but collection has not, is your second big staying-in-business test. (The first test was meeting payroll to this period.) When financing inventory or receivables expect to be able to obtain only 70 to 80 percent of these collateral items as a loan. The other 20 to 30 percent is the lender's safety cushion, in case the collateral does not liquidate (become cash) for full value. Of course, the lender gets rights to 100 percent of pledged assets even though the loan is for far less than that.

Asset Management Is Critical to Financing

How will your operating policies affect financing needs. Obviously, the wider the selection of stored items you offer and the more liberal are your credit sales terms, the greater will be your financing needs for inventory and receivables. A question you must consider closely is, "Is an increased gross profit on sales from these two policies worth their greater financing costs?"

To check your first inventory and credit decisions, obtain ratio data from Dun & Bradstreet, Robert Morris Associates, or another source. Your bank should have these data or be able to help you locate them. Look for inventory turnover and receivables turnover for businesses of the type and size of yours. You will find the following ratios,

$$\frac{\text{yearly cost of goods sold}}{\text{average inventory}} \quad \text{and} \quad \frac{\text{yearly sales}}{\text{average receivables}}$$

Let us say the above two ratios average 6 and 5. Then subtract your markup from projected sales and divide by 6 to get the inventory financing needed to support your projected annual sales. Let sales be 100 percent and say markup is to be 25 percent of sales, for example. Then you need $100 - 25 = 75$ percent divided by $6 = 12.5$ percent of projected sales in inventory.

Projecting needed receivables is even more straightforward: divide projected sales by 5.0 — that is, divide 100 percent by 5 and get 20 percent times your projected sales. Of course, you may not want to use average industry ratios as strict rules, but they remove some uncertainty. Due to inexperience you should count on using inventory and receivables less efficiently than the companies from which the average ratios were calculated. Thus, your (turnover) ratios likely will be lower; and when you divide them into projected sales, your needs will be shown higher. We assume your sales estimates are conservative, too, as a caution warranted by inexperience.

The next items to be financed are cash-on-hand and supplies. Let us say needed cash-on-hand and supplies are projected at 5 percent of annual sales. Then, your sales forecast gives you a rough idea how much money will be needed for these assets. (Cash-on-hand needed during start-up is treated later.)

How much will you need for financing fixtures, machines, and space? So far, we considered needs for cash, inventory, and receivables. We assumed all fixtures, equipment, and buildings were leased. Typically, part of these items will be leased but not all. Our question, of how much funds will be needed for these items has two major components: How much will be needed for fixtures, machines, and building, and how much of that must be financed?

How much is needed depends on (1) the volume of service, production, and sales you project; (2) how much activity you will perform in-house; and (3) how level your activity will be over time. Volume of activity comes from the all-important sales forecast, even for a service or manufacturing business. From the sales forecast you can calculate store fixture needs, machine and equipment needs, and space needs. Industry ratios and other data to estimate these needs are available through trade associations, the SBA, and government publications. For example, Dun & Bradstreet as well as Robert Morris Associates publishes the following ratios helpful for projecting required assets: sales to inventory, sales to receivables, sales to working capital.

These estimates are available for retailing, wholesaling, manufacturing, and construction businesses, each in different size classes. The data can be purchased from the publisher or, better, borrowed from your banker. Banks subscribe to D&B services and are members of Robert Morris Associates. These banks are very happy to allow their customers to use such materials; in fact, they will be encouraged to see the entrepreneur planning the business.

Another source of ratio and other financial data is Troy's *Almanac of Business and Industrial Financial Ratios*. Most libraries shelve a recent edition of this information source.

Exercise 13.A

From one of the previously mentioned ratio data sources, note the following ratios for manufacturers and retailers of clothing: cost of sales to inventory, sales to receivables, profit to sales.

Manufacturer

Retailer

Alternatives to Financing Assets

The second issue is how much of your business will be conducted in-house versus alternative methods. Service businesses do much of their operations on a building or repair site or even on a service truck and thus avoid the need to finance large building space. Retail sales businesses may lease out departments and thus reduce fixtures and inventory requirements. Wholesalers often "drop ship"; that is, have their supplier ship directly to the customer, thus avoiding most financing needs. A sales agent or broker will not have significant financing needs. By contrast, manufacturers may have inventory in two or three or more

stages of completion but may offset this financing need by purchasing larger components prefabricated. Manufacturers may subcontract certain work to other companies, thus minimizing needs for fixtures, machines, and space.

The new company owner-manager must think of these and other ways to sell a valued service or product without investing a tremendous number of dollars, which he or she does not have, at risks which he or she cannot afford. Only when the new business gets a foot in the door and establishes some predictability of sales and costs is it time to think of bringing more activities in-house.

Planning for Optimal Asset Turnover

How level (stable over time) will your workload or business activity be? This is our third determinant of needed financing. Turn back to the Chapter 6 discussion on stability of operations and to the graph with "Volume each month" on the vertical axis. There we were demonstrating that the equipment and space required by a given volume may vary 50 percent or more, depending on the stability of the operation. The summary point is that your "plant" must produce your peak volume level, and if volume is considerably below peak eleven months of the year, you need to do some hard thinking about leveling the activity. Either cut the peak activity by producing at off-peak times for inventory, or find a business whose peak allows longer utilization of capacity.

Farm equipment manufacturers produce their stock in off-peak times, then store it and induce dealers and users to store it until the peak season. Department stores use advertisements to induce white goods business to peak during their lowest activity period (January) to allow fuller utilization of capacity. These are two more ways of reducing fixed capacity requirements per dollar of sales projected. Thus, financing requirements per dollar of sales are managed. These actions must be planned well before the business is started.

Lease financing is, in an accounting sense, not asset financing at all, because leased items do not appear as assets on the balance sheet. However, from the entrepreneur's perspective, the important thing is not the terms used but how to obtain use of fixtures, machines, and building at the least cost and risk.

Although you will need the advice of an informed tax accountant on details, your objectives should be clear. It is not ownership of a machine that earns profits, but continued, efficient use of that machine. The cost of a machine includes all the cash disbursement as a result of using the item. This disbursement to own includes costs of search, contract to buy, purchase price, delivery, installation, maintenance, insurance, property tax, utilities, and interest cost less the profit taxes saved. These costs and tax savings should be compared to the costs of leasing (lease financing).

What risks of using a machine or fixtures, building, and so on are related to owning versus leasing? The risk of obsolescence is important if technological change brings better machines or materials into use every few years. The risks of machine breakdown, fire, going out of business, and increasing interest rates will be accounted for in the lease payments — that is, you cannot expect to transfer risks to the lessor without paying for that service. Tax savings may be available in greater amounts or earlier years by leasing. Your tax-wise accountant can advise here.

Leasing is one popular way of using fixtures, machines, space, and so forth; and lease financing is growing in use. On the other hand, when purchasing these items the funds can usually be borrowed via asset-based loans. Most of these items can be pledged as collateral for 70 to 80 percent of their cost. A principle of financing applicable here is that general-purpose items are better collateral than are single-use items. The bank, finance company, or other lender is going to be especially leery of accepting an item as collateral if there is no other prospective use or market for it, should it be repossessed.

How Much Financing Is Needed for Start-up?

Briefly, your financing needs at the beginning of the first month of business will be the total of the following:

Licenses (permits from local governments)
Insurance
Utilities
Lease payments
Advertising
Any purchase payables due then
Payroll costs
Miscellaneous

The second month financing needs will differ from the first month needs since certain start-up costs will not repeat, but payables will start coming due before revenues are collected. By the third month, needs should level off, but do not count on repaying any loans for several months.

As Appendix A explains further, the cash budget plus pro forma balance sheet and income statement will be helpful when you must determine how much financing the business will need and when. Of course, the costs of items you do not lease must also go into the beginning-cash-needed column.

The following illustration will show how projections of financing needs are performed. Suppose sales are projected at $200,000 for the year; inventory,

receivables, cash, and inventory of supplies are projected at 12.5 percent, 20 percent, and 5 percent of sales; and cash expenses at $2,500 a month. If you sell on credit, revenue will not come in at the rate of sales until the beginning of the third month. Then, how much financing would this business require by the end of month two?

We see needs for $75,000 for current assets plus $5,000 for expenses equals $80,000, conservatively. If the bank will loan only 70 percent of inventory and receivables, or $45,500, where and how do you acquire the remaining $34,500? (Recall this assumes leasing everything that can possibly be leased.) Much of the remaining financing needs probably must be met by personal funds. Chapter 3 on "preparation" emphasized this point.

We presented financing questions and guidelines in order of assets needed for a business, going down the balance sheet from cash to building. We did this to focus your thinking primarily on how much "stocks" of all these asset items you must use to support the "flows" of projected sales. Along the way, we were drawn into an initial discussion of how to obtain funds for these assets. However, we have not described most sources and methods of financing by any means. This is our next task.

Where and How Start-up Credit Is Obtained

How can you finance inventory; that is, where and under what terms will you obtain funds to buy and own inventory? As stated earlier, personal savings, a relative, or a friend will be your initial source. After these, banks, commercial finance companies, and inventory suppliers probably will be your first, second, and third choices. Your bank will usually charge somewhat lower interest rates than the others. Look for least cost (lowest effective interest rate) financing first then trade off cost against other terms. A 12 percent loan with restrictive terms may or may not be better than a 14 percent loan with more lenient terms. Restrictive terms such as limits on officer's salaries and other debts and required record keeping are to protect the lender, but they in fact protect the business as well. Other terms may be irritating; but, on the other hand, interest costs can determine success or failure of marginal businesses. Most new businesses are just that — marginal.

The "effective cost" includes all loan-related costs of the funds per year divided by the amount of funds used by your business. At times the effective cost will be considerably higher than the nominal (stated) cost because:

1. Interest does not include a loan origination fee or other charge.
2. Interest is deducted in advance, thus reducing usable funds.

3. A minimum compensating balance must be left with the bank, again reducing usable funds.
4. You can borrow only in certain large chunks, but your needs change by small increments, leaving you with unused borrowed funds.

Lenders prefer to loan "on the borrower's signature alone." A lender who does not trust your signature enough may request collateral.

A recent study on banking practices encountered by small businesses found those less than three years of age were required to use collateral 71 percent of the time (*Credit, Banks and Small Business* 1983). This declined to 50 percent for older small businesses. Only 37 percent of loans less than $5,000 required collateral, whereas 82 percent above $300,000 did. Collateral was required by 52 percent of loans for one year or less, but by 87 percent of loans for over five years. Thus, we see three sources of risk — new company, size of loan, and length of loan — being offset by banks' greater use of collateral. Banks are beginning to enter the asset-based (collateral is pledged) lending market, and your banker may make such a loan (*Wall Street Journal* 1984). In almost any situation except starting a business, you may not need collateral. But, if you have quit your job, leased a store, hired employees, and ordered a huge amount of unproven inventory, you are at the height of risk; hence, the lender's caution.

Without a business track record, your performance and that of your business are impossible to predict, and you will generally pay a premium interest rate. Those who need funds most are least able to obtain them, and they pay the highest price. Also, when a lender incurs cost, such as to loan funds and take collateral to reduce risk, that cost will be passed on to the borrower. The lender must identify the assets and ensure that any funds from their sale are paid directly to the lender. Infamous, fast-talking individuals have pledged phony collateral. (Salad oil tanks filled with water except for a layer of salad oil on top made news a while back.)

In the bank credit study referred to earlier, the most often mentioned type of collateral was plant and equipment (51 percent of the time), followed by owner's home (37 percent), inventory (28 percent), accounts receivable (17 percent), and owners stocks or bonds (17 percent of the time). Service firms were most likely to pledge receivables; sales firms pledged inventory most often; and manufacturing firms pledged plant and equipment most often.

If your bank or commercial finance company does not loan money backed by inventory, perhaps the supplier will loan you the inventory. However, if your new supplier should agree to sell on credit, the interest might be quite high. If sold 2/10 net 30 your effective cost is $2/98 \times 360/20 = 36.7$ percent. This is the cost because, by paying in 30 days rather than 10, you are charged $2 for each $98 (the amount due if paid by the tenth day) borrowed. In a 360-day year, this 20-day loan could recur 18 times! Expensive.

Generally, you will be ahead to pay suppliers promptly and use the goodwill thus generated to negotiate concessions on price, delivery, return privileges, custom products, rush orders, and so on. A principle here is, use resource providers for their specialty — suppliers for purchases, financiers for financing, accountant for accounting, lawyer for legal help, ad agency for advertising, etc.

How does the entrepreneur convince persons and institutions with money to lend it? As with physical assets, money may be owned by the user or borrowed. The idea is to obtain its use. You may borrow money and risk the guarantee to repay it plus a fixed interest cost on a schedule. Your guarantee holds whether you are able to profitably use the money or even if you lose it all.

Alternately you may induce persons and organizations to pool their money and buy into the *new* company along with you, the founder. If you use this kind of money, you do not have the risk of a fixed schedule of repayments with interest. In fact, you are not legally obligated to ever pay any return to the providers — the other owners. Now, with all the risks of changes in costs, of little demand for your product, an inefficient start-up period, employees who may leave for better employment, and other risks, why would an entrepreneur agree to the risk of guaranteeing to repay large sums of money plus stiff interest?

Recall that in Chapter 2 we discussed the entrepreneur's willingness to risk to achieve. Also, we reported in Chapter 2 that many entrepreneurs strongly want to be independent — to be their own bosses. These personality characteristics are part of the reason you may limit your use of outside funds to that which you borrow; for only when you borrow do you maintain operating independence (control). Managed financial risk does not deter entrepreneurs. However, the coin has another side. Entrepreneurs generally have very limited ability to pool others' money, called *equity financing.* Many do not want it; but even of those who do, many cannot get it. Back to our main question, how to convince persons to part with money, specifically to loan money.

You need to show the lender whatever place of business exists before the major loan. The lender will want to see if there is an appearance of care and order and see the condition of any material, inventory, and space you have at the time, although your business plan will provide the details for an advance overview about customers and products or services. Start convincing early.

Four Cs of credit are usually said to be the heart of this convincing. The business plan (Chapter 14) is one medium by which these Cs are presented by the entrepreneur to the money person.

Character. The reputation of the applicant for paying bills and repaying borrowed money as promised.

Capacity. The expected inflow of funds to the applicant, from employment, a spouse, cosigner, and from the new business.

Conditions. The appearance of your balance sheet, the success or failure of other businesses in markets similar to yours and those starting businesses, the supply of money to the lender, and competing requests for it.

Collateral. The hedge or fall-back position of the lender in the event the loan is not repaid, the lender's claim on marketable assets.

The Cs of credit convey the idea that you, the borrower are the main determinant of the loan. Then, the lender wants to know how you will use the funds to generate enough returns to repay the loan plus interest. The business plan contains most of the information the lender needs but not necessarily in the best form. Ask the banker or other lender what format the written loan request should be in. This person or someone in the bank's credit department may also need to calculate certain ratios and balances on your personal financial statement and that of your fledgling business. These calculations are aided by an application format chosen by the lender.

To conclude our discussion on convincing the lender, we suggest you place yourself in the lending officer's shoes. The lender must not only risk his or her investors' money on you but must convince the internal loan committee to do the same. You must provide the data and plan to help your lender convince the committee.

Although credit is widely available, sources of equity are not. Venture (equity) providers typically want 30 to 40 percent average annual rates of return, which they obtain by buying a majority of the entrepreneur's company cheaply. In addition to the risk factor, a reason venture capitalists can demand such high returns (low equity prices) is the illiquidity of their investment in the fledgling company. They have no assurance of buyers when they wish to sell, usually three or four years after purchase.

To obtain their money they have to take the company public through an expensive and cumbersome initial public offering (IPO) or locate a holding or operating company interested in owning a young, small company. If there were even a "thin" market (only occasional transactions) for new company stock, then investors would not require as high returns as they do, so entrepreneurs could get more money for their stock.

Wisconsin Securities Commission member Walter H. White and the SBA's Frank Swain have expressed interest in starting regional stock markets for small companies (Emshwiller 1989). The model inspiring their interest is a market for small companies' stock started by the London Stock Exchange in 1987. In the United States, such a market may be functioning, on a pilot basis, by the time the reader reads this book. If so, expect a broker to "make a market" in stock of a qualifying company, buy substantial equity, guide the business (a revision of it), and ensure that accurate financial information is available for investors. Having described credit sources and means of obtaining

credit and having introduced the equity funding challenge, we now examine when to use the different types of outside financing.

Financing at Different Stages of Development

It is not the primary purpose of this book to describe in detail financing for the perhaps 1 to 2 percent of new companies that produce to tens of millions of dollars of annual sales. Financing rules and sources for companies in strong growth situations are very different from those of the other 98 percent of businesses. However, because a goal of most early stage entrepreneurs is to expand their businesses beyond the size needed for an average income, we will identify the sources of financing most used at each of three stages.*

Arnold Cooper (1979) divided the growth of businesses into three clear stages. Others have enumerated two or four or more stages, but Cooper's model is widely used. Financing needs differ from one stage one to the next, so we will describe the stages. The present financing sources and other considerations needed at each stage are shown in Table 13.1.

Stage 1. *The start-up stage*, includes the decision to found a firm and position it within a particular industry using a particular competitive strategy.

Stage 2. *The early growth stage*, is when the initial product and market strategy is being tested. The owner-manager tends to maintain direct contact with all major activities. The firm's sales pattern often stabilizes here.

Stage 3. *The later growth stage*, is often characterized by multiple sites for retail and service businesses and by some diversification for manufacturing companies. At this stage, the firm usually has one or more levels of middle management and some delegation of decision making.

Forces at work causing different financing to be used at each stage include risk-return, control, markets, and government regulation.

Risk was discussed in the entrepreneur and acquisition chapters and already in this financing chapter. Stage 1 is the highest risk stage of new companies. Stage 3 is the least risky, because of management experience, established customers, suppliers, and dependable employees. The first type of

* For those interested in further reading, articles are listed at the end of the chapter.

TABLE 13.1 FINANCING SOURCES AND CONSIDERATION OF EACH GROWTH STAGE

1. Start-up (typically 1 year or less)	2. Early Growth (typically 2 years to infinity)	3. Later Growth (no typical time limit)
Money comes from personal and family savings and by borrowing from bank, against house. Continued employment, income from spouse's job, and loans from family members are also frequent sources. Personal risk and sacrifice are foremost in entrepreneur's mind, along with having enough money to last until revenue begins to come in steadily. Leasing companies are used increasingly. Rule 504 Regulation D is used at times.	Funds come from banks and commercial credit companies. Later, SBA and SBIC loans are occasionally obtained. Limited and general partnerships, private placement, sale of unregistered Regulation D Rule 504, and stock, venture capital and leasing are used. Maintaining payable interest payments, retaining control of the business, and minimizing tax payments are main considerations when choosing financing. Equity must be large enough to support debt, yet not so large as to dilute owner's claims and control.	Stage 2 sources still used, plus regulation Rule 505 stock, public placement of debt, preferred stock, and stock with warrants; leasing is used. Considerations are similar to those in stage 1. Also, a decision must be made whether to remain a closed corporation or go public, and what mix of debt equity balances risk and control. Timing of initial public offering depends on financing needs, costs of IPO, and securities market's receptiveness to new issues (Deloitte Haskins and Sells 1982).

risk to be aware of is "business risk." This risk is that sales will not materialize, given prices high enough to provide a profit margin.

Who will bear the business risk — that is, who will lose if operating profits drop or become losses? To answer this let us specify the claimants on a company's revenue in the approximate order of the priority of their claims. In other words, if the company goes bankrupt, what would be the order of payment, thus the reverse order of risk bearing? The first claimants bear least risk and last claimants bear most risk:

1. Tax recipients
2. Employees
3. Suppliers
4. Creditors
   a. Secured (and lessors') debt
   b. Unsecured debt
   c. Subordinated debt

5. Preferred shareholders (limited partners, if a partnership)
6. Common shareholders (general partners, if a partnership)

As we saw in Chapter 6 on low cost, fixed costs would occur even if no sales were made. If sales never reach a robust (breakeven) level, fixed operating costs will not be covered. When losses are blamed on inadequate sales, analysts often term this *business risk*. When high fixed costs are blamed, this risk is called *operating risk*. Either way, it is a first-cause risk and its effects depend on how great is the shortfall.

Financing costs can be thought of as fixed and variable much like operating costs in Chapter 6. Which cost is fixed, the returns to creditors or to owners? Think about this. Which payment must be made on a calendar schedule, whether there is income or not? Interest and principle payment to creditors, of course. Therefore, who bears the first and most risk of a shortfall of funds? Owners, of course. Let us pursue this thought further. Would the creditors' risk be greater if they only loaned 10 percent of assets or 60 percent? Why? Loaning 60 percent means interest obligations are at least six times greater than if only 10 percent were loaned; thus, there is a much greater chance that part of the obligation could not be met in a given period. Also, when 60 percent is loaned, assets can only fall in value by 40 percent and still leave the creditors protected. Assets values often fall more than that.

Because we have the least confidence in sales in stage 1, it follows that in this stage, business cannot stand much debt. Hence, the reliance for most financing on owner savings, income of spouse, and other noninstitutional sources.

When debt is obtained, it is often based on the owner's personal assets and income, on cosigned notes, or on collateralized loans. Debt at this stage is likely to be short term, because an early repayment schedule is less risky to the lender than a later one. Further, the loan agreement is likely to have restrictive clauses, limiting manager salaries, dividends, and incurring new debt.

In sum, we see that lenders, especially stage one lenders, minimize their risks in four broad ways. First, they limit the amount of debt relative to assets and equity. Second, they strengthen their claims by requiring security (collateral). Third, they limit the term over which the debt is outstanding. Fourth, they require restrictive clauses in the loan agreement. All these protective actions shift risk to the entrepreneur.

Stage 1 companies may be able to raise up to $500,000 from friends and relatives and anyone a broker can sell the issue to in a Regulation D, Rule 504 private placement. This rule by the Securities and Exchange Commission says that a company can raise money by equity, debt, and limited partnership, without registering the offering with the SEC. Brokers can be used and can charge any commission the issuer will pay. Not registering with the SEC still saves significant costs and time, compared to "registered offerings." We will not cover registered public offerings because they usually are several years away

from start-up. This rule generally is used by firms with the potential for sustained growth or firms having access to wealthy backers (friends or relatives).

In stage 2, called early growth, sales are relatively stable. This is similar to saying that cash is normally available from gross profit to pay fixed operating costs and moderate financing costs. The business begins to be able to acquire funds on its own merit, apart from the personal assets and income of the entrepreneur, family, and friends. The bank, commercial credit company, and SBA are some of the next sources of debt funding, listed in order of increasing risk they normally accept.

Commercial credit companies make short-term loans (less than a year) and term loans (of one to five years), depending on what assets are being purchased. Inventory usually would sell and receivables be collected in two to six months, and this would be the range of most loans. The terms of loans of these companies and of banks overlap. Commercial credit companies will loan where banks will not.

The Small Business Administration (SBA) also loans to firms with higher risks than banks. In fact, the largest SBA program is "guaranteed loans," wherein the SBA guarantees up to 90 percent of a bank loan. You must show that banks will not loan to you before SBA will consider your application.

Typically the risks scaring the (not guaranteed) bank are from inadequate collateral, inadequate equity, or too long a term (Bates 1982). Stage 2 businesses may qualify for bank loans but not for the amount needed nor the duration. The SBA will often loan for a longer period than will a bank. A larger than acceptable loan (request) is essentially the same as inadequate collateral and or equity.

The statistics related to the adequacy of equity and the duration of a loan are as follows: small firms have an average of 65 percent debt/equity, whereas large firms' ratios average 59 percent. Small firms' total capital on average is 38 percent short-term debt, whereas large firms' short-term debt averages 28 percent (Andrews 1984). How could this be? Small firms, including most new ones, have inherently more business risk than large firms. Yet the financial risks for start-ups, from inadequate equity and quick repayment requirements, are higher too! Such are the predicaments of entrepreneurs — they have few financing options, especially if they want to grow.

Stage 2 companies may use Rule 504, mentioned earlier, or they may be ready for a Rule 505 stock offering. Up to $5 million of this stock can be sold to up to thirty-five persons without qualifications, plus to an unlimited number of accredited investors.

An important question prospective equity investors ask is how and when they might get their money out of the company. Exit mechanisms for venture investors are limited to essentially three forms: (1) public sale of the firm's shares, (2) merger with or sale to a larger established firm, or (3) repurchase of shares by the firm or its management (Wetzel 1982). Robinson and Pearce (1986) found that, although there is growing divergence of venture capital firms across different sources and uses of their own investments in growth compa-

nies, the goals and priorities of these companies have changed neither over time nor across firms. The most common objective remains annualized after-tax return on investments of between 25 and 40 percent. A five to six year investment time horizon and basing the investment on the management team were high priorities discovered universally across venture capital firms.

Wetzel goes on to comment on those firms his research found to face the most difficult financing problems:

> Access to the public equity markets or merger with a larger firm is seldom feasible for smaller, slower-growth firms. Between the lifestyle ventures and the "high-potential" firms are a group of privately held "foundation firms" . . . typically requir[ing] risk capital in amounts ranging from $50,000 to $500,000, are expanding at rates between 10% and 30% a year, are unlikely to qualify for a public stock offering or merger with a larger firm within five to ten years, employ from 10 to 600 people, and generate annual sales between $1 million and $20 million. (Wetzel 1982, pp. 149, 150)

The troublesome firm to finance is the established foundation firm growing faster than retained earnings can support, but not fast enough to attract venture capital (Wetzel 1982). When the fledgling company needs to build its equity base, often to provide safety for still more debt, it faces a thorny problem of pricing that equity to an outsider.

Exercise 13.B

Locate a nearby company that has grown significantly over the past five years. Arrange an interview and ask about (1) their asset management and (2) sources of funds.

Pricing Your Equity

When the time comes for the entrepreneur to raise outside equity capital, a major question is how you should price the equity you will give up. Although an entrepreneur and new equity investor will negotiate their arrangement, the following scenario shows a common and logical way of determining a starting point percentage of a new business an equity investor might want (Timmons,

Smollen, and Dingee 1985). Assume earnings of the business are expected to start in year three and amount to $100,000 that year. Assume you need $200,000 of outside equity financing now and that the risk is such that the investor wants a 33 percent return each year money is invested. Further, assume that ventures similar in risk and growth prospect to yours carry a price-earnings ratio of 7 (a P/E of 7 is equivalent to discounting an infinite stream of earnings at approximately 14.3 percent annually). Thus, your firm is projected to be worth $700,000 in three years.* The present value of $700,000 in three years at a 33 percent discount rate is $700,000/1.33^3 = $700,000/2.3526 = $297,543. Because you are asking the investor to invest $200,000, that person should obtain 200,000/297,543 = 67 percent of the ownership (see the asterisk in Table 13.2 on page 214). The formula will follow. Table 13.2 displays the effect, on ownership interest that might be given up, of different periods until initial earnings, and of different required rate of return on investment. We still assume new equity needed equals twice year m earnings and the price-earnings ratio is 7.

If new equity were to equal only projected earnings, then the percentages given up would be halved, and so on. Thus, the percent of equity a company founder might expect to give up to outside investors can be calculated given the following factors:

e = the amount of first earnings expected,
n = the number of years from now in which first earnings are expected,
r = rate of return that outside investors will require annually,
m = the price-earnings ratio expected in year n.

Thus, the projected value of the company is $V = em/(1 + r)^n$. From the preceding example,

$$(100{,}000)(7)/(1 + .333)^3 = \$297{,}543$$

Then, the percent, P, of the company that outside investors will expect for dollars, d, is

$$P = (d/V)100$$

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* Lipper, 1984, says the worth of the deal is not given nearly enough focus. His book should be consulted by the entrepreneur wanting to raise substantial growth capital.

TABLE 13.2 PERCENT OF OWNERSHIP OBTAINED BY OUTSIDE INVESTOR

	Number of Years until First Significant Earnings			
Required Rate of Return	**1**	**2**	**3**	**4**
20%	34.2	41.2	49.4	59.2
25%	35.7	44.6	55.8	69.8
33%	38.0	50.6	67.2*	89.4
50%	42.4	64.2	96.4	144.6

From the example,

$$(200{,}000/297{,}543)100 = 67.2\%$$

A number of observations are useful now. First, the entrepreneur should expect to give up a significantly lower percentage of the company by waiting to sell part of the equity until earnings are nearer in the future (a smaller n in the formula denominator). Second, the less risky venture does not require relinquishing as great a percentage of ownership as does the riskier one (a smaller r in the denominator). Therefore, debugging the business for another year has merit and helps you retain more of your company in two distinct ways: You move closer to the time of profits and you should be able to reduce the (risk and) required rate of return to the investor. Third, and not shown on Table 13.2, is a compounding effect expected between risk and period until payoff — that is, if investors are asked to invest for three years before receiving a profit, they will require a higher rate than if expecting the firm to earn profits in the second year.

The fourth point to note is that whether you retain majority interest may depend upon the years-to-profit and on the perceived investment risk. The dash line through Table 13.2 cuts its contents into an upper left part in which the entrepreneur controls majority interest and a lower right part in which the entrepreneur retains only a minority interest. (The lower right percent (144.6) greater than 100 indicates the business has negative value because likely loss exceeds likely income.) A fifth point here is that as the ratio of new equity financing to projected earnings falls, the percentages in the table fall proportionately. This is another reason to delay using outside equity until projected earnings are higher and expected sooner.

Summary

The main questions faced by the entrepreneur are how much financing will be needed and how it will be obtained. We saw that the amount depends primarily on the assets needed to finance projected sales levels. These needs can be minimized by using others' assets and by fully utilizing the assets at your disposal. Obtaining funds depends on the character, capacity, conditions, and collateral of the entrepreneur and of the new business. Personal funds and debt are the main sources in the start-up stage, credit in the later stages, with outside equity playing a larger role as growth is more assured.

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Wall Street Journal. For example, a recent "Small Business" column stated that asset-based lending to small companies has found favor with banks. This column also reported that the U.S. Chamber of Commerce and the SBA want Congress to change banking law to permit banks to own up to 40 percent of the voting stock in small companies.

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CHAPTER 14

The Strategic Business Plan

The most important advice I ever got in business came from a colleague of mine . . . "Never forget, Jan, that the most difficult thing in doing good business is to say no to bad business, bad opportunities."

—Jan Carlzon, president and CEO of Scandinavian Airline System

Business planning is the subject of some controversy, many arguing that, of course, you should plan or else you are just wandering, continually fighting emergencies. Others say what is the use of planning since the future cannot be predicted. Besides, there is no time to plan, with all the problems of a business to solve. For those who want to plan, and we strongly encourage it, this chapter offers guidelines. If you seriously attempt to follow these guidelines, you will do many hours of invaluable research and become knowledgeable about all aspects of your intended business strategy. Conversely, if you have conducted diligent research, you know most of the information needed to set down your business plan. In either case, in writing the plan, you will be forced to consider your intended actions systematically and with care. The process of planning is its main value. However, the result will prove useful, too.

A strategic business plan includes two central choices that define the essence of your business: what product (or service) will you sell and to whom

will you sell it? As the early chapters discussed at length, choices will be made between a low-cost product and a high-cost one. The product should provide a benefit that no other product offers. A women's clothing store offering fashions for mothers and daughters might be a successful product idea, because mother-daughter shopping pairs seem to buy consistently. Whatever the product concept, it should be clear and it should be pursued intensely.

The selected market must fit the product. The novice asks, why select a market? A business will sell to anyone. The marketer responds, when selling a product in a market, identify the people for whom your product meets needs better than does any rival's product. Then pursue those people intensely, integrating product, package, price, place, and promotion with the focal market to best reach them.

The strategic plan will be a road map for you when moments of uncertainty or alternate opportunities appear. On a day when you feel like "chucking it" or when a seemingly easier way momentarily entices you, your plan will remind of your long-term intentions. You will have something to show your banker and possibly others from whom you will want support. There is no controversy on this point — your banker will expect to see a convincing plan.

The Business in Seven Parts

Our guidelines suggest a plan in seven parts: the introduction and overview; the managers and supporters; the product and its benefits; the market, rivals, customers, and sales; the physical business establishment; the organization of the entire staff and tasks; and finally the projected level of operations and consequent financial needs to initially support it.

Introduction

In the introduction, describe your business goal. What business do you want to conduct? Why do you think there is space in the crowded world of competing businesses for one more? What value will you provide that is not available now? The definition of the business should be in fifty words or fewer. If not, consider further exactly what you want to do. This definition and the part on management are the heart of your plan. *The introduction should be no more than one page long.*

Management

For each owner-manager, list the following information:

Name

Education

Any special training and resulting skills

Employment experience (responsibilities, activities, decisions)

Performance of unit for which owner-manager was responsible, and starting and ending salaries

Current financial statements (assets and how to verify; liabilities, income, and how to verify)

For each supporter of the business other than those just listed, give the name, relation to or interest in the business (for example, committed customer, supplier, creditor, investor, other), and the nature of the commitment (oral, written, date, amount).

This section should run two to four pages.

Products and Their Benefits

Describe the product (or service) thoroughly, specifying size, weight, performance abilities (if appropriate, describe performance tests, measures, inspections); include drawings or pictures.

Describe the benefits the product user will receive, tangible (clean car or shelter, for example) and emotional (status or security, for example).

Identify costs of production and delivery associated with each unit of product (or service). This includes purchased items or parts, materials (and labor time × wage if you manufacture the product). Overhead (fixed) costs will be described under "establishment" and "organization." Identify expected suppliers and an alternate for each needed item, repeating information from "supporters," if necessary.

Identify and describe up to three main alternative or substitute products you expect customers to have available. Include all features possibly significant in customer's choice among competing products.

This section should run three to six pages long.

Market, Rivals, Customers, and Projected Sales

Identify the total market (units and dollars of sales per month) assuming all sellers including your business expend expected level of effort to sell products. Limit the territory to that you initially expect to cover well, such as a side of a city, a whole metropolitan area, or a state. How much has this market increased or decreased over the past two years? One year?

Describe existing rival sellers: their product lines, estimated monthly sales, costs, selling prices, and profits. Describe either the top four sellers or the number selling 80 percent of the market, whichever is less.

Do you know that the market is growing enough that you can obtain customers without taking them from existing sellers? If not, as is likely, exactly how will you cause some of rivals' customers to switch to your business? The

earlier comparison of products is to be used here, along with any differences in location, terms of sale, and price.

Describe your customers. If relevant, tell where they live. How old are they? What is their income? What do they do, like, or want? How will you make them your customers? Describe publicity, advertising, personal selling, promotions.

Project sales, by type of product if you will sell a line or by meal if a restaurant. Then multiply units times price to project sales revenue. What is your basis for these projects? Have you interviewed a similar new business in another market? Have you used SBA guidelines or other methods of estimating? Project sales by day for the first month, then by month for twelve months, then by quarter for two more years. A summary of these projections will be the foundation for financial projects.

Expect this section to run five to eight pages.

The Physical Establishment

Where will the business be? What kind of building or part of one? What access will you need to services (phone, photocopying, fax, bookkeeping, group insurance, and janitorial), transportation, customer traffic, parking space, and car ingress/egress? What will the place cost, up front or monthly? Will improvements be required? What contract, at what cost, when?

Itemize any furniture, fixtures, equipment, machines that will have to be added to make the place ready for business. What is the cost of each item?

Tally the required starting inventory of products for sale. Do you need any raw materials, parts, or supplies? What is the amount and cost of each?

What zoning restrictions will apply to you? Will you need any health department inspections, fire marshal approval, or other?

Who insures the building, inventory, and other property? At what cost per month?

This section should run three to five pages.

The Organization

Describe the responsibilities and activities of each manager. What assistance will each have, making up the total workforce? When will these persons be hired and trained? What will be the direct wage or salary cost of each (beginning at hiring time, not necessarily opening day) beyond the direct labor cost of factory labor already described under "product"? If the hours for which employees will be hired depends on how many customers enter, estimate those hours for an expected level of business. Do this with a chart, with hours of the day across the top and employees listed down the left side. This chart will show

the level of staffing at each hour of the day. What will be the direct labor cost for the first month? What will it be for each month for a year?

What will be the supplemental payroll costs of workers compensation insurance, health insurance, FICA, unemployment insurance, vacation fill-ins? Calculate each for the month.

What business license is required? What does it cost? Licenses, insurance, minor lease payments, and certain other costs will be paid annually. On your cash budget they will appear in the first period, when due. On the monthly income statement one-twelfth of the annual cost will appear each month, to match them to the revenues they help generate.

This section will run three to five pages.

Financing

From the sales projection, transfer summary figures to the beginning of the income statement. From the product section, transfer estimated direct production costs. From the establishment section, transfer costs associated with the facility. And, from the organization part, pull the costs of staffing. From these, you have the material for projecting an income statement for twelve months. Also, from the establishment section, you have the data for the asset side of the pro forma balance sheet.

Your accountant will help you construct a projected cash budget, showing cash receipts from sales, anticipated cash expenses plus cash outlays for investments, such as equipment or a trademark. Of course, if you need a loan, the loan and payments will be on the cash budget as inflow and outflows.

Your projected income statement will not tell you how much cash will be needed and when, though it is necessary for the Internal Revenue Service and it matches period *i* costs to period *i* revenues in a way that the cash budget does not. A course in accrual accounting or an accountant with a teaching inclination may be needed to explain this further.

Appendix A on finances includes a simplified example of developing all these statements in a spreadsheet, along with formula showing how data in the example were obtained. Especially if you use a computer spreadsheet — to do optimistic, likely, and pessimistic projections — study the example in Appendix A to get you under way.

Persons interested in further material on preparing for and writing a business plan are referred to the *Business Planning Guide* (1988) or Mancuso (1985) in the References.

Later, one of the case studies uses a business plan constructed by two partners wishing to manufacture natural spice blends. This plan is given only as an example, not a model of a correct plan. The partners did go on to build a successful company, Parsley Patch. The plan was revised almost continually in the start-up and early growth phases.

This section should run three to five pages.

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CHAPTER 15

Will You Be an Intrapreneur?

The cowboy versus the corporation.
— Rosabeth Moss Kanter

An intrapreneur is an entrepreneur within or supported by an established corporation. The answer to the title question depends on you and the organization where you work (Pinchott 1985). In this chapter we describe important characteristics of organizations that are habitats for intrapreneurs. First let us examine why intrapreneurs are important.

Why Are Intrapreneurs Important?

Would a 25 percent decrease in sales be important to the 3M corporation? Would 22 percent less sales be important to Johnson & Johnson? No one doubts that 22–25 percent of a corporation's sales are important. These were the percentages of these companies' 1987 sales coming from intrapreneurial efforts in the form of new products. So, one reason intrapreneurship is impor-

tant is that without it corporations' dying products would mean dying sales, like a machine running out of fuel. With intrapreneurship, the corporation is like a plant or animal that continually renews itself by creating new cells to replace dying ones.

Other reasons for the importance of intrapreneurship are new sophisticated rivals of our major corporations, distrust of traditional corporate management, and the exodus of some of corporations' best and brightest people to become entrepreneurs (Kuratko and Hodgetts 1989). The economy's need for the strong performance of entrepreneurial companies was cited in Chapter 1.

Japanese rivals have taken sales from U.S. corporations producing everything from autos to farm tractors, from TVs to VCRs. U.S. products and jobs are lost. These rivals are accumulating great wealth in U.S. dollars — claims against U.S. goods, services, and productive assets. Domestically, new rivals eat into the activity of nonintrapreneurial organizations. Where was the U.S. Post Office when Federal Express started overnight delivery? Where was IBM when personal computers and software began? Where were General Mills, Pillsbury, and the other giant food companies when newcomer Budget Gourmet developed a profitable $300 million business in frozen foods?

Traditional corporate management has developed a reputation for avoiding one kind of risk labeled the *risk of sinking the boat.* So intently do many corporations avoid new business ventures that might sink the boat that they fall into an often worse trap — the risk of missing the boat, of not trying to be innovative, while others take away business (Dickson and Giglierano 1986). These two complementary types of risk will be described later when we explore the process (steps) of intrapreneuring, especially new product development and associated timing of cash flows.

Miles and Snow (1978) call these traditional corporations *defenders* who adopt strategies to protect their core businesses against perceived threats. In business, as in sports, cards, chess, or debate, the best defense is often a good offense. Miles and Snow call entrepreneurial corporations with strong offenses *prospectors;* they are aggressive at starting or entering new businesses.

Corporations that cannot host aggressive intrapreneurs may miss important chances, as did Hewlett Packard on the exodus of Stephen Jobs, of later Apple fame, and Ken Olsen, who founded Digital Equipment Corporation.

Do corporate managers value entrepreneurship? Do they believe it is important to their organizations? Erik Rule and Don Irvin (1988), with Coopers and Lybrand Consulting Group, surveyed senior managers in 104 corporations. These managers (over 85 percent) responded that their companies are as intrapreneurial as other companies or more so. However, about 50 percent said they were dissatisfied to very dissatisfied. And almost 70 percent indicated they plan to increase efforts to encourage intrapreneurship over the next ten years. Before addressing the process — the how-to — of encouraging productive intrapreneurship, we note three common myths (Kuratko and Hodgetts 1989) and other barriers.

Barriers to Intrapreneurship

One barrier to venturing inside established companies is the myth that entrepreneurs and intrapreneurs lack analytical skills, they "shoot from the hip." This often associates them with a belief that luck distinguishes the successful from those who are not. Research conducted at Baylor University (see Chapter 2) and other places shows that entrepreneurs probe their expected customers and suppliers about becoming firm customers and suppliers. They tend to do lots of homework.

Another barrier is the myth that these people take great risks, that they are gamblers. Again, research places them in the middle of the risk scale, willing to accept more (sink the boat) risk than some, but calculating risks carefully through probing, focused questioning, and other venture preparation.

The third barrier is the myth that entrepreneurs are power hungry, driven to control large business empires. In fact, most entrepreneurs start businesses that remain small. Their activities seem to revolve around the goals of providing "a better mousetrap" (product orientation) or filling a gap in a market (customer orientation). They take great pride in their achievements, but a need for power appears no more in entrepreneurs than in others.

Although myths can be barriers to the use of these people by corporations, the traditional organizations' ways of doing things set up more important barriers. Since Max Weber described and prescribed bureaucracies four decades ago, we have realized that they can be efficient at producing uniform products for stable markets. However, since Burns and Stalker's (1961) seminal research, we have realized that many so-called mechanistic practices of traditional organizations are barriers to innovation. How do some organizations become starters and growers of new business?

Becoming an Entrepreneurial Organization

Having argued that intrapreneurs are important to host corporations' entrepreneurial possibilities and the economy and having looked briefly at myths and other barriers to intrapreneurship, let us examine actions by which barriers can be overcome and intrapreneurship developed. We begin by identifying intrapreneurial people.

Identifying and Hiring Intrapreneurs

Recruiting practices often emphasize bringing in persons who have never experimented, never gone out on a limb, and never innovated. On the other hand, the company can look for people who have invented a product or service or

have started or expanded business. When recruiting young people, find those who have been entrepreneurial while in college or even high school.

Maidique (1980) described a psychological profile of independent, inside entrepreneurs based on a study of 150 of these people. The study concluded by saying the entrepreneurial personality is characterized by an unwillingness to submit to authority, an inability to work with it, and a consequent need to escape from it. Maidique's statements are very incomplete, though findings reported in Chapter 2 corroborate them. The anti-authority profile reported by Maidique helps explain why Rule and Irvin found companies saying they are not doing nearly enough to support intrapreneurship. Such birds are hard to keep caged!

Art Fry, the father of the Post-it note pad from 3M corporation, says corporations should hire intrapreneur types as well as weed out existing ones within the company (*Journal of Business Strategy* 1988). He sees their personalities in positive terms. They are motivated, according to Fry, "mostly to make something happen, to make something take shape, and to come alive as a result of the excitement and the satisfaction of success" (p. 23).

There is a problem in identifying intrapreneurial people within a corporation. When asked, "Are you intrapreneurial?" most people say yes. Further, if exciting projects, "free" time, budgets, and other resources are dangled in front of most employees, they will try to appear intrapreneurial to qualify for such plums. So corporations should not dangle plums before their people, tempting them to pretend to be what they are not. Rather, in many successfully intrapreneurial corporations, the plums (recognition, bonuses, and stock options) come only after the performance. So these prizes and other forms of recognition are rewards for achieving (where entrepreneurs have strong needs) rather than "seducements." Observing the rewards of one employee's innovation encourages the onlookers' initiatives.

3M simply asks, "Is anybody interested in working on this idea?" (Bart 1988). In other words, let intrapreneurs self-select but without lots of preproject inducements.

Another aspect of self-selection is to see which intrapreneurs use their ideas to persuade management to "buy into" the intrapreneurship project. The objective of identifying profitable (innovative) ideas may be more to the point than identifying self-styled intrapreneurs. By providing organic environments and waiting for persuasive ideas, management identifies the best idea and the champion of that idea — the intrapreneur.

Along with identifying key ideas and people, management needs to present realistic job previews to budding intrapreneurs, not just rosy ones. As Fry at 3M says, "failure is the most common thing; success is the least common. The old saying is true. You have to kiss a lot of frogs to find a prince" (*Journal of Business Strategy* 1988, p. 23).

Intrapreneurism is not born painlessly. Albert Shapero (1978) cites a classic situation giving rise to intrapreneurship. "A tradition-bound manager is

brought in from outside and placed in charge of a division whose staff is way ahead of him in its thinking. Technical staff members then face the choice of leaving the company or working their way into independence within it. The intracorporate solution is to hustle funds from other divisions and departments to sustain their endangered projects" (p. 35). This triggering of intrapreneurial ventures Shapero calls displacement. He likens it to other more researched forms of displacement, leading to entrepreneurial behavior on the outside.

Developing Intrapreneurship

Beyond identifying innovative people and ideas, certain personnel practices have a direct impact on the level of intrapreneurship in a company — practices that reflect the values of the top manager. This person plays so many important roles — behavior model, ceremony leader, conflict arbitrator, resource allocater, chief strategist and, coach — that his or her behavior and values are the single most important influence on intrapreneurship. The top manager creates the environment that underwrites risks, absorbs failures, and praises successes, often becoming personally involved, as Lew Lehr did at 3M corporation. "He had his secretary send out some samples of the pads to CEOs in the Fortune 500 and to their secretaries . . . you felt empowered . . . he was an excellent intrapreneur himself and had an ability to spot this trait in others and to provide encouragement" (*Journal of Business Strategy* 1988, p. 24).

At 3M there is a practice of allowing certain professional employees to work up to 15 percent of their time on projects of their own choosing. This practice costs money and can only be sustained where there are slack organizational resources, but something similar is necessary for the development of ideas and products.

Other practices encouraging the intrinsic motivation of entrepreneurs — like the desire to do it because it is exciting, interesting, or fun — are to form small teams that meet often to develop new businesses, to provide feedback especially on successes, and to accept new business ideas.

Practices that extrinsically stimulate innovation revolve around reward systems. Monetary rewards can be used, such as pay bonuses and stock ownership. Another reward is recognition by important people, in special ceremonies or in company publications. Finally, the personnel practices must reward innovation and innovative people differently from people who do not help bring about new business.

In addition to personnel practices, *product and service practices* can stimulate intrapreneurism. A company can target a percent of sales to be derived from new products (those that have been on the market five years or less). 3M as well as Johnson & Johnson and many other companies emphasize sales of products in this category. This measure of performance focuses attention on intrapreneurship.

Company leaders can make product choices. Rather than trying to be all things to all buyers, companies that choose low cost or some product differentiation compete better than those stuck in the middle. Being aware of the stage of the product life cycle helps make sound choices between product simplification and complex product add-ons. As the former president of Pepsico Andrall Pearson (1988) said, the leadership should have a clear idea of the kind of competitive edges being pursued.

Pearson, now professor at the Harvard Business School, also urges corporate leaders to look at their business and markets through the eyes of Japanese rivals. How many customers have they taken from us by producing lighter weight, simpler, and easier to use motorcycles, watches, cameras, and radios? Leaders may help segment markets differently to compete more effectively. Apple computer's focus on the education market is an example. Taco Bell noted that working women were avoiding its Mexican food chain because the food was too spicy. So Taco Bell developed a taco salad served in a light flour tortilla and seasoned very mildly. The salad increased in-store sales more than 20 percent, with 70 percent of this coming from women — mostly new customers. It took Taco Bell nearly two years to (1) get the idea, (2) research and (3) develop it, (4) test market several versions of the salad, and finally (5) launch the winner nationally. There was an obvious risk that this long process could end in failure, but there was another, though less obvious, risk of missing the opportunity.

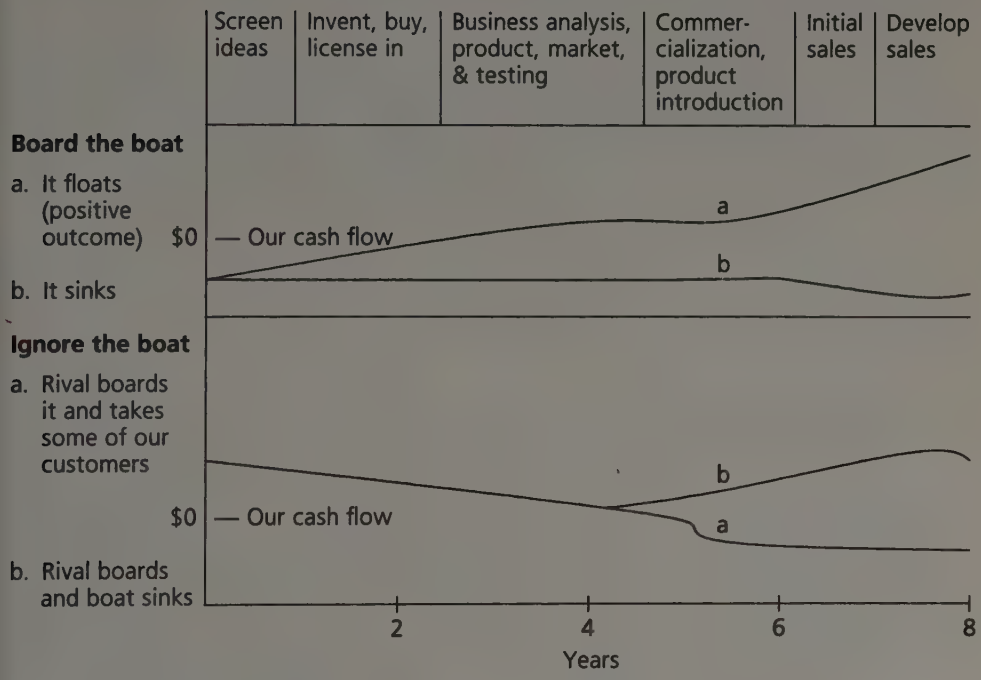
Balancing the "Boat" Risks

Dickson and Giglierano (1986) provide an interesting framework for deciding whether to pursue an innovative idea. Two risks are present. The sinking-the-boat risk (the more visible one) is the likelihood that a new venture will fail; that is, it will substantially fail to reach a satisfactory sales, profit, or ROI target. The complementary risk, of missing the boat, is the likelihood of not pursuing a strategic opportunity out of fear of failure. Nobel Prize winner Herbert Simon (1976) said that managers attempt to achieve satisfactory outcomes, which he labeled *satisficing*, by looking for "good enough" courses of action. His understanding of managers as "satisficers," not maximizers, has influenced our contemporary critique that too many managers do not pursue a wide range of opportunities, only the known ones that promise satisfactory yields.

We examine possible outcomes of a company versus its main rival in Figure 15.1. Here, success and failure are on one axis, whereas our behavior and that of our rivals are on the other axis. The outcomes are inside the matrix. The matrix shows two boxes with unknown or no outcomes, three with positive outcomes, and three with negative ones. Although this matrix may oversimplify the situation, it shows the potential outcomes from accepting or ignoring "the boat," the opportunity to innovate. Now study Figure 15.2, depicting the cash flow outcomes of pursuing or rejecting opportunities to innovate.

Actions on opportunity	VENTURE OUTCOMES Success	Failure
We reject and rival rejects	Would not know outcome	Would not know outcome
We reject and rival accepts	Rival moves ahead of us, takes customers	Rival falls behind us
We accept and rival rejects	We move ahead of rival, take customers	We fall unprofitably behind rival
We accept and rival accepts	Remain profitably even with rival	Unprofitably even with rival

FIGURE 15.1 Outcomes from Missing the Boat and Boarding It



Notes: Board-the-boat negative results show in company cash flow figures from year one, whereas positive results may show only in years 4–6 and beyond.

Ignore-the-boat negative results (from lost sales to rival who boarded the boat) may not show in cash flow until many years after decision to ignore and then may not be directly attributable to an earlier decision. Positive results could follow from ignoring the boat if rival boarded and the boat sank, leaving us stronger than the rival.

FIGURE 15.2 Likely Effects on Cash Flows of Boarding the Boat and of Ignoring It

Managing the Risk of Sinking the Boat

You manage the risk of sinking by careful product testing then market testing, as discussed in Chapters 7 and 8. How can a company manage the risk of missing the boat; that is, increase its pursuit of new business opportunities? Dickson and Giglierano (1986) studied this problem closely and concluded the aggressive company should do the following:

1. Establish bottom-up scanning procedures to find new opportunities, as illustrated by an operative Arm and Hammer employee who observed that baking soda is an effective refrigerator deodorizer.
2. Develop a broad perspective when evaluating the opposition, including the effect on the company of others' products or services. Keep rivals away from customers.
3. Avoid the current decision-making bias against sink-the-boat risk by forming venture teams that can cut through delays of consultation and approval and "crash" the product development and launch time. This action may help avoid group thinking, a creeping commitment to the new product or service that in turn causes rigidity and lack of adaptation during the planning process.
4. Do a careful autopsy if the venture fails. The cause may have been thinking too conservatively, only pursuing sure products.*

We end this brief consideration of intrapreneurship as we began it, by focusing on the individual and his or her idea. Twenty-five years ago D. A. Schon wrote, "no ordinary involvement with a new idea provides the energy required to cope with the indifference and resistance that major technical change provokes . . . champion of new inventions . . . display persistence and courage of heroic quality" (quoted in Maidique 1980, p. 60). Art Fry, an average guy who stayed with some failed sticky stuff until it became Post-it note pads, offered this advice to would-be intrapreneurs, "Choose the things you like to do. You'll work hardest at it and you'll have more successes. If we try to do things that will improve the quality of people's time and business, we're going to be successful" (*Journal of Business Strategy* 1988, p. 24).

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* From Dickson and Giglierno's "Missing the Boat and Sinking the Boat: A Conceptual Model of Entrepreneurial Risk." (July). © 1986 by *Journal of Marketing*. Used with permission.

Summary

Intrapreneurs are necessary because without them companies cannot competitively renew their businesses. Traditional bureaucratic management does not succeed in a dynamic environment. Myths often prevent corporations from hosting intrapreneurs, but established companies can be entrepreneurial by hiring, allowing self-selection, and rewarding these people. Avoiding risks of venture failure must not be allowed to assure the less visible risk of failure to venture. Both types of risk can be managed.

A Closing Comment

Intrapreneuring completes our text study of entrepreneurship. If you have carefully studied these chapters, completed the exercises, and now analyze the cases, you should have a general knowledge and perspective helpful in starting and expanding a business.

Those of you without a technical background, business experience, and money will need to invest substantial time and effort before starting a business. Others, with this preparation behind them, should have found in the book a springboard for initiating action. Further, the latter group will find this material useful as a reference manual for researching particular points once into the start-up process.

Whether you start a new business, assist a friend, lend emotional support, give strategic guidance, become intrapreneurial, or merely become a more educated person, it is our hope that you draw from this material that which you need to help attain your goals.

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PART IV

Cases

A Note on Entrepreneurship Case Analysis

Before discussing case analysis generally, note that case writers and instructors often pose certain questions at the end of their cases. These questions are carefully thought out and answering them will provide learning experiences. In addition, the case questions may emphasize ideas on which you or your group wish to focus. The following comments are about entrepreneurship cases, such as those in this book and others you may examine.

Studying entrepreneurship through cases forms a bridge between learning from a book and learning by actually starting up a company. Cases should take you from ideals or models and to situations you will encounter. That is, your text may contain model standards by which to evaluate or guide the planning represented by the case; however, the case is closer to a specific real situation than a text.

When studying cases to extend text- or lecture-based knowledge, use the text as a guide, checklist, or model to help determine what in the case appears useful, valid, or complete, and what appears useless, invalid, or incomplete. For example, the case-topic table indicates that the Sandy Point Yacht Club case includes decisions in differentiation, market entry, and financing. That is, the focus is on models and suggestions helpful in analyzing, evaluating, and improving those aspects of the case.

The cases and start-up plans you might consult are best approached as feasibility studies. *Feasible* can be interpreted as the revenue-expense breakeven as a minimum (see the chapters on differentiation and low cost positioning). To determine the feasibility of JJ's Marina, for example, estimate fixed costs by month, estimate sales and margins, then calculate whether the margin percent times sales dollars cover fixed expenses. Pizza Delight and most companies will be expected to produce certain income levels to be considered feasible businesses.

There are two approaches to feasibility: (1) Is the projected or actual business feasible given projected sales, expenses, and investments? (2) At what level of sales would the business become feasible? Pursuing the first approach, you carefully project fixed costs, variable costs, and sales; carefully estimate them; calculate profits or losses for chosen periods; then decide if the calculated outcomes are worth risking time and investment. Pursuing the second question, you estimate fixed costs and margin rates under three or four rough plans; divide rates into costs, and see what level of sales is required in each plan; then ask what alternative operations would produce these sales and which of these is most feasible.

The Parsley Patch Business Plan is an authentic plan that was revised periodically as the company developed. It is not edited because it is original, not normative, and not meant to follow a professor's prescription. The first Parsley Patch plan was written in a college class in entrepreneurship.

CASE-TOPIC MATRIX

Text topic	Chapter #	Parsley patch	Sharpco	Sandy point yacht club	JJ's marina	Pizza delight	Hopscotch	Artisan's haven
Introduction	1							
Self-assessment, career	2		*			*	*	*
Preparation, career	3		*		*			*
Start-up ideas	4		*		*		*	
Differentiation	5		*	*	*		*	
Lowest cost	6							
Market entry	7		*	*	*		*	
Who to sell to	8		*		*		*	

Who will supply	9							
Franchises	10					*		
Licenses	11							
Acquisition	12					*		*
Financing	13		*	*	*			
Business plan	14	*		*	*		*	
Intrapreneurship	15							
Appendix: Finance	A				*			
Forms	B							*
Taxes	C							

A useful project using the Parsley Patch Plan would be to rewrite it. It can be "cleaned up," organizing topics according to the business plan chapter arrangement. Analysts can identify items omitted, discuss why, and say how this information (on jobs, costs, sales) could be derived.

Alternatively, the case can be discussed without rewriting, simply suggesting organization and additional information. For example, what is their market? How large is it? What important trends are taking place? How should product development interact with market testing? Note that Bertani and Sherwood correctly emphasized marketing questions.

Another useful approach would be to project income statements, balance sheets, and cash flows for two to four years, perhaps using Lotus 1-2-3, as in Appendix A. The sophistication of these analyses must depend upon the case analyst's training and experience. Forming groups with different skills can create a team more capable than an individual, but this also brings certain difficulties to the task. Whatever the format, the objective of case analysis is to bridge the gap between the text and real life.

CASE 1

Parsley Patch, Inc. Business Plan

Information

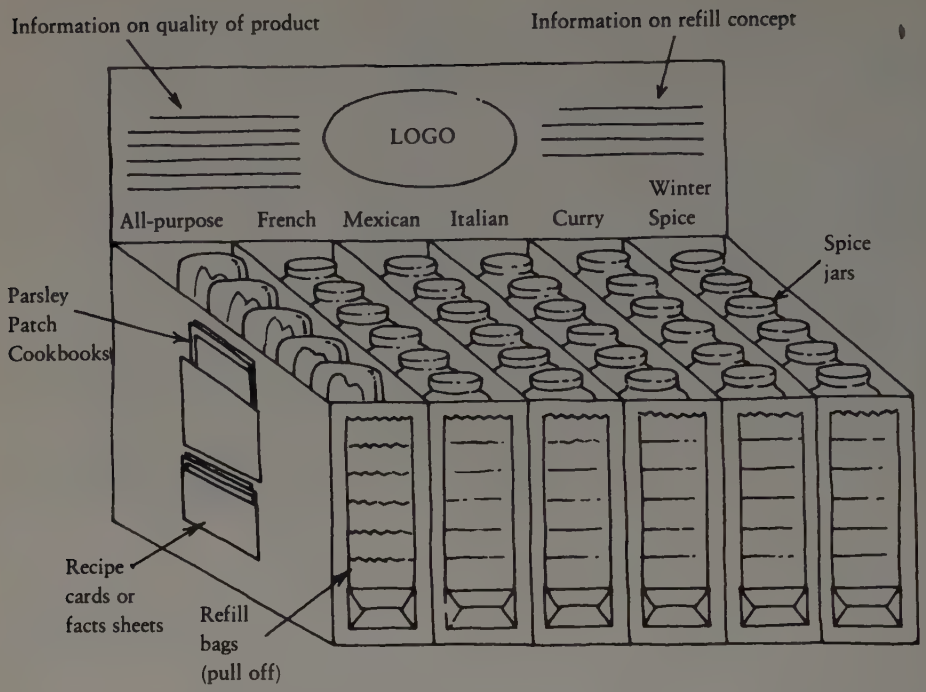
Type of Business and Product or Service

The Parsley Patch is in the business of manufacturing natural spice blends. The line consists of six spice blends, with exclusive recipes developed by the owners. The spice blends are packaged in refillable and decorative old-fashioned jars. Cellophane refill bags will be offered at the same point of purchase as the jars. Promotional strategy will focus on educating the consumer regarding the availability of refill bags. The six blends and refill bags will be housed in a custom-designed point-of-purchase display case. [See Figure 1 on page 240.]

The blends will be sold to retail food, specialty, and gift shops. Agent and merchant middlemen will be contracted with as business expands. The final users are consumers who will purchase Parsley Patch blends in-store.

Parsley Patch, Incorporated is a new business, manufacturing an innovative product line.

This is a sample business plan and does not reflect policies or practices relating to the current conduct of this business.



Unit will house 12 units of each blend, with an equal number of cellophane refill bags. First display units will be made from scrap redwood; final model will be heavy corrugated cardboard suitable for use as a shipping unit.

FIGURE 1 Display Unit Concept

Offices/Plant

We have leased 1000 square feet of warehouse space at 860 Piner Road, Suite 18. The warehouse is centrally located, being just off Hwy. 101, between Steele Lane and Bicentennial Way. The manufacturing, bottling and distribution/sale of the product will take place from this space.

Personnel

Initially the owners will be the only employees. As the company grows we will hire office and warehouse personnel as needed. We plan to utilize the skills of minority and handicapped workers to the fullest extent possible.

Economic/Accounting

We will realize profits from the sale of the finished product to stores. Prices will be determined by the owners dependent upon manufacturing costs and a to-be-determined profit margin. Our accounting and bookkeeping is being set up by Pat Stoll, CPA, Sebastopol, California.

Inventory

Our inventory includes

1. 5 and 8 oz. Wheaton jars
2. Cellophane bags in two sizes, $3 \times 6''$ and $4\frac{3}{4} \times 6\frac{3}{4}''$
3. Twenty-three 40–60 lb. drums of herbs and spices
4. Labelling and packaging materials

Equipment

1. Hobart Food Cutter and Mixer HCM-450
2. Hobart Metric and American Scales
3. Refrigerator
4. Work Table
5. Desk and chairs
6. Filing cabinet

Names of Suppliers

1. Wheaton Consumer Products, New Jersey (jars)
2. Milvan Company, Newark, California (bags)
3. Whole Herb Company, Mill Valley, California (herbs)
4. Hirshifelder Wholesale Foods, Richmond, California (seeds)

Nonperishable supply prices are stable for six months. Herb prices fluctuate from month to month, but are guaranteed for thirty days. The cost of herbs as a component of cost of goods sold is determined by assuming maximum price for a three-month period. No problems are foreseen with suppliers.

Legal

The Parsley Patch is a corporation. Shares will be privately held, each owner having equal shares. Our attorney is Hilda Hazelwood, Esq., Cotati, California.

We are licensed with the Franchise Tax Board, State Board of Equalization, Sr JH 27-693368.

Insurance Coverage is with Wilkey and Marocco Insurance, Santa Rosa, California. Coverage includes Fire, Extended Coverage and Comprehensive Form General Liability (including product liability).

Health code requirements are to maintain a clean, rodent-free environment. Regulations are obtained from California Sherman Food, Drug and Cosmetic Law, Chapter 4 — Packaging, Labelling, Advertising; and Chapter Seven on Food Sanitation. No health permits are required by law. The County Health Department and County Food and Drug Administration Officers have been consulted.

Trademark and copyright will be applied for.

Future Plans

Phase 1. Penetrate market in Sonoma County and later into Marin, San Francisco, Contra Costa, Napa, and Alameda Counties with original product line.

Phase 2. Expand market to include commercial sales to restaurants and caterers, and implement a mail order program.

Phase 3. Expand product line to include more blends and possibly salad dressings, seasoning mixes. Expansion of product line to include diverse product offerings will be done only after comprehensive marketing data gathering.

Market Analysis

Customers

Our customers are retail stores (grocery, specialty and gourmet, gift) who resell to final consumers.

We are the only product on the market presenting a unified package that answers most cooking needs. Our concoctions reduce the need to purchase costly individual spices. The Parsley Patch concept is unique because we are the

only company offering decorative, refillable jars; we are the first spice company to encourage the recycling/reuse of spice bottles.

Final Consumer Characteristics

Age: 25 years and over
Income: $15,000 and over
Outstanding commonality: looking for premium, gourmet and natural (i.e., unadulterated) food items. Generally well-educated and seeking high-quality products; attracted to recycling ethic.

Market Need

We foresee that our product is a new beginning in what has been a relatively closed market. Our concept will open new avenues to be explored and confidently predict rapid market expansion.

Out research and development activities have revealed positive support for the spice blends and the refillable jar concept. Samples were given to retail store owners and final consumers. Interviews were held with those sampling the blends and ratings given to quality and conceptual marketability. Some questions were raised about the product pricing. However, it was generally felt that the availability of the refill bags as an alternative primary purchase compensated for the price of the jars.

Market Data

The total population of Sonoma County in 1980 was approximately 284,000. The per household Effective Buying Income (EBI)* for 1979 was $19,600. Fifty-five percent of the county's residents earn over $15,000 and 31 percent are between the ages of 25 and 49. This segment of the population is our target market. Spending profiles show that this group has the highest buying power per capita. [See Table 1.]

Santa Rosa is the fourteenth fastest growing metropolitan area in the country, with a projected growth rate of 16.6 percent by 1984. Neighboring counties and metropolitan areas (e.g., San Francisco, Oakland, San Jose) have highly favorable growth projections both in terms of population and EBI. Five of the United State's most affluent metro areas are in California. This information is important to our future expansion plans.

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* *Sales and Marketing Management,* October 27, 1980.

TABLE 1 CITY POPULATION: ANNUAL POPULATION TRENDS, 1970–1980

	Apr. 1970 (Fed. Census)	Feb. 1972 (DOF)	Jan. 1974 (DOF)	Jan. 1976 (DOF)	Jan. 1978 (DOF)	Jan. 1980 (DOF)
Cloverdale	3,250	3,380	3,370	3,630	3,750	3,950
Cotati	1,370	1,630	2,830	2,840	2,840	2,830
Healdsburg	5,440	5,610	5,900	6,175	6,575	7,025
Petaluma	24,870	29,070	31,150	31,200	31,700	32,750
Rohnert Park	6,130	7,280	11,600	13,450	18,000	22,550
Santa Rosa	50,000	56,160	61,700	66,400	73,500	78,300
Sebastopol	3,990	4,100	4,480	4,610	4,810	5,100
Sonoma	4,110	4,800	4,890	5,425	5,725	5,925
Total city	99,160	112,030	125,920	133,730	146,900	158,430
% of change		(13.0%)	(12.3%)	(6.2%)	(9.8%)	(7.8%)
Total uncorporated	105,725	106,230	109,180	116,470	120,900	126,000
% of change		(0.5%)	(2.7%)	(6.6%)	(3.8%)	(4.2%)
Total county	204,885	218,260	235,100	*252,200	267,800	*284,400
% of change		(6.5%)	(7.7%)	(7.2%)	(6.1%)	(6.1%)

* Totals may not add due to independent rounding.

Source: California State Department of Finance.

Environmental Factors

Demographic

Population increases in the immediate target market and expanded market are favorable factors.

Economic

The trend toward consumer purchase of high-quality goods enhances our marketability. The segment of the market in the 35–49 age group has the largest amount of discretionary income; this trend will hold throughout the 1980s.

Ecological

As consumers become more aware of dwindling resources and the benefits of energy and resource conservation, the concept of reusable/refillable bottles is attractive. The refill bags are made of cellophane, a biodegradable material.

Cultural

Attitudes toward "smaller is beautiful" tie in with the Parsley Patch's project image and goal of providing a small but superior line of natural, unadulterated high-quality spice blends. As consumer groups demand more information be made available to the public regarding nutrition and health, we will meet that demand through micro seminars and demonstrations.

Political/Legal

Statutes and regulations may be changed from time to time by the Food and Drug Administration. There is presently a movement toward complete disclosure of ingredients and sodium content of purchased food items. We would welcome this regulation, as it is in our favor competitively speaking. Most spice blends offered by competitors have high sodium levels; many have artificial flavors and colors added that are being tested presently for carcinogenicity. When the consumer market becomes more discriminatory and shops with a focus toward health factors, we will benefit.

Competition

Shoffeitt Gourmet Seasoners in Healdsburg is the closest and most direct competitor. Shoffeitt manufactures a variety of spice blends. He purports to be developing a small line of natural spice blends, but it is not on the market as yet. The average price of Shoffeitt blends, packaged in plastic bottles, is $1.45.

Other major competition comes from the large spice companies, Spice Islands and Shillig-McCormack, who offer a complete line of bottled spices, such as parsley, oregano, etc., as well as blends. We plan to capture some of these sales.

There are a large number of minor competitors, such as Spike and Veg-it.

The image presented by major competitors is basically low-priced, plastic, or inexpensive spice bottles. There are several premium priced European spice blends available in a few high priced stores, but distribution is limited, and in-store visibility is low.

Our most direct competitor, Shoffeitt Gourmet Seasonings, is widely distributed in Sonoma County. We plan to capture 30 percent of that market.

Competitive Advantages and Disadvantages

Our product meets market needs by providing a comprehensive set of spice blends useful in the kinds of food most frequently prepared in target market kitchens. At present, no other company is offering natural gourmet spice blends in decorative refillable bottles. Our point-of-purchase display unit, which is in the design stage, will house the entire product line. It will be 18″ in length and is designed to be self-contained and an attractive addition to the retailer's shelves.

The benefits of the display unit are

1. It neatly houses the Parsley Patch product line and is self-feeding (that is, as one bottle is removed the next one slides down providing an orderly appearance)
2. It draws attention as a point-of-purchase display
3. It provides a competitive advantage with its high visibility. Furthermore, the self-contained unit prevents the displacement of our product line by competitors' products.
4. The Parsley Patch cookbook, still in the formative stages, will provide original recipes specific to the various blends. It will also provide cooking and nutritional information, such as the use of salt and fats in

the diet. This is an innovative idea not done by another competitor. The availability of tear-off recipe cards will also enhance sales.

Disadvantages

High price, unknown name, faithfulness to already established brands; low distribution initially.

Projections

Distribution of sample product to consumers and several store owners has generated interest among a cross-section of consumers. Four key stores in the Santa Rosa area have verbally agreed to carry our product. Heavy selling will begin when labels are complete and prototype display units are ready.

Market Strategy

The design and style of the spice jars, refill bags, and point-of-purchase display are original and very attractive. The uniqueness of the concept (i.e., attractive bottles with refill bags, housed in a handsome display case) will be an inducement to the retailer to purchase the product line. The cookbook, and free recipe cards with nutritional information sheets, provide a competitive advantage. The unified concept, based on high-quality, hand-blended natural spices with a personal statement of philosophy to be printed on the label, will be to our advantage. In our first phase, Sonoma County, we intend to strongly emphasize the localness of our product line. There is a favorable connotation to Sonoma County — with the many wineries and Farm Trails offering fresh produce and unique wares. We intend to capitalize on this advantage in the county and in surrounding counties in the Bay Area.

The relatively high price of the spice blends is commensurate with the appeal to our target market. We are asking premium prices for a premium product. Store sales in high-end specialty and gourmet markets bear out that people are willing to pay for high-quality goods. Even so, when the retail price of an attractive spice jar is coupled with the cost of filling that jar with a spice blend, the price is not inordinately high.

Initially, selling and distribution will be handled directly by Parsley Patch. Shipping by most reasonable means will be done where indicated, as out-of-county sales come in. Agent and merchant middlemen will be employed as the company begins to grow. Careful cost accounting will be done to determine the most feasible means of delivering goods to wholesalers and retailers.

Promotional Strategy

In-store demonstrations and talks will be given to promote the product line. Advertising support will be obtained through newspaper advertising. *Parsley Patch Cookbook* will be a promotional tool as well.

Management

1. Financial statements attached [not included here]
2. Personal family budgets attached [not included here]
3. Prior experience
   A. Small Business for Women SSU
   B. SBA Workshop, San Francisco, August 1980
   C. Marketing SSU
   D. College graduates, June 1981, Sonoma State University
   E. Husbands with sales expertise
   F. Network of friends, relatives in retail, wholesale trades; insurance; accounting; law; real estate. For every need we have, one of the partners has a close contact who has enabled us to obtain free counsel and or services.
   G. Partners have extensive prior job experience.
4. Time management: Times will be designated on a daily, weekly and monthly basis for manufacturing, selling, accounting and review. A weekly planning and review session will be held, during which a weekly accounting will be done and plans made for the coming week.

Financial

Present Funds

$2,000 personal contributions by owners
$5,000 student loans through Sonoma State University
$7,000

Estimated Start-up Costs

Hobart food mixer	$5,000.00
Chris Blum Productions	3,000.00
Wheaton Consumers Products	3,000.00
Legal fees	1,000.00
Rent and utility deposits	800.00
Leasehold renovations	200.00
Herbs	500.00
Cellophane refill bags	200.00
Display units	1,000.00
Shipping boxes	300.00
Desk, filing cabinet, chairs, misc.	1,000.00
Advertising	1,000.00
Printing	2,500.00
	$19,500.00

Product-Line

All-Purpose Blend

A bold blend of sesame seeds and herbs that adds depth of flavor to vegetables, soups, omelettes and egg dishes, grains, legumes, casseroles, salads, meats, poultry, and fish. The merging of our blend with whole foods and love will nourish body and soul.

French Blend

A subtle blend of herbs and spices that re-creates the essence of a French country kitchen. Excellent in quiches, omelettes, souffles, soups, vegetables, salads and salad dressings, fish, fowl, and beef. Try substituting this blend for the herbs called for in traditional French recipes.

Italian Blend

A blend of spices that calls forth the warmth of an Italian kitchen. Use in sauces, pasta dishes, casseroles, pizza, frittatas, vegetables, egg dishes, salads and salad dressings, dips, and soups. Experiment and enjoy!

Mexican Blend

A robust blend of spices that delivers vitality to Mexican dishes. Excellent in chili salsa, enchiladas, tacos, chili beans, huevos rancheros, chile rellenos, cheese dips, and guacamole.

Curry Blend

A lively blend of spices that captures the intrigue of distant lands. This heady and aromatic blend is delightfully suited for all curry dishes, rice pilafs, bean dishes, and dips.

Winter Spice Blend

The spirit of simple living is summoned by the memory of home-baked muffins, apple cobbler, pumpkin pie and the warmth of the hearthstone. Continue this tradition of love in baking that nourishes and soothes the body and soul. Especially suited for use in ginger breads, apple and pumpkin pies, fruit and spice breads, cookies, muffins, french toast, and sweet potatoes.

CASE 2

Sharpco, Inc.

Arthur Sharplin

The most important thing is making money. We're pushing harder than ever to do this. My wife Wanda and I want Sharpco to pay off all its debt. This is mainly a psychological problem to me. The company went through a cash crunch when business turned up in March. Had to borrow another $30,000. That's uncomfortable. Besides, we have a better use for the $10,000 Sharpco pays on debt every month. It could be invested in used tractors for parts. Selling used parts is our most profitable business. And, it takes almost none of my time.

We're doing several things to increase profits and keep the workload under control. We keep on inching prices up. I have just raised the published charge for shop work to $29 an hour, from $26. We charge $10 extra for overtime. It costs us only about $5 more. Our customers don't know this but we put $32 per hour, instead of $29, in lump-sum bids. And we always beat the flat-rate times used in the bid calculations. I talk to the men frequently about getting the billing out as soon as the work is finished and making sure every bolt and nut gets charged.

Used with permission of Arthur Sharplin.

> Every person here believes in what we are doing. They work as a team. And we have a nice facility — good location, nearly new building, great computer system, the best shop equipment. No competitor, not even the Caterpillar dealer, can match our quality. We've been working six days a week for months. I am even holding up our latest advertising mailout because we can't handle the business surge they always produce.

These comments were made in mid 1988 by James Sharplin, owner of Sharpco, Inc. of Monroe, Louisiana. Sharpco provided repair service; new, used, and reconditioned parts; and welding and steel fabrication for crawler tractors and other construction equipment. Figure 1 shows the company's location.

Background

Art, Jerry, and James Sharplin worked as teenagers and young adults at their father's welding and automobile repair shop in the small town of Delhi, Louisiana. The family had moved to Delhi in 1954 after years of sharecropping, during which Mr. Sharplin had worked intermittently as a mechanic and equipment operator. Art was the third of six brothers, Jerry the fifth, and James the youngest.

Art joined the Navy in 1960 and served eleven years. He attended night school at Memphis State University during the late 1960s, earning a business administration degree. Jerry studied engineering in college and later became a skilled steel fabricator and an industrial construction superintendent, mainly supervising work in chemical plants in and around Baton Rouge, Louisiana. In the meantime, James attended college, majoring in business management, and became a shop supervisor for the Caterpillar dealer in Monroe. Neither James nor Jerry ever graduated from college.

After Art left the Navy in 1971, he and Jerry formed a small but instantly profitable construction firm in Baton Rouge, which they soon moved to Monroe, Louisiana. In late 1971, they invited James to join them in business, with his small equity investment to be paid from company profits. The three made plans to open a steel fabrication shop as an adjunct to the contracting operation. They bought a relatively isolated parcel of land at the eastern edge of Monroe and built a $49' \times 49'$ shop building, mostly of used materials. At Jerry's suggestion, the company name was changed to Sharpco, Inc.

Almost from the first, James worked full-time at the Monroe facility. Jerry was in charge of the construction operation. Art was responsible mainly for finance and administration, although he spent many hours working in the shop and on construction jobs. He also traveled back and forth to Louisiana

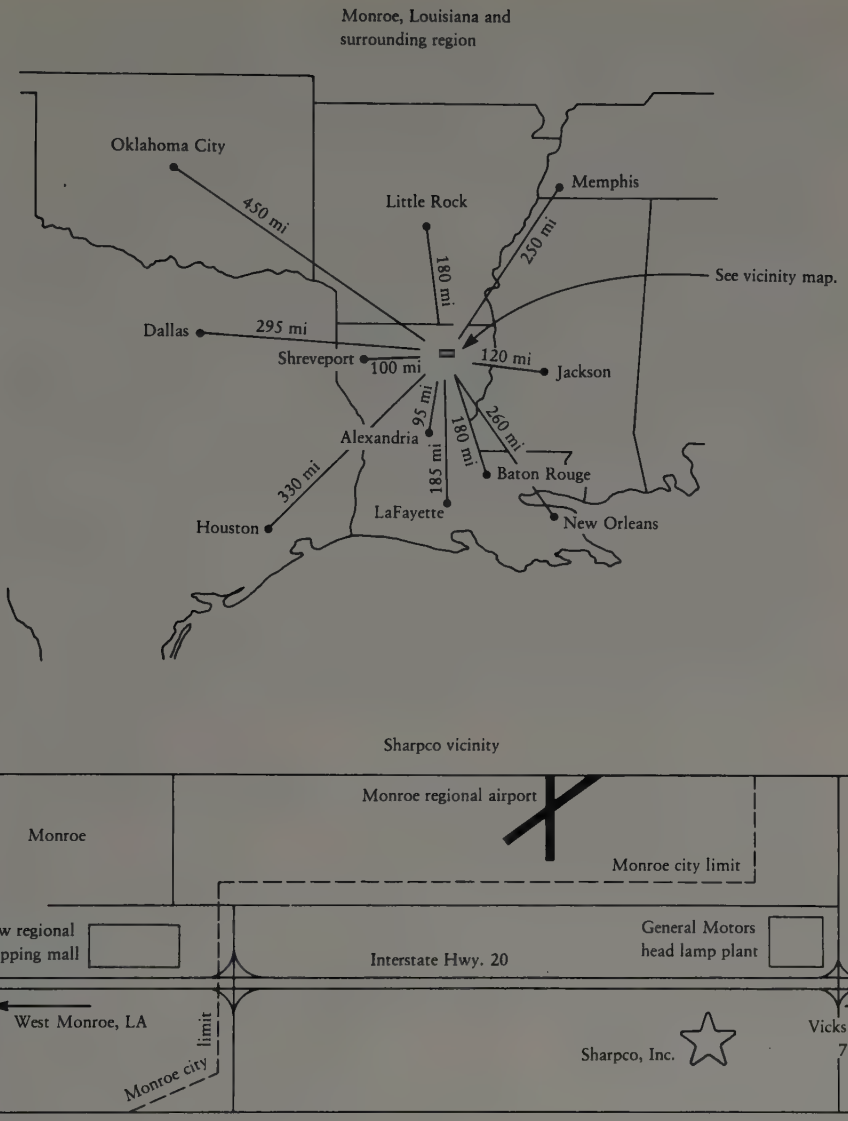


FIGURE 1 Sharpco's Location

State University, four hours away, where he was pursuing graduate work part-time.

Until about 1974 the Monroe operation was basically an unspecialized welding shop. Typical items fabricated included steel tanks and hoppers, welded beams and columns for buildings, farm equipment components, and so

forth. The firm also did repair welding, often in area fields and factories. The shop was outfitted with a growing hodgepodge of tools and equipment, much of it having been purchased for this or that construction job. In addition to regular "stick" welding machines, powered by gasoline engines, there were semiautomatic welders for use only in the shop.

Recalling those early days, James said, "We had our shoddy little shop and very little concrete outside. The area was low; we reclaimed it from a cotton patch. So we worked in the mud a lot. When it rained the commode would back up. And the roof leaked — not enough slope. The office was a construction shack. We seemed a rough bunch, I know, but there was no shortage of enthusiasm, dreams, or willingness to work."

Through the last half of the 1970s, Sharpco grew and changed. James began soliciting repair work on heavy bulldozer blades and other high-strength welding projects, often for customers he had known at the Caterpillar dealership. In 1975 he designed and fabricated his first land-clearing blade. That year the shop also began doing "undercarriage" repair, replacing pads and doing other mechanic and welding work on the heavy tracks that drive crawler tractors. An increasing amount of new and used steel, particularly of the triple-strength "T-1" variety, was kept in inventory. Much of the steel was cut to size and sold at retail, mostly to customers who did their own welding. Art wanted to develop this as a major business. He made several substantial purchases of distressed steel inventories. Both the shop and construction operations grew more profitable.

In the mid-1970s the operations were separated into Sharpco, Inc., owned by James and Art, and a construction company, owned by Jerry and Art. James added a respectable office in 1976 and doubled the size of the shop building. He bought Sharpco's first major new machine, a $36,000 "track press," which allowed the firm to provide complete undercarriage service for crawler tractors. A 12,000 square foot building was added in 1979 to house the steel sales operation. That operation was never very profitable, however, and would be phased down beginning the next year.

In 1980 Art exchanged his interest in Sharpco for other assets the Sharplin's had accumulated. In 1984 Art proposed that he build and finance a new facility for Sharpco, on property he had reserved for that purpose next to Interstate Highway 20. James and Wanda agreed and construction was started that fall. Art's son, Danny, then 22, had a small construction firm. He supervised the construction project, doing most of the actual building erection himself. Sharpco opened in its new location in January 1985. Figure 2 shows the plant layout. James described his new plant:

> Art and I made sure everything was just like I wanted it. The location was right, a 4.5 acre lot on the I-20 Frontage Road. With 30,000 square feet under roof, we had room to grow. It has been more than three years and I still think the layout is very nearly

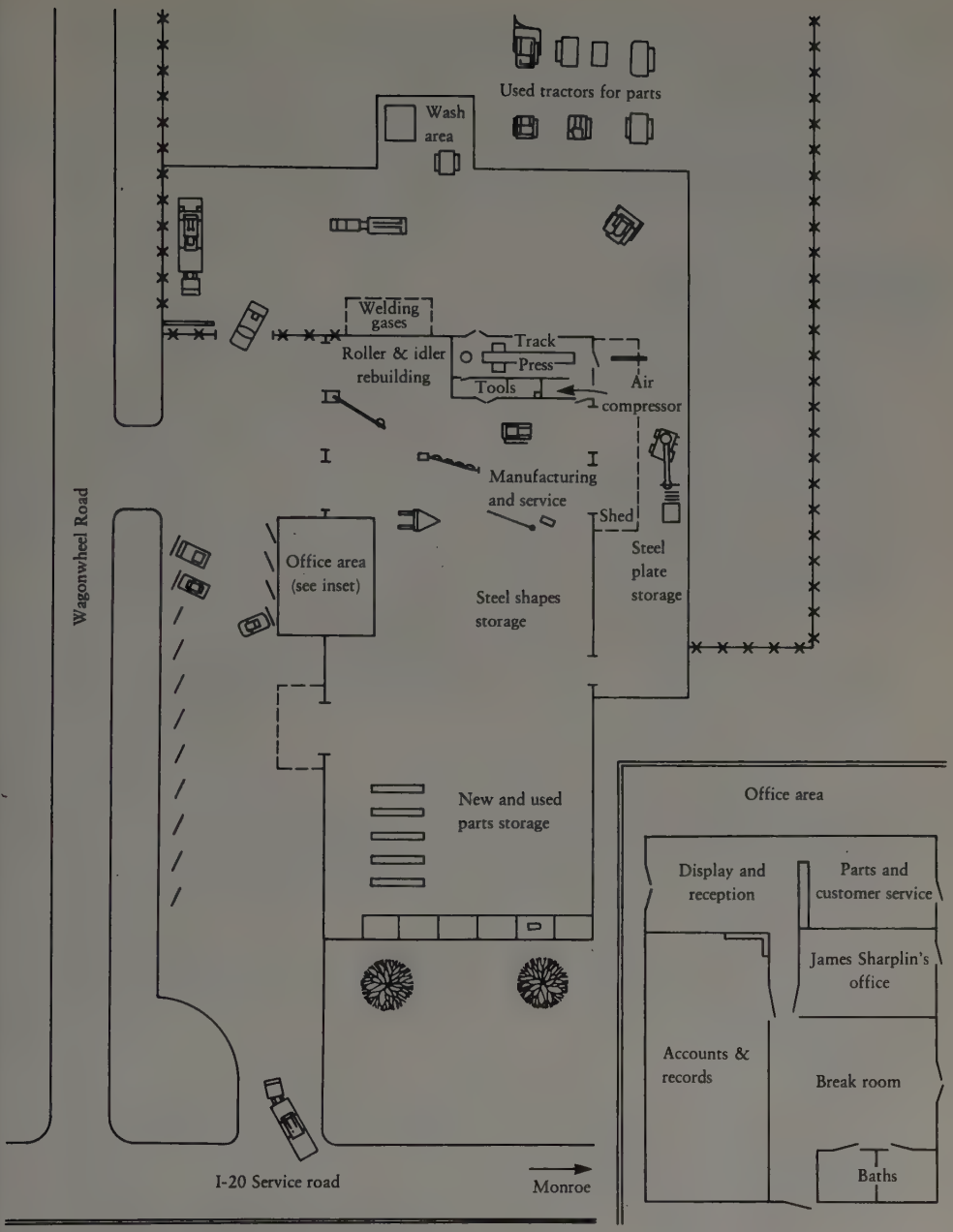


FIGURE 2 Sharpco Plant Layout

perfect. We used extra-strength concrete with plenty reinforcement. Danny did the building shell, but I built the office area myself. Art knew no one else could satisfy me there. I also put in the electrical, air, and water systems. We put in heavy columns to support overhead cranes. But we decided to wait on the cranes until I could afford to do it right. I put them in in 1987.

Personnel and Organization

After 1980, the work force at Sharpco varied from as many as thirty down to its 1988 level of sixteen. As a general rule, Sharpco had kept a cadre of experienced workers and filled in with temporary welders and mechanics during busy periods. But James said, "I have become disillusioned with that idea. As we became more sophisticated, there was no room for workers who didn't know our system, and what I expect. Now, we just strain through the busy periods — raising price, working long hours, letting the backlog run up. Slack times are infrequent, but we can always build a blade or bucket for inventory, or we can tear down a used tractor and put the parts on the shelf."

Table 1 gives information about each Sharpco employee as of July 1988. Jerry and Jimmy Thompson were brothers and James's grandnephews. Tim and Jeff Sharplin were sons of James's older brothers Tom and Leon. Glyn Jordon was Art's nephew by marriage.

There was never a formal organization chart for Sharpco. However, the diagram in Figure 3 was drawn by James to give an idea of the organization structure as it existed in 1988. The lines of authority at Sharpco were not rigidly followed. James routinely bypassed each of his direct subordinates and dealt directly with workers. "The managers all work as a team," said James. "Any one of us can make a major or minor decision — or write a $10,000 check." Everyone in the organization was expected to pitch in wherever there was a need for extra help and to accept direction from whomever knew most about the particular job being done. Asked to comment on his four managers, James said,

> Jerry is dedicated to Sharpco. His decisions are always close to what mine would be. He is a good welder and the best all-around mechanic we have. The men respect him and that helps make him a good manager. Customers like him; they ask for him. They know they can depend on what he says. He has a good memory, too. He usually can say if we have a part without even checking the computer. Jerry's main recreation is hunting. I try to make sure he has some time off during hunting season. He and Peggy are the two people I could never imagine doing without.

TABLE 1 Information about Sharpco Employees

Name	Age	Tenure	Position/Skills
James Sharplin	43	16	Owner
Peggy Turnage	51	10	Office manager/clerical, computer, administrative
Marilyn Baugh	21	2	Clerk/clerical
Jerry Thompson	34	14	Shop manager/master mechanic and master welder
Tim Sharplin	28	7	Used parts and warehouse manager/mechanic, welder
Glyn Jordan	31	12	New parts manager, counterman/welder, mechanic
Glen Eppinette	47	3	Engine, transmission mechanic/master mechanic
Gene Lowe	31	10	Lead welder/master welder, mechanic
Juan Hernandez	35	10	Track press operator/master track mechanic, mechanic
Jerry Hodges	42	12	Welder/mechanic
Rodney Gee	27	8	Truck driver/mechanic, welder
Jimmy Thompson	38	3	Mechanic
Jeff Sharplin	28	2	Welder, mechanic helper
Billy Gresham	30	0	Welder
James Moore	52	0	Custodian

Note: A "master welder" or "master mechanic," according to James Sharplin, was one who knew all important aspects of the job and was able to do it well. For example, a master welder could do complex layout work, in addition to welding skillfully; and a master mechanic could rebuild engines and transmissions, all without supervision.

Peggy has taken a number of college courses but she has taught herself more than most college graduates ever learn. She is the most cost-conscious person in the whole organization, including me. Somehow, Peggy and the computer were an instant match. She is a highly religious lady. I think this accounts to some degree for her diligence, and I know I can trust her with anything I have. There has never been the slightest need for me to check up on her. Everyone here respects her and her presence helps keep foul language and rowdy behavior at a minimum. Peggy usually is miles ahead of me with any information I need — like sales statistics. She put the used parts on the computer without any guidance. And the information was in a form she knew I could use. If things move too fast she just works nights and Saturdays. She does all the advertising better than

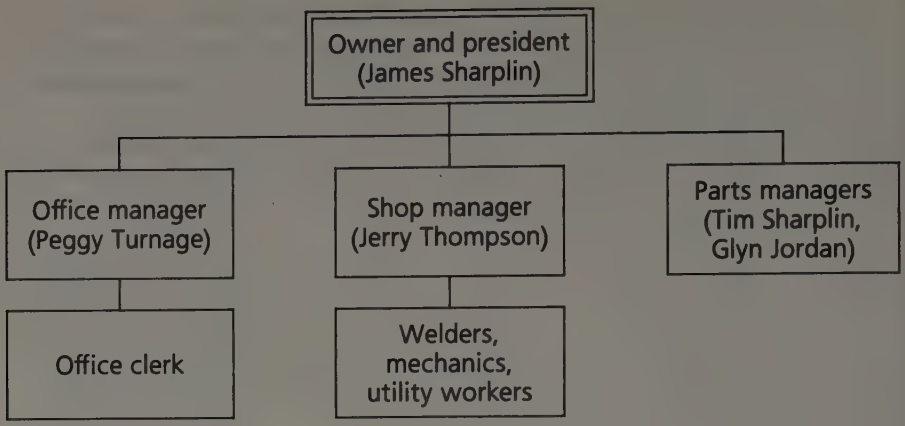


FIGURE 3 James Sharplin's Representation of the Sharpco Organization in 1988

any ad agency could. She comes up with the ideas, does the copy, and just runs it by me for approval. Peggy is a perfectionist.

Tim's life is strictly work, family, church, and school. He attended the university part-time until last semester, studying business. Tim has a good number of outside obligations, including school. But whenever I need him he is there. He asked me if he should let his school wait while we were swamped last year. I told him that he might take one course instead of two, only if he thought it best. But I felt he should continue his education without a break. Still, he decided to skip last semester. He works hard — wants to do things right. He grew up on a farm, where he often had neither the time nor the equipment to do high-quality work. He had to come almost from ground zero — learning welding, learning crawler tractors, learning fabrication. He has taken on more and more. He's selling a great deal over the phone. He personally sees after every piece of equipment we tear down for parts, keeping up with the components we recondition, keeping the warehouse area in order. He receives every part, whether new or used, and makes sure it goes on the computer. Also works in the shop a good bit.

Glyn went to work for me the first time in 1976 for $3.50 an hour. Today he makes $2,060 a month. One of the most important people at Sharpco. We let him go several times; couldn't find just the right spot for him. He's possessive. Likes an area that is his and that has status. He never liked grease and grime, although he is a darn good mechanic and welder. I suddenly realized one day I had

the perfect job for him, working on the national used parts network and with the computer screen, microfilm, and parts books. I called Glyn and he came back the next week. Any time we buy a new or used part, something is said to Glyn about where to get it. Nine times out of ten he buys it. He knows where the cheapest prices are, even for small items. He does all this plus takes care of every customer who comes in the front door and a great many of the call-in orders, too. He and Tim have our parts business under control.

There was no formal performance appraisal at Sharpco and no written compensation policy. Sharpco furnished medical insurance for James (Peggy was covered under her husband's policy, furnished by his employer). The company paid for health insurance for each employee, with them paying the cost for dependents. The managers were paid salaries. Hourly paid workers made from $7 to $11 an hour, about average for the area. Every year, James said, he ranked the employees in order of what he considered their contribution to the company. Then he adjusted the pay of any whose pay seemed inequitable. Practically all hiring and firing was done by James personally, although Jerry had authority to terminate any worker.

Operations

As indicated earlier, Sharpco's three businesses in 1988 were repair service; new, reconditioned, and used parts sales; and welding and steel fabrication for heavy equipment, mainly crawler tractors.

Crawler Tractor Repair Service

Machinery and components to be repaired usually were brought to the Sharpco plant on customer trucks, although Sharpco did keep several trucks of varying sizes to make pick-ups and deliveries when necessary. Practically all of the equipment that came in to be repaired was covered with dirt and mud. Cleaning was done in the wash area using a special high pressure washer and steam cleaner.

The major components of crawler tractors normally needing repair include undercarriages, final drives, steering clutches, transmissions, and engines. Figure 4 shows a typical crawler tractor with the main relevant parts labeled. The undercarriage is that part of the tractor nearest the ground, including the heavy steel tracks along with rollers, sprockets, and structural members designed to pull the tracks and keep them in alignment. The final drives are large

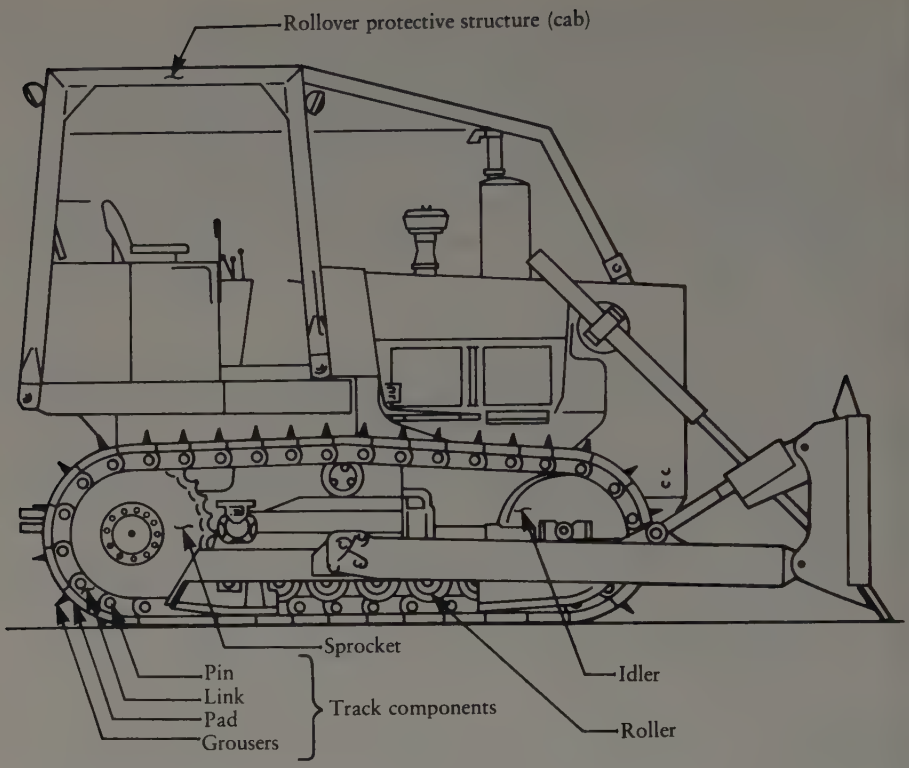


FIGURE 4 A Typical Crawler Tractor

gear boxes on both sides of the tractor that transmit power to the tracks. In Figure 4 the final drive is hidden from view behind the sprocket. The steering clutches are located above and between the final drives. They allow either the left or right final drive to be disengaged so that the brake can be applied on the respective side, causing the tractor to turn. The transmission is a gear box near the center of the tractor that transmits power from the engine through a large gear to the steering clutches.

The tracks and related components cannot be insulated from the sand, dirt, and gravel in which a tractor usually operates. Consequently, all of the moving surfaces wear away steadily, especially those in contact with one another. The track chain is similar to a large bicycle chain. As the track is pulled by the sprocket around the idler and rollers, the pins wear out mainly on just one side. Each pin fits into a bushing that also wears out in the direction of the stress. A typical undercarriage will require major repair after 3000 hours of use and overhaul after 1500 additional hours. Major repair consists of removing the tracks and turning each pin and the respective bushing half around so that

the least worn surfaces are in contact. To do this, a portable hydraulic press is used to press out one of the pins. This may require 200 tons of force. Then the tracks, weighing as much as 3,000 pounds each, are moved to the track press, where the remaining pins are pressed out, along with the respective bushings. All parts are then inspected and the tracks reassembled with the pins and bushings in their new positions. While the track is off, all undercarriage components are inspected for cracks, leaking oil seals, excessive wear, and other defects. Of course, any needed repairs are made before the tractor is reassembled.

When a major overhaul is due, pins and bushings are replaced, idlers and rollers exchanged or reconditioned, and new sprockets installed. About every second major overhaul, worn grousers have to be cut off and new ones welded onto the track pads. The entire track chain also may have to be replaced. Less frequently, final drives, steering clutches, transmissions, and engines require repair. These components are sealed from the grit that affects the undercarriage, are bathed in oil, and have close clearances. The final drives are essentially integral with the tractor frame, so they are repaired in place. But the other oil-bathed components typically are moved to a clean room area for disassembly and repair. Of course, minor repairs and adjustments often can be made to any component without removing it from the tractor.

Sales of New, Used, and Reconditioned Parts

James said, "There are three reasons I will put a new part in inventory: if it is a fast-moving item, if it is a low-cost part that can hold up shop work; or if the discount is so high I just can't resist it. Of course, I am not going to stock any part unless we have a good demand history on it." Tim Sharplin added, "The stocking quantities are in the computer, but I just walk through with a summary sheet when it is time to order for inventory. Or I order when the last part comes out of a bin."

The heavy, hardened tractor parts such as track chains, rollers and shells, pins and bushings, and gears were made mainly by subsidized firms in Italy. Sharpco purchased them through major distributors in, for example, Jackson, Mississippi, New Orleans, and Dallas. Glyn Jordon remarked, "We have often thought about buying these parts direct from Simmel and Ital (two Italian companies) to pick up an extra 10 percent or so. James even went to Italy to learn about the industry. But we get overnight delivery from the distributors, by common carrier. I think financing and handling a big inventory would eat up any gain." In 1988 a Jacksonville, Florida, distributor offered to have containers (each about 40,000 pounds, about $1 a pound) of parts drop-shipped from Italy at an average savings of about 7 percent off Sharpco's recent f.o.b. cost. James said, "I might do that for the hot items. If we choose right, that inventory will turn every two months. And we can fill in from our regular distributors."

Sharpco's engine components — pistons, bearings, cylinder liners, and so forth — came mostly from U.S. manufacturers, some purchased directly, others through distributors. Glyn said, "Several of the U.S. manufacturers have just merged under JPI Industries. So it is easier for us to buy direct. UPS works better and better for the small parts. I still have to deal with too many suppliers, though. We even have to buy some things from the Caterpillar, Case, and John Deere dealers. They used to try to screw us up — wouldn't get back to us, sent the wrong part, gave smart aleck answers. But they show respect now."

The used parts inventory consisted of about thirty tractors. Most of these had been disassembled, with the important components put on shelves in the warehouse area. After most of the salable parts were removed, the tractor carcasses were sold for scrap. Sharpco was connected to a nationwide used parts dealers network. A computer terminal and printer at Glyn Jordan's work station continually transmitted inquiries and cost and availability information. Orders and shipment confirmations also were sent through this system, often supplemented by telephone calls.

Transmissions, winches, track rollers and idlers, and certain other complex assemblies from the used tractors usually were reconditioned before storage. This involved complete disassembly and inspection, replacement or buildup or worn components, reassembly, and painting. Many assemblies were brought in by customers for reconditioning. Others were removed from customer tractors by Sharpco workers, reconditioned, and reinstalled. For example, as part of one major undercarriage overhaul, the outer rings were cut off both track sprockets (see Figure 4). New rings were welded in place and the assemblies carefully checked. The reconditioned sprockets were then painted before reinstallation. Reconditioning of idlers involved using an automatic welding machine to build up the surfaces that came in contact with the track chains. Build-up of rollers had proven to produce quality problems, so Sharpco replaced the entire shells on them, using undamaged internal parts from the old rollers. Oil-bathed units, such as transmissions, were reconditioned in the clean room, by Glen Eppinette.

Welding and Steel Fabrication

Among the items Sharpco fabricated were roll-over protective structures (cabs) such as that shown on the tractor in Figure 4. Several of Sharpco's customers were involved in land clearing, although that business declined after the mid-1970s. The tractors they used had heavy steel screens welded or bolted around the cabs to protect the operators from tree limbs. Sharpco also made and installed these screens. The cabs and screens were made from ordinary steel. However, most of the items the company fabricated involved the use of high-strength steel, about three times as strong and hard as ordinary steel (and more than twice as costly). Several of the units made using this steel are shown in Figure 5.

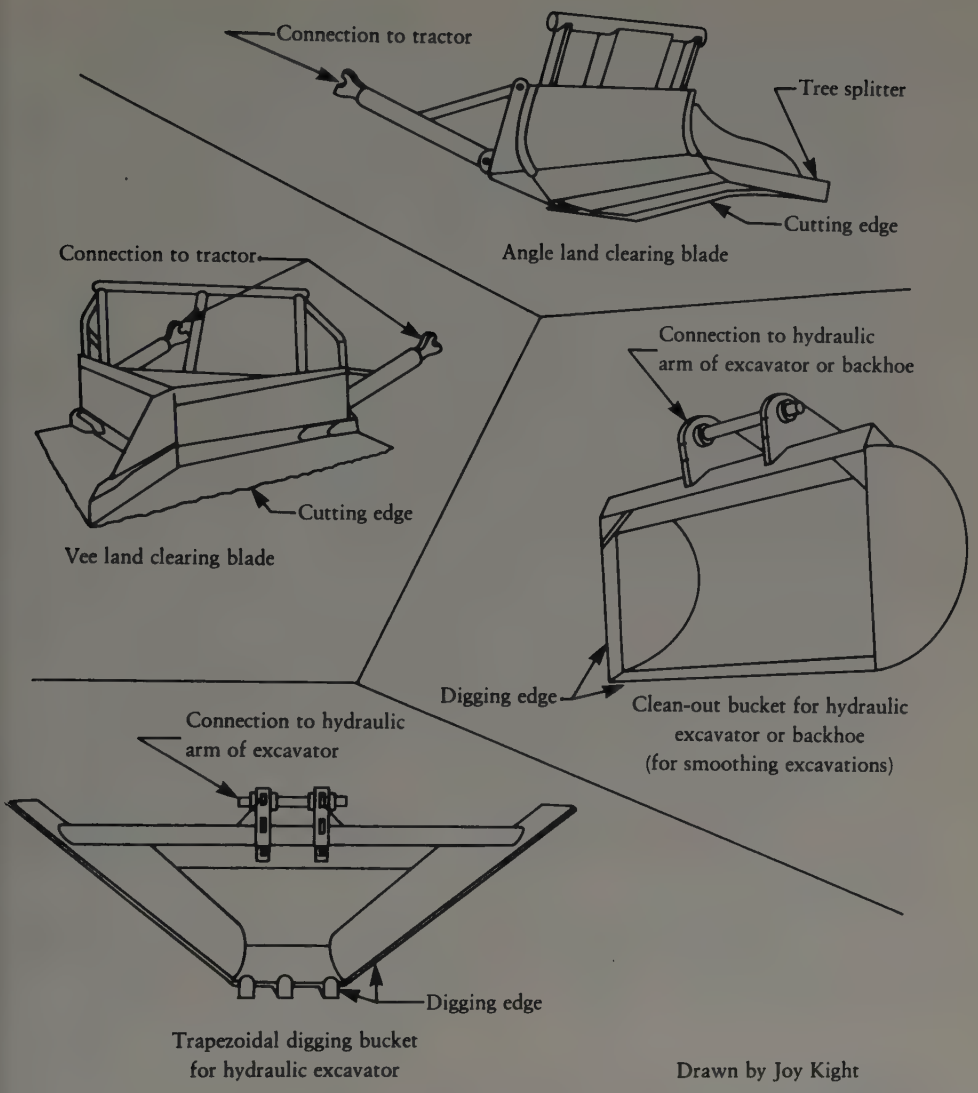


FIGURE 5 Items Sharpco Made Using High-Strength Steel

Special steel was used for cutting edges and strength members on the blades and buckets. This steel was purchased from major steel distributors in $8' \times 20'$ sheets, ranging in thickness from $\frac{3}{8}''$ to $2''$. A portable acetylene cutting torch that runs on a small track was used to cut the steel to shape. Pieces that were to become cutting or digging edges were clamped in a vertical position and the edge cut to a sharp angle using the same kind of automatic

torch. Curved pieces of mild steel (used for noncritical parts of digging buckets) and the steel pins and bushings used to attach the buckets to hydraulic excavators and backhoes were furnished by a local machine shop.

After the parts of a digging bucket or land-clearing blade were cut and shaped, they were welded together just enough to hold them. Then they were carefully inspected prior to final welding. To ensure against failure, Sharpco workers welded all critical points manually, allowing components to cool between layers of weld material. This process required special high-strength electrodes (welding rods). Less critical welds were made with semiautomatic machines, which are much faster and easier to operate than manual ones and which use large rolls of wire instead of individual welding electrodes.

Sharpco digging buckets ranged in size from small standard buckets weighing only 300 pounds to trapezoidal buckets weighing over a ton and measuring 17′ across. A trapezoidal bucket is designed to dig a complete drainage canal as the hydraulic excavator or backhoe to which it is attached slowly drives along the intended canal path, scooping out as much as 3′ of new ditch with each stroke and laying the dirt aside. James estimated the firm had sold fifteen digging buckets during the year ended July 1988, at an average price of $3,500. Sharpco land-clearing blades and rakes weighed up to eight tons. The largest Sharpco vee-blade had two serrated cutting edges, each 20′ long. Pushed by the largest production model tractor made by Caterpillar or Fiat-Allis, one of these blades cleared a swath 16′ wide through timber that was up to 30″ in diameter. Sharpco sold two of these blades, at $24,000 each, in 1987 and one in the first half of 1988.

Blades and buckets require replacement of cutting edges and other wearing surfaces after extended use. They are designed so that the worn parts can be cut loose and new ones installed through a procedure similar to the original manufacture.

Items Sharpco reconditioned or fabricated were painted at the Sharpco plant. Rollers and small parts were simply dipped into a paint vat. Larger items were spray painted.

Marketing

Jerry Thompson told how Sharpco's product and service mix changed from 1974 on:

> When I went to work here, we did mostly welding and fabrication. The steel inventory was small, but it grew. Then we started making and repairing land-clearing blades and doing repair welding on 'dozer cabs and screens. We did out first track in 1975; laid it out on the floor and worked it with hand tools and hammers. A year later

> we had our track press and were doing complete undercarriage repair. That led to final drives, then to steering clutches, transmissions, and, now, engines. We are still best at undercarriage work, but we make better profits on the other stuff. We sell more parts than ever, and we did have a big parts inventory. But we let the big distributors hold most of the inventory now. Our welding and fabrication work shifted almost completely to heavy equipment. We keep just enough steel for our own use. Any that we sell is generally T-1 we cut for customers. Land clearing has about petered out.

Although the customer list totaled more than 1,500, only 15 accounted for half of Sharpco's 1987 revenue. For example, one road contractor was billed $272,831 during the year. And sales to a logging contractor were $136,012. Sales concentration by customer decreased in the first half of 1988, with half the revenue coming from twenty customers. The change was primarily due to a drop in billings to the road contractor just mentioned; the contractor had missed several large bid jobs. Only ten customers were among the top thirty during both periods.

Sharpco's customers included contractors, parish (county) governments, industrial companies (especially wood products producers), large farmers, and other heavy equipment owners, as well as equipment dealers who purchased Sharpco products and services for resale. Occasionally, local equipment dealers employed Sharpco to repair tracks and recondition rollers and idlers for them. The company shipped an increasing number of parts to used parts dealers around the country. Still, every one of the top thirty customers, accounting for 62.2 percent of 1987 sales, was located within a 100 mile radius of Monroe.

Sharpco's overall pricing philosophy, as expressed by James Sharplin, was, "to make sure every sale is a good deal for the customer and to maximize our profit over the long haul." James went on to say he used price as a mechanism to trim sales peaks and to keep Sharpco concentrated in certain types of work. He explained,

> When a backlog starts to build I ask everyone to price more work on a lump-sum basis, and put materials and labor in at higher numbers. Customers usually want fixed pricing anyway, although we make it clear unanticipated problems will result in a call to the customer and a price adjustment. By the way, unlike the OEM dealers we try to catch everything in the estimate. They try to undershoot on estimates, to make sales. Our lump-sum prices usually don't have to be changed. Another method we use to increase prices during peak periods is giving customers the option of shorter delivery times if they pay for labor at overtime rates. Of course, when work is slack we reverse these procedures.

We want to do the most profitable kinds of work and the kinds we are most competent at. For example, I don't want to be in the retail steel business. So we sell steel at double our cost. Until I had the best engine mechanic in North Louisiana and a good 'clean room' we priced engine work high. Now, I want all Glen Eppinette can do. We've done fifty or so engine jobs, with a zero failure rate. Of course, as we get better at something, we can make more money, even at lower prices.

James had written a subprogram to assist in pricing parts. For each item the salesperson simply selected a code from the matrix shown in Table 2. Prices could also be set by entering any of the following codes (where R = replacement cost): F (1.2R), G (1.3R), Q (1.5R), K (2.0R), T (0.95A), E (0.9A), L (0.5A), R (0.4A), S (0.35A), and O (price entered manually). Codes L, R, and S were for used parts only. Glyn said, "I use the codes as starting points, but more often than not I enter the prices of major items manually, adjusting them up or down to stay near list, but below it." Tim added he often priced used parts at near 60 percent of OEM list.

TABLE 2 Sharpco Parts Pricing Matrix

Parts category	B Price	C Price	D Price
Undercarriage groups	0.90A	1.20R	1.15R
Undercarriage items	0.95A	0.98A	1.20R
Final drive and steering parts	0.98A	1.50R	1.40R
Bearings	0.95A	0.98A	1.30R
Winch parts	0.90A	1.40R	1.30R
Housings, frames, and misc. parts	0.90A	1.50R	1.30R
Engine parts	0.90A	1.40R	1.30R
Transmission and related parts	0.90A	1.50R	1.40R
Blade and hydraulic parts	0.90A	1.60R	1.40R
Radiator and related parts	0.90A	1.40R	1.30R
Bolts and nuts	2.80R	2.00R	1.50R
Seals and gaskets	0.98A	1.60R	1.40R
Filters and lubricants	1.70R	1.60R	1.50R
Steel	2.00R	1.70R	1.50R
Electrical parts	1.50R	1.40R	1.30R

Note: A = OEM (original equipment manufacturers, such as Caterpillar and John Deere) list price and R = replacement price. OEM list prices were keyboarded from price lists obtained through an association Sharpco had joined and from cooperative employees of certain dealers. Replacement price was calculated by the program as the average price paid, including freight, for units taken from stock. It was entered by the salesperson for buyout parts.

In general, labor was priced at $29 per hour, $39 if for customer-authorized overtime. As mentioned previously, other hourly rates sometimes were used in calculating lump-sum bids. For most standard operations, James had entered flat-rate labor prices into the computer data base. The flat-rate prices were calculated using $32 an hour and "liberal" time estimates. Even then, James often adjusted the rates upward when he learned he was well below what OEM (original equipment manufacturers, such as Caterpillar and John Deere) dealers were charging for any operation.

Glyn Jordon explained how pricing was done on one job:

> Here is a Peck Construction invoice for $12,909 I just priced. A few weeks ago I went up to Truxno (about 50 miles from Monroe) and helped Benoit Holloway (the owner) set the load on some taper bearings we had furnished. He and I looked over his final drives and undercarriage and talked about repairs they needed. Later he just brought the tractor by and told me to have it fixed. We replaced the bottom track rollers and overhauled both final drives. I suppose Benoit just trusted us to treat him as well as we could. Oh, I talked with him about the price of two or three major components, and Tim did, too. But we never really priced anything until the job was completed. I generally selected C pricing but used Q or K when that didn't get us up against OEM list. I had trouble getting the margin up on this job, because we made a mistake and had to spend about 35 hours correcting it. Benoit should not pay for our mistake. Besides, he does most of his own work and knows how long a job should take.

All invoices were reviewed by James or Jerry Thompson before presentation to customers. A summary sheet printed by the computer with each invoice revealed "cost" and "profit" information. *Cost* was calculated using $22 per hour for labor, whether regular time or overtime, and "replacement cost" for parts. As mentioned earlier, replacement cost was average cost, including freight, for parts taken from stock and invoice cost plus freight for purchased items. A check of summary sheets for eighty-eight invoices written during June 1988 revealed the following information:

Main items invoiced	Total billed	Total cost	Profit
Parts	$ 27,422.54	$17,469.54	$ 9,953.00
Undercarriage repairs	28,254.15	20,633.11	7,621.04
Repair Oil-Bathed items	15,635.84	10,163.51	5,472.33
Total	$105,756.59	$69,983.60	$35,772.99

Sharpco priced its digging buckets at or above dealer list prices. According to James Sharplin, this was justified because the Sharpco buckets had a significantly lower failure rate than those equipment dealers furnished.

Sharpco's primary means of promotion was direct mail. James said, "If we find out someone has a crawler tractor or other piece of heavy equipment we put them on the list. There are about 2,000 names on it now. I try to get a mailing out every quarter. But when we are busy, we don't get around to it." James said he planned to do a special mailout emphasizing Sharpco's willingness to loan out its final drive press and portable track press and to help customer mechanics with special problems. Though there was no requirement they do so, customers usually bought any needed repair parts from Sharpco when they borrowed its equipment.

The firm spent about $700 a month on telephone yellow pages advertising. This provided for one-fourth page under "Contractors Equipment and Supplies," one-fourth page under "Welding," and a business card type advertisement briefly listing Sharpco's businesses under "Tractor Equipment and Parts." During 1986 and 1987, Sharpco had advertised in *The Contractor's Hotline*, a national weekly newspaper offering heavy equipment and parts for sale to about 5,000 equipment owners and dealers. These advertisements cost about $1,400 each quarter, "Too much," James said, "so I discontinued them." He added, "I am going to do some advertising in contractors magazines, though. That is a good way to reach a national market."

Sharpco employed no outside salesperson. James explained, "I have hired three different salesmen. But I could never come up with a good pay scheme. I tried straight salary; but that salesman goofed off, and I fired him. I put one on commission and he got credit for sales he had little to do with. Also, it is hard to find someone with enough knowledge to really help a customer." James required Glyn Jordan, Tim, or Jerry Thompson to call each customer soon after any major purchase "to see if there are problems." And each, including James, spent about a day a week in the field. "In hate 'cold calling,'" said James, "So we only go out when there is a problem to solve, or a customer has called, or we want to check on a major job we have done."

Finance and Accounting

The Case Appendix provides financial summaries for Sharpco based upon unaudited statements prepared by the firm's CPA. Until 1987 Sharpco banked with Guaranty Bank and Trust Company, of Delhi, Louisiana. The chief executive of Guaranty, Jimmy Sehon, had gotten to know the Sharplins when he owned an automobile dealership across the street from Mr. Sharplin's shop. Art, Jerry, and James, along with their spouses, had to sign continuing guaranty agreements with the bank to get the loans Sharpco needed. Art and his wife remained liable on the bank loans until 1986, when they were paid off. In

addition, the bank required a mortgage on Sharpco's real estate and personal property, including inventories. In general, the loans were represented by short-term notes of varying amounts, although proceeds often were used for building additions and equipment. When notes matured they would be "rolled over," usually with some principal reduction.

After Jimmy Sehon retired in 1986, James decided to reorganize his financing. He negotiated a $340,000 revolving credit arrangement with Louisiana Bank, in Monroe. Borrowings were represented by one-year notes. James also set up a $100,000 credit line at the bank for working capital purposes. None of the credit line had been drawn down as of mid-1988. Sharpco gave the bank a mortgage on its Frontage Road land and building, but none on the company's movable property. Art had financed the new facility but agreed to subordinate his mortgage to the bank's. James and Wanda both signed continuing guaranty agreements with Louisiana Bank.

At about the same time, Sharpco borrowed $75,000 at 10 percent interest from a friend of James, who thought that better than holding the money in CDs. James cosigned the note representing this loan, which was unsecured. James made a similar arrangement, for $200,000, with his brother Jerry, at 10.75 percent interest. Sharpco paid off its loans from Guaranty Bank and the debt to Art in 1987, finding it necessary to borrow about $200,000 from Louisiana Bank, also at a 10.75 percent rate. Jerry and his wife had been released from the Guaranty Bank debt earlier and Art and his wife were released at this time. Under the terms of the respective notes Sharpco was obligated to pay $5,200 a month to Louisiana Bank and $5,348 a month to Jerry Sharplin, although the company frequently paid more. For example, Sharpco made a separate $25,000 payment on the Louisiana Bank loan in July 1988.

The Machinery and Equipment account declined as Sharpco wrote off equipment that had been depreciated to zero. This was done to decrease local property taxes.

In mid-July 1988 James made plans to attend several equipment auctions. He said, "I still have about $40,000 in extra cash. That should buy five or six used tractors."

Excerpts from an Interview with James Sharplin

Q: How are sales and profits coming this year?

A: First, let me say we've taken everything that's bad out of accounts receivable. We wrote off Mr. Brewster's $10,000, even though I think he will pay me. I want my accounts receivable to reflect what I think I'll get during the next reasonable period. Up to about the 15th of January, I billed everything into December because I expected 1988 to be better than 1987. Still, I think we'll be 5 or 10 percent ahead of last year's sales by the end of the year. And

with the attention I'm giving the profits. Every job we do I look at the return — the computer prints out all the direct costs on every job and the price, so I know the gross margin. I think we're going to increase profits substantially, although I can't put a number on it.

Q: Do you spend much time in the shop?

A: A day or more a week. I've spent a lot of time out there this year running the automatic welder. I've built up every idler for the last year. And while that machine's running, I watch my people. I really like what I see.

Q: Is it worth the drain on your time?

A: Yes. The people are continually coming by me out there because they view me more as one of them. When I'm in the office, they seldom come in — almost never. I don't spend an hour on that machine that one of the workers doesn't come by and say a word to me about something. People are more friendly. I can solve problems a lot faster and a lot easier. It just occurred to me one day; I'd been out there about two or three months and I got to learning things about the people that I never knew before — know all of their families, all of their kids, when they're playing ball. Just this little bit of interaction has raised the level of — I'll just call it happiness — in the shop.

Q: Do you have a separate personnel record for each person?

A: Yes, but I keep one folder in my desk with everybody's information in it.

Q: How do you use the information you keep?

A: At the end of the year I have every employee in for a fifteen or twenty minute talk. I keep a list of what I gave them for Christmas bonuses last year and the year before. I talk to the people once a year about money. So far I've given everybody a raise every year. It's worked beautifully. Nobody's concerned with how much they're making because I've told them that this is their wage for the year. I've worked to get those wages high so I won't lose them.

Q: How high are the wages?

A: Gene Lowe makes $10.50 an hour. Glen Eppinette makes $10.50. They're the highest paid hourly workers. Compared to other places in Monroe, across the board my people are making generally about a dollar an hour more.

Q: Have you told the people that you won't cut their work week?

A: I've said it from time to time. But it's not a firm policy. They don't expect I ever will because they don't think we'll ever run out of things to do.

Q: What do you see for your nephew Tim in the future?

A: I see him eventually going on and buying Sharpco from me. I see him buying it on a long-term pay-out to me. I want him, though, to get his education, although it hurts a lot. It's not as much getting a degree as more knowledge about business and finance.

Q: Any new expansion plans of any kind?

A: I can't let up and let Sharpco just coast along. It doesn't work for me that way. I believe that within the next five years, we'll have to add on to our facility. I had no idea I could build a 30,000 square foot facility and fill it up within three years with work. And we are filled up.

Q: Is there a Sharpco philosophy?

A: I think it's in caring about what you're doing; caring about who you're doing it for; and caring about the people around you — who you're doing it with. I believe the most important thing is just caring, though. Caring about who's on the other end of the phone, not letting it ring over two or three times. Caring about the other managers — one of us may be way out back and getting paged for a phonecall and if I see them out there or one of them sees me out there, they'll yell, "Never mind, I'll take it." It's caring about company property. Caring about our fellow man's self-esteem. Caring enough to make a good impression at each point of contact with customers and vendors. I could go on and on, but in short I care about what employees, customers, and vendors think of me and Sharpco.

Q: If you had to say what major problem that you have right now, what would it be, James?

A: The immediate thing that's bothering me is that we've got all this work piled up to do and only sixteen people to do it.

Q: Why don't you hire some more people, James?

A: We can't find them. We can't find them who even weld like we like to see it welded, who know enough about tractors to do the mechanical work up to our standards.

Q: You're worried about letting the customer down? What are you doing about that?

A: We're working six ten-hour days right now. If Sunday was not Mother's Day, we'd work Sunday. And we'll certainly work next Sunday. That is the most I can do. To hire more people, we'll just have to train them, and they're not gonna be worth much to us until we get them trained. We need to hire them in the winter and train them through the winter. So we'll just have to work.

Q: What direction from a standpoint of business mix do you see Sharpco taking?

A: I don't see us giving up anything we've ever learned to do, like work on land clearing equipment, but I do see us buying more tractors to scrap and I do see us selling more and more new parts. What I'd like to see us do is buy more used tractors and be the primary source in north Louisiana and south Arkansas for used tractor parts, specializing in blades and buckets — used blades, new buckets. I know people who specialize in Caterpillars and people who specialize in John Deeres and people who specialize in winches, but I don't know anybody in the nation that has a real good inventory of used blades. We get a blade with every tractor and I bought a bunch of blades just off-handed that I knew were good deals. But I'm just virtually out of blades.

Q: How many tractors do you want out there in the used tractor lot?

A: I don't have a limit as to how many; I want to use up the $10 or 12,000 a month buying tractors. That would be a savings for the future as I see it. It's amazing how fast we come out of a used tractor. We paid $8,000 about two months ago for a Komatsu. The first week we had it, we sold $3,500 worth

of miscellaneous parts off of it. Within a month, we'd sold the winch off of it for $6,500. A week later we sold the motor for $3,500. There was a $2,000 sale of final drive parts. I can remember those. I know there have been other sales. A person is coming today to pick up the track shoes for $2,800. We still have a transmission, and it's quoted for $4,500 to a man. There are still a lot of parts left. An estimate would be $10 or 12,000 worth of parts still here. That was an ideal tractor, the Komatsu. All of them won't be that good. But they'll approach that. A lot of them will.

Q: Have you firmly decided to pay yourself out of debt before you start buying these other tractors?

A: I'll still make those buys that just fall in my lap, like when an auction occurs right close to me or something like that.

Q: What is the most profitable business that you're in right now?

A: Nonundercarriage crawler tractor repair. It's not as big as undercarriage yet, but one day it will be.

Q: What about the new parts business?

A: I think I'm doing new parts about the way I should — stocking only fast-moving parts and getting the others overnight from distributors. I've got Burgman [a parts distributor] coming out Monday. They're closing their Mobile store and they want to see if I'll stock more parts; buying by the 40,000 pound container, and so forth. That way I could gain another 7 or 8 percent. I think I'll buy a few containers of fast-moving D6C [a mid-sized Caterpillar tractor] and John Deere 450 [a small tractor] parts.

Q: Just those two tractors?

A: There may be a D4 or a few others, but mainly those two because I know I can sell those within a year.

Q: What about your own time, James? Are you working sixty-hour weeks?

A: I worked less than that this year, for the first time. The boys are doing more of the work. I find them staying late and me going home. I remember I used to be here at five-thirty or six in the morning. I come at six-thirty regularly now. My standard going home time is seven but I take off at five o'clock or four thirty and go to Erin's [his daughter] ball practice. I also leave early to go shopping or eat out or anything like that. The hours I work now are easy hours. I'm excited most of the time about what's in store today.

Excerpts from an Interview with Peggy Turnage

Q: How do you think Sharpco compares with, say, Louisiana Machinery [the Caterpillar dealer], or Pipes [the Fiat-Allis dealer], or Norwell Equipment [the John Deere dealer] today?

A: There's no inferiority now at all. We have the people, the staff, and whatever we need to do the job here that is equal to or exceeds what anybody else has. This is more of a family-type atmosphere here.

Q: What about the attitude of the customer? Do you think the customer considers Sharpco as good as, say, Louisiana Machinery?

A: I think so, and maybe even better in some respects. Customers think they are coming to concerned people; that is exactly true.

Q: What else have you noticed about Sharpco over the years?

A: I think that Sharpco has matured a lot. Certainly a number of the people have grown more mature, but the company in general has matured a lot, too. I've been here ten years one month ago this week, and most of those people we've got out there are right at 30 or less years old. They were just kids when I came here. Gene Lowe, Juan, Jerry Thompson, Glyn Jordan, and Jerry Hodges were here. Some have left for a time or two and come back. Rodney came in 1980. So these are basically people who have grown from young manhood to some 30 years old working for Sharpco. So, of course, they've matured. It's sort of become a family unit through this process.

Q: Have credit losses been a problem?

A: We always check credit carefully before we do the work. If there's even any slowness in their credit history, we do not extend credit. The customer is told at that point that he must pay upon delivery of his merchandise. That's firm.

Q: What else can you say about Sharpco?

A: It's a comfortable place. You feel as if you're cared about.

Appendix: Financial Summaries

Sharpco, Inc., Comparative Balance Sheets ($000)

	1985	1986	1987	1988*
Assets				
Current Assets:				
Cash	$ 47	$ 33	$ 66	$ 63
Accounts Receivable	230	208	240	320
Allowance for Bad Debts	(7)	(2)	0	0
Inventory	307	349	247	223
Prepaid Insurance	3	0	0	14
Total Current Assets	580	588	553	620

* Through June 30.

(*Continued*)

Sharpco, Inc., Comparative Balance Sheets ($000), continued

	1985	1986	1987	1988*
Fixed Assets				
Buildings & Improvements	427	427	427	475
Machinery & Equipment	96	6	0	0
Office Equipment	85	86	91	91
Vehicles	117	92	83	62
Total	725	611	601	628
Less: Accumulated Depreciation	217	170	224	209
Net Depreciable Assets	508	441	377	419
Land	50	50	50	50
Total Fixed Assets	558	491	427	469
Other Assets	1	1	1	1
Total Assets	$1,139	$1,080	$981	$1,090
Liabilities and Stockholders' Equity				
Current Liabilities				
Accounts Payable	$ 60	$ 47	$ 67	$ 95
Accrued Payroll Taxes	2	3	2	(2)
Accrued Income Taxes	(3)	(1)	1	(6)
Notes Payable	38	94	77	75
Sales Tax Payable	2	6	7	8
Property Tax Payable				6
Interest Payable	1	3	0	0
Total Current Liabilities	100	152	154	176
Long-Term Liabilities				
Notes Payable	630	498	355	414
Total Liabilities	730	650	509	590
Stockholders' Equity				
Common Stock	34	34	34	34
Retained Earnings	386	407	449	477
	420	441	483	511
Less: Cost of Treasury Stock	(11)	(11)	(11)	(11)
Total Stockholders' Equity	409	430	472	500
Total Liabilities & Equity	$1,139	$1,080	$981	$1,090
Revenue				
Sales	$1,336	$1,540	$1,820	$880
Other Income	15	10	11	0
Total Revenue	1,351	1,550	1,831	880
Direct Costs				
Materials	596	695	937	392
Labor	139	161	185	98
Subcontractors	16	2	12	5
Freight	10	27	33	14
Other Direct Costs	1	0	1	0
Total Direct Costs	762	885	1,168	509
Gross Profit	589	665	663	371
Operating Expenses	540	650	611	286
Net Profit before Income Taxes	49	15	52	85
Provision for Income Taxes	1	(6)	10	5
Net Profit	$ 48	$ 21	$ 42	$ 80

* Through June 30.

Sharpco, Inc., Unadjusted Sales by Month ($000)

	1981	1982	1983	1984	1985	1986	1987	1988
Jan.	56	73	61	51	75	124	107	56
Feb.	68	92	83	75	62	142	97	94
Mar.	78	111	69	42	126	95	125	153
Apr.	73	80	52	70	149	166	181	178
May	86	127	45	152	161	150	165	209
June	33	77	94	143	116	120	136	190
July	66	109	138	143	92	140	127	
Aug.	69	139	139	117	139	143	246	
Sep.	67	96	88	184	78	65	189	
Oct.	77	83	149	116	206	182	153	
Nov.	77	57	106	49	89	84	132	
Dec.	51	25	77	64	43	128	161	
	802	1068	1101	1205	1336	1540	1820	880

Note: Totals may not check, due to rounding.

Sharpco, Inc., Schedule of Operating Expenses ($000)

	1985	1986	1987	1988
Advertising	26	40	34	15
Bad Debts	16	22	1	9
Delivery	15	14	24	13
Depreciation	97	75	71	28
Dues and Subscriptions	2	2	1	0
Gas and Oil	16	11	14	7
Insurance	35	34	43	15
Interest	66	77	53	23
Maintenance and Repairs	19	23	56	12
Miscellaneous	4	4	6	1
Office Supplies	19	19	31	11
Payroll Taxes	26	29	27	13
Professional Services	7	6	8	2
Rent	2	2	2	1
Salaries — Administrative	125	151	153	80
Officer's Bonus	0	56	0	0
Small Tools	7	13	16	15
Supplies	11	15	16	8
Taxes and Licenses	10	17	17	15
Telephone	19	21	20	9
Travel	5	5	1	0
Utilities	13	14	17	9
Total	$540	$650	$611	$286

CASE 3

Sandy Point Yacht Club

Thomas H. Stevenson

Early last year [1987], Richard Brinkley, an attorney in Atlanta acquired approximately 22 acres on a large nearby lake. Brinkley's interest in local waterfront property stemmed from the fact that, in addition to his law practice, he also owned and operated a boat dealership and marine store. This store, located about one-half mile from the lake, carried several lines of power boats, a complete line of waterskiing equipment, small Sunfish sailboats, and various boating accessories. Brinkley Marine was also a regular participant in the Atlanta Boat Show. This show, held annually in the spring, attracted boating enthusiasts from Georgia, South Carolina, Tennessee and other Southeastern states. Atlanta's size and accessibility made the show particularly attractive to dealers introducing their new lines; and the timing was perfect for "kicking off" the boating season. Normally in excess of 75 dealers exhibited at the show

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This case was prepared by Thomas H. Stevenson of the University of North Carolina at Charlotte from research by Tina M. Beatty as a basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation.

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as did real estate developers and others with commerical interests in boating and water recreation.

Brinkley intended to use his waterfront acreage for the development of a yacht club. To Brinkley, this development would provide synergy with his boat dealership and the opportunity to capitalize on his established connections with water sports enthusiasts. He was expecting to profit both from the development and from the additional sales the club should provide Brinkley Marine. Construction on the club, called Sandy Point Yacht Club, was delayed until six months ago, due to the high interest rates prevalent at the time of purchase. Now the project was four months from completion, but advance sales of memberships were below expectations. Brinkley hoped that the site's visibility and "word-of-mouth" communications would generate interest. He now was considering a more aggressive approach and realized that some important promotion decisions would need to be made, but time was short and funds were limited.

The Lake Site

Sandy Point Yacht Club was being built on a large fresh-water lake in central Georgia. The lake served as a source of drinking water and recreational activities for the region. The lake had approximately 165 miles of shoreline and encompassed 5,410 surface acres.

Nearby Macon, with its approximately 125,000 inhabitants, and the well-populated surrounding suburban area provided a large population base, in excess of 250,000, for use of the lake. It also attracted people from the eastern suburbs of Atlanta, approximately an hour's drive away. Boating, waterskiing, and fishing were popular summertime activities for the people of this area. Traditionally, the lake's development had consisted of second-home, summer cottages. However, the last decade had brought more, larger-scale land development to the area.

Sandy Point Yacht Club was built on a point on the lake that was accessible via state highway's from heavily traveled Interstates 75 and 20. The site had a great deal of waterfront footage, was heavily wooded, was easily adaptable to development, and was considered to be a prime piece of lakefront property. Brinkley acquired the property at a "distress" price as a result of the bankruptcy of the previous owner, a real estate developer.

Sandy Point was not to be without competition; within ten miles were two large, exclusive, residential developments that offered club facilities and atmosphere. In addition, the lake already had several public marinas that provided boat slip rental and fuel and supplies, but these offered little in terms

of a resort atmosphere and did not offer "on-premise" activities like swimming, sundecks, and bathhouse facilities. Slip rentals at these marinas averaged $50 per month. Several of these marinas, particularly those that catered to sailboats longer than 20 feet (an increasingly popular type of boat), had waiting lists for their slips — many sailboats were stored, not in slips, but at the marinas' docks.

Sandy Point Yacht Club

Sandy Point Yacht Club was to be a private club (membership fees were to be required). Initiation fees were to be $750 during preconstruction and for the first year after the opening. If response were good, membership fees were expected to increase to $1,000, further increases were to be evaluated in the future. Annual maintenance fees were $400 per year; these were also expected to increase as the club added to its facilities. Boat slip rental fees were to be in line with the competition; slips were expected to range from $50 to $60 per month. Members who did not rent slips could park their boats and trailers in a designated area on the property at no additional charge.

The Club was designed to appeal to both families and individuals interested in aquatic recreation. The "typical member" was to be a middle class family with or without children, with an annual income of between $25,000 to $40,000 (lower income families were unlikely to be able to afford membership, higher income families were likely to own summer homes or would belong to more exclusive clubs). Singles were also likely members, but there were expected to be fewer of them, since small boat ownership is concentrated in families. At least 75 percent of the members were expected to be boating enthusiasts, owning smaller sailboats (under 30 feet), run-abouts, and outboard fishing boats. The club's trading area extended for about a 50-mile radius. Members would span age groups from the mid-20's on up, including both employed and retired members.

Early in the planning stage, Brinkley had hired a marina consultant/planning specialist to develop the site plan. Therefore, the Club's facilities were well planned, as was its site. Sandy Point Yacht Club would eventually become a convenient, local resort.

The club was to be built in several phases over a five-year period. The first phase of construction, to be completed this spring, included the following:

— a landscaped entrance with a large entryway sign and an electronic, card-operated, entry gate,

— a paved driveway and paved parking areas,

— a 12-foot wide, 40-foot long, stationary wooden pier,

— a floating ship's store with fuel dock, located at the end of the pier, able to accommodate approximately thirty boats,

— 42 covered 20-foot boat slips,

— a 20-foot × 200-foot sandy beach area and a roped off swimming area,

— a 6-foot wide boardwalk along the back of the beach bordered by a buffer area of trees, shrubs, and grass,

— a sundeck behind the beach area, adjoined by an arcade building housing video games, a juke box, and a snack bar,

— bathhouses for men and women,

— a double boat launching ramp, and

— a boat and trailer storage area for 100 boats.

The master plan included several more phases of construction. The following items were to complete the entire yacht club:

— 258 additional boat slips of various sizes,

— a continuation of the boardwalk along the shoreline,

— a showroom/sales facility for Brinkley Marine,

— a dry storage facility for 400 boats,

— a shopping area,

— a waterfront steak and seafood restaurant with seating capacity for 100 persons,

— a large swimming pool,

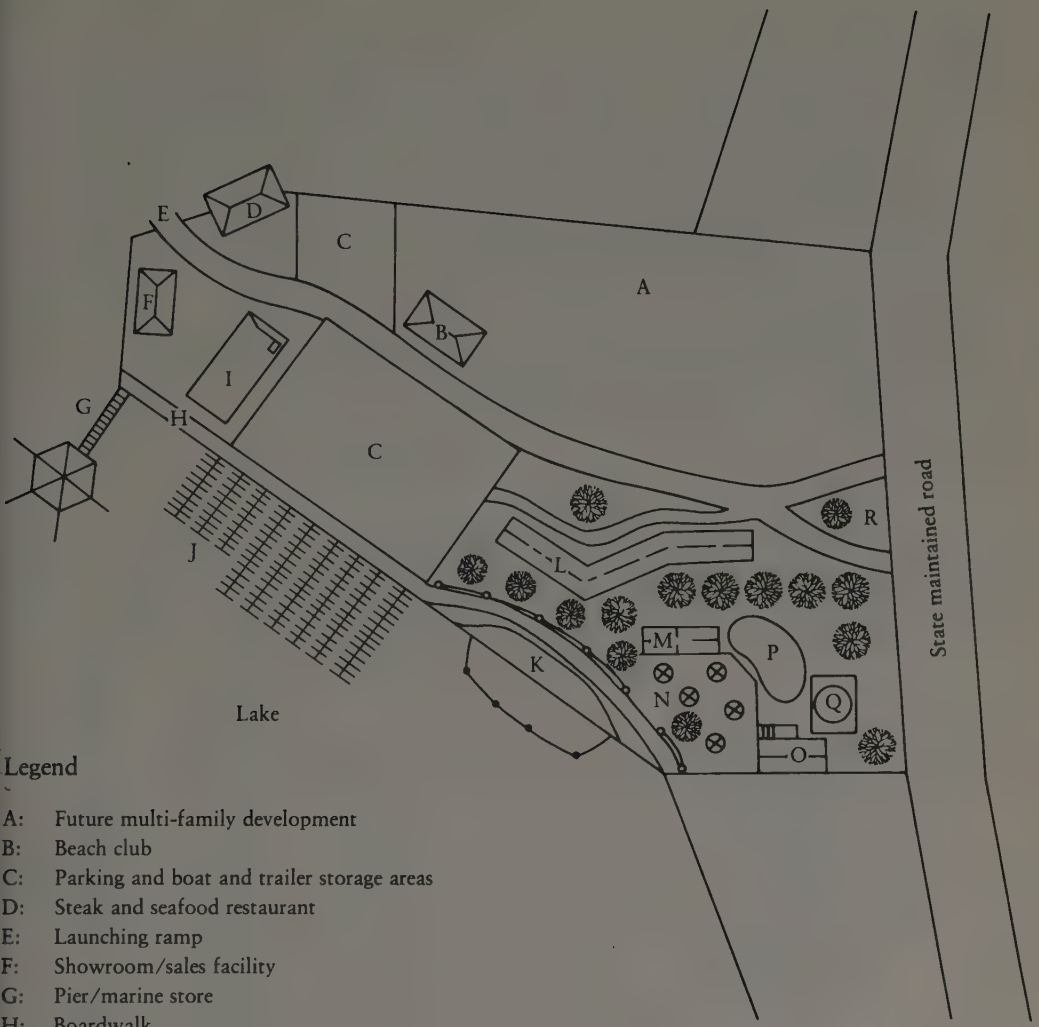
— a large hot tub and garden area,

— a water ski school to provide instruction in both slalom course and ski jump,

— a "beach" club for dancing, and

— a multi-family residential development on the property. (See Figure 1 for the proposed layout of the development.)

Upon completion, Sandy Point Yacht Club was to provide a complete range of activities well within the reach, both financially and geographically, of a middle class family.



Legend

A: Future multi-family development
B: Beach club
C: Parking and boat and trailer storage areas
D: Steak and seafood restaurant
E: Launching ramp
F: Showroom/sales facility
G: Pier/marine store
H: Boardwalk
I: Dry storage facility
J: Boat slips
K: Sandy beach/swimming area
L: Shopping area
M: Bathhouses
N: Sundeck
O: Arcade
P: Swimming pool
Q: Hot tub
R: Entryway, location of sign

FIGURE 1 Proposed Layout of the Development

Sales to Date

Brinkley had high expectations and hopes for his venture and was very anxious about the spring opening. Opening day was four months away and response was moderate; to date only 40 memberships were sold. He hoped to have 200 sold by opening day. His first year target sales were forecast at 400 memberships. This was the minimum acceptable if he were to obtain additional financing to begin the second phase of the project. (See Table 1 for a first year cash flow projection.)

Brinkley was unsure of the role that advertising and promotional efforts should play because Sandy Point was to be a private club. Nevertheless, he was aware that the two large, exclusive, residential developments extensively advertised their openings. They used newspaper and radio advertisements that

TABLE 1 Sandy Point Marina One-Year Cash Flow Projection

	Number of Units Sold		
	100 Units	250 Units	400 Units
Cash Provided by			
Sales of Memberships	$75,000	$187,500	$300,000
Maintenance Fees	40,000	100,000	160,000
Gas & Oil Sales	18,750	28,125	46,875
Snack & Vending Sales	18,000	24,050	36,000
Ship Rental	11,000	21,000	21,000
Miscellaneous	1,000	1,700	2,300
Total Cash Received	163,750	362,375	566,175
Cash Applied to			
Principle & Interest on Mortgage	286,000	286,000	286,000
Gas & Oil Purchases	12,500	18,750	31,250
Snack & Vending Purchases	9,000	12,025	18,000
Salaries	21,000	31,500	52,000
Owners Draw	36,000	36,000	36,000
Utilities	1,400	2,100	4,000
Supplies	1,000	1,000	1,000
Repairs & Maintenance	2,000	2,500	3,500
Office Trailer Lease	3,600	3,600	3,600
Miscellaneous	500	500	500
Insurances	11,000	13,000	18,000
Taxes	9,000	11,000	15,000
Total Cash Disbursed	393,000	417,975	468,850
Cash Increase ⟨decrease⟩	⟨229,250⟩	⟨55,600⟩	97,325

stressed their exclusiveness, club-type facilities, and atmosphere. Tours were conducted during the first few months. Both developments targeted their promotional efforts toward home buyers. These two projects also took advantage of publicity — each was the subject of several feature articles in area newspapers.

Brinkley also knew that the four area marinas used little advertising. Their major promotional efforts consisted of Yellow Pages advertisements in area telephone directories. Many of these marinas had waiting lists for their boat slips. These marinas received a great deal of their business from the personal recommendations of their patrons. There appeared to be a tendency for people to use a particular marina because it was the one that their friends used. So far the only promotional efforts Brinkley had used for Sandy Point were personal sales to purchasers of boats at Brinkley Marine. He began to wonder if these efforts were sufficient, especially in comparison to those of other recently developed facilities on the lake. As opening day loomed nearer and nearer, Brinkley's uneasiness about slow membership sales made him realize that a more structured approach was needed for Sandy Point's promotional efforts. He wondered how much to budget for these activities and how such monies should be spent. He also wondered what changes would be required in the promotion strategy and budgets as additional phases of Sandy Point were completed and what would be his long-term need for promotion as Sandy Point matured.

CASE 4

The Case of JJ's Marina

Douglass G. Norvell and Cheryl A. Hatcher

After retiring from the U.S. Navy as a lieutenant commander, Johnson Jordan, called "JJ" by his friends, was about to fulfill a lifelong dream to own and operate his own marina. Johnson planned to own and operate a marina ever since 1970, when he purchased a 15 acre tract of land on the Bull's Head River. When he purchased the land, it was on the edge of Charlotte, South Carolina, near the city dump; so, he was able to buy it for $5000 an acre. Most people thought he had been "taken to the cleaners" in that transaction but Jordon was able to lease it to a local shrimper who, getting on in years, wanted a job "on the beach" and sought to put in a small business to store boats, sell bait and tackle, and otherwise support anglers.

Through the years, the tenant steadily improved the site, adding a fuel dock, bait and tackle shop with an office attached to it, and sixty homemade floating docks. Later a boat ramp and plenty of parking space for anglers were added. Anglers who preferred to leave their boats at the marina on trailers paid $25 per month. Those who kept their boats in the water paid $3 per boat foot per month. The dock rentals provided about $120,000 per year, and the fuel dock made a gross profit of about $20,000. The bait and tackle shop also made a gross profit of about $20,000 per year. After all the bills and rent were paid the lessee made about $35,000 on the marina.

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The New Marina

After notifying the lessee that the lease would not be renewed, Jordan applied for the necessary permits to build a marina. The U.S. Army Corps of Engineers grants permits, but the applications are reviewed by the Coastal Council, the Department of Health and Environmental Concerns, the Department of Fish and Wildlife, the County of York, the City of Charlotte, and others. Public notices of Jordan's permit application also attracted the interest of several environmentalist groups, who reviewed it and raised a number of issues. After eighteen months and $150,000 in legal fees, Jordan finally received a permit to build a marina of 150 floating docks (with plans for a future expansion of 150 additional slips) and a 300 slot dry storage building, where boats would be put into racks with a forklift.

The marina is an excellent site, as the garbage dump was removed earlier to accommodate Interstate 26. On the land side, a good golfer can drive balls to the interstate with a two-iron from the top of the proposed dry stack building. This action would, of course, pose a considerable hazard to the 80,000 cars that pass along the freeway each day. On the water side, it is 36 feet deep at dockside, which is enough to accommodate a destroyer. The only impediment to navigation is the Bull's Head River Bridge, which has a 20-foot clearance. However, the marina is on a federally maintained, 300-foot channel and has the right to request bridge openings. Offshore anglers in 26-foot boats can be in deep water fifteen minutes from leaving the site, and inshore anglers can catch fish off their boats at the marina. Perhaps most important, the site is only 3 miles from the center of downtown Charlotte, which has a favorable business environment. In spite of its proximity to the city, the site has much wildlife. A creek along one side of the property, listed as an "unnamed estuary" on the nautical charts, is home to several alligators, and migrating ducks use the creek as a winter resting place. A family of dolphins is often seen in the river near the site.

The Business Environment of the Charlotte Region

For any new business, including a marina complex, the business environment of the region is probably the most important aspect affecting its feasibility. In cases where marinas are not financial successes, the major contributing factor usually is the lack of a high level of demand for recreational boating. For example, the state of North Carolina built a luxurious marina in an isolated coastal region that was a failure in its early years because of low demand. The

state of Alabama built a large installation on Lake Eufala that did not achieve an acceptable occupancy rate until its fourth year. In both of these cases, the regions simply did not have a population large enough to support the marinas. Even where there is a large population, a marina may not be successful because of a downturn in economic activity. This happened when a very large luxury marina in Houston, Texas, did not meet its goals because of the downturn in economic activity associated with the decline in petroleum revenues and exploration. All three of these marinas were well-managed but operated in a business environment that was not conducive to continued growth.

The business environment in the Charlotte region is highly conducive to the establishment of a marina. In the trading area or SMSA (Standard Metropolitan Statistics Area) of Charlotte, which includes Horry, Jackson, and York counties, population, income, housing, and employment are all increasing.

In terms of population, the Charlotte region was the fastest growing city in South Carolina from 1970 to 1980. During that decade, almost one-fifth of all the population growth in the state occurred in the tri-county area. According to the most recent projections, the HJY (Horry, Jackson, York County) region will continue as one of the fastest growing areas in the state through the end of the century.

The population of the tri-county region is expected to increase by more than 200,000 people in the next twenty years. The Bull's Head River area along Interstate Highway 26, which encompasses the site of the proposed marina, is cited as one of the major growth areas in the HJY region. Moreover, its development will be accelerated by the continued construction of the Dwight Eisenhower Expressway System.

Personal incomes also are increasing. In 1982, total personal income for the tri-county area exceeded $3.9 billion. It rose from $2,482 million in 1978 to $3,907 million in 1982. In 1980, per capita income for the region was $6,000 and median household income was $15,501.

Housing starts are increasing; nearly 50,000 units were added to the area's housing stock during the 1970s. Moreover, rental units represented 38 percent of the region's housing in 1970, but only 36 percent in 1980, which would indicate that more people bought homes.

Employment also is increasing sharply in the HJY region, and more important for the proposed marina, most of the increased employment is in the civilian nongovernment labor force, particularly among professionals. From 1970 to 1980 the civilian labor force increased from 103,159 to 164,700 or an increase of 60 percent. Of particular interest was the increase in employment in the health services from 6,006 to 13,430. Viewed another way, fourteen new jobs in the health services industry were created every week in Charlotte from 1970 to 1980 and would continue at an accelerated rate.

The business environment in the Charlotte region is especially encouraging for the establishment of a marina complex. Growth in population, income, and employment drive the demand for recreational boating. Particularly en-

couraging is the growth in employment in the health services field, given that the Charlotte health services complex is less than 3 miles from the site of the proposed marina and a "straight shot" on the freeway.

The Boating Environment

The boating environment in the Charlotte area is conducive to the establishment of additional marina facilities. South Carolina has a strong boating tradition, and Charlotte is the boating capital of South Carolina. The strong boating tradition is evidenced by the sharp increase in boating registration in recent years.

In examining the boating registrations of the Charlotte region, we will seek to determine how the number of boats in our target markets have changed. The target market for the dry stack storage is composed mostly of boats between 16 and 26 feet long, those kept in wet slips generally are considered to be boats over 26 feet. However, keep in mind that some larger boats are found in dry stacks (in south Florida boats up to 42 feet are stacked), and some smaller boats are kept in wet slips (virtually every marina will have some 16-foot outboards in the water). However, most of the boats in a dry stack will be smaller than the boats in wet slips.

TABLE 1 Registration of Motorboats (including powered sailboats) from 16 to less than 26 feet in South Carolina from 1977 through 1987

Year	Inboard (number)	Outboard (number)	Total (number)
1977	10,714	27,284	37,998
1978	11,905	29,523	41,423
1979	13,162	31,950	45,112
1980	14,138	34,901	48,229
1981	15,014	35,988	51,002
1982	15,848	37,869	53,717
1983	16,399	39,043	55,382
1984	16,845	40,253	57,098
1985	16,728	46,850	63,578
1986	18,473	51,181	69,654
1987	20,350	56,979	77,329

Source: Boating Registration Statistics: National Marine Manufacturers Association, 1987.

TABLE 2 Registration of Motorboats (including powered sailboats) from 26 to less than 40 feet in South Carolina from 1977 through 1987

Year	Inboard (number)	Outboard (number)	Total (number)
1977	1,078	1,059	2,137
1978	1,185	1,111	2,296
1979	1,290	1,184	2,474
1980	1,366	1,243	2,609
1981	1,441	1,307	2,748
1982	1,501	1,368	2,869
1983	1,547	1,410	2,957
1984	1,595	1,454	3,049
1985	1,456	2,112	3,568
1986	1,584	2,371	3,955
1987	1,941	2,193	4,134

Source: Boating Registration Statistics: National Marine Manufacturers Association, 1987.

The recent increases in boating registrations are shown in Tables 1 and 2. Case Table 1 lists the registration of boats that would be likely candidates as dry stack customers, boats between 16 and 26 feet in length. As shown in Table 1, the number of these boats have increased between 2,000 and 7,000 units per year since 1977. Further, given that the Charlotte region has about 14 percent of the state's population, we can reasonably assume that at least 10,000 boat owners are in the region and are potential dry stack customers.

Table 2 shows the number of boats that are more than 26 feet but less than 40 feet in length. This size of boat generally is considered a prime candidate for wet slip marinas, as boats over 26 feet are difficult to carry on a trailer and should be kept in the water. Moreover, those over 40 feet tend to be transient or specialized craft. As shown in Table 2, the number of these 16 to 40 foot crafts in the state have been growing from 100 to 200 per year since 1977. Again, we can reasonably assume that at least 400 of these boats are registered in Charlotte. However, as we shall see, the number of boats berthed in Charlotte exceeds registrations because of upcountry ownership.

The phenomenon of upcountry ownership, where people living in the foothills west of Columbia keep a boat in Charlotte, is extremely important in this study. The Charlotte County Marina Impact Study conducted in 1984 estimated that about one in five boats berthed in Charlotte belonged to an out-of-towner. There are a number of reasons a boat owner who lives in

Atlanta, Greenville, or Columbia would keep a boat on the coast. These are as follows:

1. A strong interest in ocean sailing. Breezes tend to be irregular at inland lakes unlike the ocean where seas are infrequently calm.
2. To use with a condominium purchased in one of the developments along the coast.
3. To use their powerboat as a "floating condo," where they can come to enjoy Charlotte for a weekend.
4. To participate in saltwater fishing.

This last point is particularly important. There is a strong saltwater sport fishing tradition in the southeastern United States. These sport fishermen, who use boats 23 feet and larger will fish principally near the Gulf Stream, which is a two or three hour run from Charlotte depending on the weather, type of boat, and other variables. These saltwater sport fishermen spend a considerable amount of money on fuel and supplies. For example, a trip to the Gulf Stream requires from 80 to 100 gallons of fuel, as well as bait, drinks, and other supplies. Many of the saltwater sport fishermen live in the foothills. The magazine, *Salt Water Sportman* has over 5000 subscribers who live within a six hour drive of Charlotte. In virtually all of the foothill urban centers, there are saltwater sport fishing clubs with active memberships. Again, keep in mind that this is just one type of potential marina user in the Charlotte market.

The Marina Industry in the Charlotte Area

In 1984, the Division of Natural Resources of the state of South Carolina commissioned a study of the marina industry in the HJY (Horry, Jackson, York County) region. The study, conducted by Kerr, Taylor, and Rogers, Inc., during 1984, was an exhaustive analysis of the supply and demand for the marinas in the area. A number of interesting issues were examined; we will consider each in turn.

The first issue regarded the need for marina space in the area. The study concluded the following:

1. South Carolina is one of the most active boating states in the United States.
2. Over the past 10 years, the number of boats registered in South Carolina has increased by 47 percent.

3. Approximately 20 percent of the boats in Charlotte are owned by out-of-towners.
4. There was a total demand for about 1,300 slips in 1983.
5. The demand would grow about 60 slips a year, resulting in a demand of 1,480 slips by 1986.
6. Boat owners keep their boats close to their homes.

The next issue dealt with the supply of slips in the area. The study concluded the following:

1. In 1983 there was a supply of 1,361 slips resulting in a slight oversupply.
2. The vacancy rate for marinas west of the Bull's Head River was 21 percent because most boat owners live in other locations.

Further, the study pointed out that the demand for marina space is concentrated near the downtown area. At the same time, the supply of marina space in this area is limited by the opposition of environmentalist groups who oppose marina expansion. For example, a recent request for a permit to add 100 slips at Ralph's Boat Harbour, which is in Charlotte, was met with such strong community resistance that the original permit application was denied and a revised application was forced into litigation.

The Division of Natural Resources study also predicted that, based on the planned installation of slips, the total supply would rise to 1,747 slips by the year 1990, whereas the demand would rise by only 1,510 slips, creating a surplus. However, the surplus would occur at the extremities of the market region rather than the center. As the study predicted, Botany Bay Marina, at the southeast end of the market, currently has a surplus of slips. Dunes Ferry Marina, at the northeast end of the market, had a light surplus last year but presently is full. Both of these marinas are at least a half hour drive from the site and in somewhat undesirable waters. The Dunes Ferry Marina is an hour away from good sailing water. Large-boat sport fishermen must either cruise the Intracoastal Waterway for 6 miles to Charlotte Harbor for access to the ocean or utilize Capt. John's or Mikell's Inlets, both of which are extremely treacherous. The waters surrounding Botany Bay Marina are even less inviting to boating, where larger sailboats and powerboats are confined to a radius of about 5 miles of good boating waters. Therefore, a vacant slip at Dunes Ferry or Botany Bay Marina does not necessarily compete with a vacant slip at JJ's Marina because JJ's is at the center of the market. Users at JJ's Marina will have the advantage of a slip that is easily accessible from their homes and near good boating waters.

Types of Marina Users in the Charlotte Market

In understanding the Charlotte boating market, keep in mind that it is unique in many respects. Boat owners in Charlotte are driven by a strong boating tradition, status variables associated with different kinds of boating often are vested with inflexible opinions and attitudes. A marketing strategy that recognizes the unique nature of this market has a reasonable chance of success. One that overlooks it has a high probability of failure.

There are a variety of potential marina users in the Charlotte area. They are classified according to the size and kind of boat they own, how and where the boat is used, or where the owner lives. Each type of user, or particular market segment, has its own needs.

Local powerboats must be kept in the water because they are 26 feet or longer. There are about 1,000 of these boats in the Charlotte area. Smaller versions, 16 to 26 feet, including outboards, are potential users of dry stack facility. The local powerboats are desirable customers for a marina. Generally speaking, powerboats cost more per foot than sailboats, particularly around the 30 foot range. Boat owners with more expensive boats are likely to be more affluent customers who tend to spend more on fuel and supplies.

Transient powerboats are large powerboats that migrate from North to South and back each year. They number about 2,000 and pass within 2 miles of JJ's once in April and again in October. Transient powerboat owners are a lucrative market because they are accustomed to paying as high as $1.75 per foot per day for docking; also, according to other marina operators on the Intracostal Waterway, transient powerboat owners will purchase an average of 200 gallons of fuel at each stop.

It should be noted here that the Municipal Marina has a very poor reputation among transients. Boat owners complain of poor service (no help with lines), hostile employees, and worse, outright cheating at the fuel dock. One boat owner, who owns a marina near Charleston, indicated that the only time he has ever been cheated at a fuel dock was at the Municipal Marina. The dock attendant charged him for more fuel than his boat holds. The poor reputation of the Municipal Marina is extremely important. It has been said many times that Bull's Head River Marina owes its existence to the poor reputation of Municipal Marina.

There are about 1,000 sailboats in the Charlotte market. Sailboat owners tend to spend less money than powerboat owners and are heavy users of marina services. About 1000 transient sailboats migrate each year on the Intracoastal Waterways. They are mostly budget travelers who have more time than money. In the spring and fall, transient sailboats can be seen anchored at locations where they can put ashore in their dinghies for free.

Large offshore angler boats number about 500 in the Charlotte market area. They tend to purchase large amounts of fuel and supplies. Some of these large offshore anglers are available for charter, and still others are "head boats" that take anglers out for bottom fishing. Six-pack charter and head boats are often unappreciated users in marinas. They shop around for fuel, negotiate discounts, are very heavy users of parking spaces, and require a great deal of service from the marina management and staff. Most resort marina operators try to minimize the number of charter boats in their marina and would get rid of all of them were it not for top management. Typically, top management wants a few charter boats for the convenience of resort guests and for the atmosphere that they create at the marina.

Total sales of small offshore angler boats should be about 350 to 500 per year. Therefore, if we assume that a boat lasts ten years then between 3500 and 5000 of them are in the Charlotte market and fish the Intracoastal Waterways. These boats are very desirable tenants for a dry stack operation.

Extended storage boat owners live at remote locations such as Piedmont and tend to use their boats less than other users. About 200 of these boats are kept in Charlotte.

Live-aboards or those who reside in their boats are very small in number. There are only about 50 in Charlotte.

The desirability of different types of customers can be seen by examining Table 3. In assessing the potential value of the different types of customers, it is necessary to consider both the number of these customers and their desirability. In the case of JJ's Marina, local power boat owners are numerous and highly valued customers because they usually are middle-aged customers who

TABLE 3 Types of Potential Marina Users in the Charlotte Marina Area and Their Desirability as Customers

Kind of Customer	Number in Charlotte Market	Desirability
Local Powerboats	1,000	High
Transient Powerboats	2,000	High
Local Sailboats	1,000	Medium
Transient Sailboats	1,000	Very Low
Large Off-Shore Anglers	500	Medium
Small Off-Shore Anglers	3,500–5,000	High
Extended Storage	200	Medium
Live-Aboards	50	Low

spend freely. Transient powerboats are greater in number and the owners are big spenders on docking and fuel, but they are in the market only during April and October. Small offshore anglers are a good market for wet slip operations. After examining where other marinas are positioned in the market, we will recommend selected target markets for JJ's Marina.

Existing Marinas in the Charlotte Area

The next step in the analysis is to examine the existing marinas, how they are positioned in the market with respect to the customers they serve, and what advantages they offer the prospective user. A summary of the different marinas and their storage capacities is presented in Table 4.

Harbour Cove Marina

Harbour Cove is a medium-sized commercial marina. It has 100 slips and is in the process of being converted from a rental marina into a condominium marina where boat owners will own slips and share in the management of the operation. Currently Harbour Cove charges $6.50 per boat foot per month.

TABLE 4 Storage Capacity of Marinas in the Charlotte Market Area

Marina	Dry Stack Storage Spaces (number)	Wet Slip Storage Spaces (number)	Maximum Boat Size (feet)	Control Depth (feet)
JJ's Marina	300	150	150	32
Bull's Head River Marina	0	100	150	10
Botany Bay Marina	120	140	100	20
Reelfoot Marina	0	14	100	20
Jo-Pearl Marina	80	0	22	7
French Creek Marina	0	200	72	12
Salty Dog Marina	0	25	50	7
Jake's Island Marina	0	70	54	7
Municipal Marina	0	305	150	25
Rum Point Marina	0	417	120	7
Big Creek Marina	0	175	100	13
Harbour Cove Marina	0	100	60	12
Dunes Ferry Marina	0	180	120	10
Ralph's Boat Harbour	136	0	32	7
Total	734	1679		

Harbour Cove is unique in this market in that only one-half of its available slips are full, divided evenly between sailboats and powerboats.

From the standpoint of the prospective user, Harbour Cove has several strong advantages. It has excellent access to sailing waters and offshore fishing, gentle currents, no bridges block its way to water, and boat security is excellent. On the other hand, it is a poor place to be in a storm, and there are some shallow waters near the site. It also has a serious problem with land traffic on the weekend.

Jake's Island Marina

Jake's Island Marina is relatively small with only seventy slips and charges $4.00 per boat foot per month. It has a major problem in that it is not situated in good boating waters. The Stono Inlet, where boaters from Jake's Island put to sea, is treacherous due to sand bars. The boats at Jake's Island are almost all powerboats.

French Creek Marina

French Creek is a relatively large commercial marina located on 3 acres at Maybank Highway and the Stono River. It has 200 slips, 140 permanent slips and 60 reserved for overnight renters. French Creek offers a variety of extra facilities that include a ramp, fuel, boat sales, a boat store, electrical hook up, waste-water pump-out, a restaurant, a laundromat, and shower and restroom facilities. There are 575 off-street parking spaces available.

French Creek previously charged $4.00 per boat foot per month to rent a slip, but currently they are charging an additional $100 nonrefundable entrance fee. Like most other marinas in the area, French Creek is at full capacity. Its business is divided evenly between sail and power boats. There is a waiting list of 200, and French Creek plans to build additional slips in the near future.

French Creek has several major disadvantages. It suffers from limited access to good boating waters; traffic to and from the marina is hampered by bridges; it has a strong current; and it is a poor place to be in a storm. On the other hand, it is an efficiently run marina with good deep water and an excellent reputation.

Municipal Marina (Charlotte Municipal)

The Municipal Marina is a very large city marina located on River Drive in Charlotte. It has the largest number of slips in the area with a total of 305 slips, 290 permanent slips and 15 overnight rentals. The Municipal Marina offers a variety of extra facilities including a ramp, fuel, boat sales, a boat store, electrical hook up, waste-water pump-out, a restaurant, a laundromat, and shower and restroom facilities. Presently, this marina has a severe parking problem, as

most of their spaces are lost to the prolonged construction of a new bridge over the Bull's Head River.

The rate charged for a slip is $3.50 per boat foot per month. Currently this marina is fully occupied, with over fifty people putting up a $100 nonrefundable deposit just to be on the waiting list. Of its present customers, 75 percent own sailboats.

There are several important advantages for the boat owner who is a customer of the Municipal Marina. The marina has excellent access to good boating waters with no bridges blocking the way. It is convenient to transients and a safe harbor in a storm. Perhaps the only disadvantages of the marina are recurring shoaling and management problems.

Jo-Pearl Marina

Jo-Pearl Marina is a small marina consisting of 2 acres of land with eighty dry stack slots for powerboats. Its unusual name is a combination of the names of the owner's second wife's children. This small operation offers only a few facilities including a fuel station and boat store. It has only twenty parking spaces available.

In 1988 Jo-Pearl charged $5.00 per boat foot per month. This rate is comparable to both Bull's Head River Marina and Botany Bay Marina. No information can be obtained about Jo-Pearl's current occupancy rate, but one can be relatively sure that they are at or near full capacity from the reports of other marinas.

Jo-Pearl has some advantages. The marina has excellent access to boating waters, particularly the Rebellion Roads area, as well as excellent storm security. However, the facility has one major disadvantage in that it is cut off by a bridge, which creates an obstacle to all but small boats.

Bull's Head River Marina

Bull's Head River Marina, a commercial establishment located on River Drive in Charlotte, is a medium-sized marina having a total of 100 slips, 85 long term and 15 for overnight rentals. Facilities available at Bull's Head River include fuel, a boat sales store, electrical hook up, a laundromat, and shower and restroom facilities. It also has 150 off-street parking spaces available, but there is no dry storage. It is presently operating at full capacity.

To keep a boat at Bull's Head River Marina, there is a one time entrance fee of $30 per boat foot and the current rate of $6.00 per boat foot per month. Bull's Head River Marina primarily is a sailboat marina and most of the boats docked there are sailing vessels.

Bull's Head River Marina abuts the Municipal Marina, so its advantages are similar. However, Bull's Head River Marina has better management, hence, many boat owners prefer to berth their craft there rather than at Municipal.

One drawback is the light construction of the floating docks, which results in some instability during turbulent weather conditions.

Botany Bay Marina

Botany Bay is a commercial marina located on George's Island. This medium-sized establishment has a total of 140 slips, 130 available for long-term rental and 10 for overnight renters. Botany Bay offers many facilities at the marina including fuel, boat sales, dry stack, electrical hook up, waste-water pump-out, a restaurant, a laundromat, and shower and restroom facilities. There are 339 off-street parking spaces available.

Botany Bay's rate for a slip is $6.50 per boat foot per month. They currently have quite a few slips available; the boats are divided evenly between sail and power.

Although Botany Bay is well managed and attractively designed, it suffers from a poor location with limited access to boating waters, bridges around the site, and strong tidal flows.

Big Creek Marina

Big Creek Marina is a 175 slip marina set on 5 acres of land on George's Island Highway. Big Creek offers very few facilities compared to other marinas in the area. These facilities include electrical hook up, waste-water pump-out, and shower and restroom facilities. There are 145 off-street spaces available.

Big Creek charges $3.50 per boat foot per month to rent a slip, which is relatively inexpensive. Big Creek also has a dry storage (not stack) service that costs the same as a wet slip. As is typical of most marinas in the area, they are at full capacity with their customers being divided evenly between sail and powerboats.

In many respects, Big Creek Marina is a medium-quality installation. It has limited access to good boating waters and there is a bridge between the marina and the Intracoastal Waterway. However, the marina is a poor place to stay during a storm and has a strong current.

Dune's Ferry Boat Marina

The Dune's Ferry Marina, which is a project formerly associated with the Dune's Resort, is in a period of expansion. At present, there are about 180 slips, almost all of which are occupied by power boats.

The Dune's Ferry Marina suffers from a poor location. It is 7 miles from good boating water with a bridge that must be opened to accommodate larger boats. It is forty-five minutes from Charlotte, longer at the height of the boating season. Although it is an attractive, well-managed facility, the principal

market for the marina consists of homeowners at the Dune and transient boaters during October and April.

Ralph's Boat Harbour

Ralph's Boat Harbour is about 3 miles upstream from the site. At present, it has 136 dry storage stacks for power boats and is seeking to add 60 wet slips. The wet slip expansion has met with enormous public resistance and likely will not be approved. Ralph's dry stack was full three months after opening.

Rum Point Marina

Rum Point Marina is scheduled to open with 417 slips October 1. However, it has rescheduled the opening several times previously due to engineering problems caused by ships' wakes and strong tidal cross currents. It will house both sail and power boats and likely will be preferred by sailboats.

Other Smaller Marinas

There are other, smaller marinas in the Charlotte market such as Salty Dog Marina, Oyster Reef, and Mile Marker '86, none of which are more than a minor force in the market.

Costs of the Marina

The marina will be an expensive operation even though the costs of the land, which is now worth $40,000 per acre, are fully retired and the permits already are obtained. The construction costs are shown in Table 5 and the anticipated annual operating costs are shown in Table 6. To offset the costs, Jordan expects the marina to fill up in about six months. The last two marinas built did not fill until a year after opening.

Jordan figures that his biggest problem is how to get a loan to build the new marina, as he only has about $50,000 left in his "Navy Nest Egg."

TABLE 5 Construction and Start-up Disbursements for JJ's Marina

Construction Costs for the Wetslip Marina	
Waterfront Preparation	$ 133,000
Pilon Installation	56,000
Floating Piers & Ramp	255,000
Electrical Service & Fixtures	48,000
Pagoda Building & Clubhouse	125,000
Signs & Miscellaneous Small Items	4,800
Subtotal	$ 621,800
Construction Costs for the Drystack Marina	
Building, Racks & Fixtures	$ 442,500
Holding & Fuel Docks	15,000
Launch & Retrieval Bulkhead (boat storage)	25,600
Fork Lift (boat handling)	160,000
Signs & Miscellaneous Small Items	3,000
Subtotal	$ 646,100
Paving, Landscape, and Utilities	
Paving (roadways, parking lot, & stormwater management system)	$ 100,000
Utilities (water, electrical, & sewage)	60,000
Landscaping	30,000
Subtotal	$ 190,000
Other Costs	
Building Renovation (sales, service, & recreation)	$ 40,000
Consultant (engineer)	10,000
Consultant (legal)	5,000
Marketing	30,000
Licenses	3,500
Computer Equipment	9,000
Chase Boat	10,000
Subtotal	$ 107,500
Total	$1,565,400

TABLE 6 Annual Operating Disbursements for the JJ's Marina Operation

Personnel	
General Manager	$ 40,000
Secretary (full-time)	18,000
Forklift Operators	40,000
Accounting Services	5,000
Janitorial Services	2,500
Subtotal	$105,500
Personnel Support	
Auto & Travel	$ 5,000
Employee Benefits	16,000
Insurance	30,000
Office Expense	4,000
Postage	1,000
Subtotal	$ 56,000
Maintenance and Utilities	
Building Maintenance	$ 1,700
Equipment Maintenance	2,200
Dock Maintenance	3,000
Telephone	3,000
Electricity	8,000
Waste Removal	3,000
Subtotal	$ 20,900
Other Costs	
Entertainment	$ 500
Promotional Expenses	6,000
Supplies	3,000
Miscellaneous	1,000
Taxes on Improvement	8,000
Subtotal	$ 18,500
Total	$200,900

CASE 5

Pizza Delights: The St. George Street Restaurant

Jay Horne, Christine Perkins, Kim Goates, Peter Asp, and Ken Sarris

Earnest Outbanks, manager of the St. George Street Pizza Delights in Roebuck, South Carolina, hung up the phone after a two hour conversation with Leonard Lloyd, owner of three Pizza Delights in Greer, South Carolina. It was 11:00 P.M. on the night of April 5, 1986, and soon it would be time to close. It occurred to Outbanks as he glanced around the restaurant he had successfully managed for five years that both he and Lloyd were on the verge of a major decision, the outcome of which was certain to shape the rest of their careers. He tried to concentrate on the job at hand but his thoughts kept returning to Lloyd's proposal.

This case was prepared by Jay Horne, Christine Perkins, Kim Goates, Peter Asp, and Ken Sarris under the direction of James J. Chrisman, assistant professor of management at the University of South Carolina. The case was prepared for classroom discussion and was not intended to illustrate either effective or ineffective handling of administrative situations. It has been disguised at the request of the case subjects. Used with permission from James J. Chrisman and the North American Case Research Association.

Outbanks's career in the pizza business had started some ten years earlier, in 1976, when he became a cook for Pizza Delights during high school. Lloyd's involvement began in 1981, when he bought his first Pizza Delights restaurant in Greer, South Carolina. By 1986, at the tender age of 25, Outbanks had become well established as the manager of the St. George Street Pizza Delights in Roebuck, a small community approximately 5 miles to the southeast of Spartanburg, South Carolina. Lloyd, on the other hand, by 1986 had established a chain of three successful Pizza Delights franchise restaurants throughout the rural Greer area, which was approximately 20 miles from Spartanburg.

Since Outbanks had taken over the company-owned restaurant on St. George Street in 1981, he had managed to change a sluggish, break-even operation into the second most profitable Pizza Delights in the Greater Spartanburg area (see Exhibit 1 for income statements for 1983 to 1985). His achievements had not escaped the attention of many fellow businesspersons in the fast growing communities that surrounded the restaurant. Leonard Lloyd had learned of Outbanks's achievements, too, as he was always on the lookout for a way to enter the more lucrative Spartanburg market.

Lloyd had contacted Outbanks on several occasions during the spring of 1986 in hopes of persuading Outbanks to join him in buying the restaurant from Pizza Delights. Although Lloyd's idea sounded quite attractive to Outbanks, who had visions of owning his own franchise for several years, he was reluctant to give an answer right away. Outbanks's career with Pizza Delights had been quite successful, and he believed that his future with the firm was bright. However, he knew that Lloyd could not be kept waiting forever and was determined to make a decision in the near future.

The remainder of this case will describe the history, environment, and operations of the Pizza Delights Corporation, the restaurants on St. George Street and in Greer, as well as Lloyd's franchising plans for Outbanks' restaurant.

Pizza Delights, Inc.: Company Background and Structure

The Pizza Delights chain was established in the greater Omaha, Nebraska, area in the late 1960s. The restaurants offered the customer a limited range of Italian dishes including pizza, spaghetti, and cavatini. The restaurants proved to be very successful. They offered something the public wanted — a high-quality pizza with a high level of personal service. The original restaurants enjoyed immediate success, as they were one of the first chains in the area to offer strictly pizza and other Italian dishes.

Due to its early success, Pizza Delights became an attractive acquisition candidate. It caught the attention of a large food manufacturing corporation, which, in the late 1970s, purchased the company as well as the rights to their

EXHIBIT 1 St. George Street Location Income Statements 1983–1985

	1985	1984	1983
Gross Food Sales:	557,278	478,603	422,375
Less: Allowances	7,869	7,547	7,038
Sales Promotions	34,394	32,982	31,651
Net Food Sales	515,015	438,074	383,686
Plus: Vending Machines	1,734	2,103	1,923
Game Machine	1,582	1,661	1,843
Total Revenue	518,331	441,838	387,452
Cost of Goods Sold	144,406	133,225	117,486
Gross Profit	373,925	308,613	269,966
Operating Costs:			
Management Salary	54,373		
Crew Labor	56,445	111,391	108,476
Other Labor	12,979		
National Advertising	7,544		5,637
Co-op Advertising	12,652	22,880	7,629
Local Advertising	9,001		8,538
Operating Expenses	12,795		13,330
Utilities Cost	19,531		16,343
Maintenance	9,749	40,464	9,019
Uniforms	349		1,113
Other	2,474		2,110
Premiums	5	1,110	210
Operating Profit	176,028	132,778	97,981
Fixed Costs:			
T.J.T.C. Expense	161	54	
Bank Charges	570	615	
Personal Property Tax	221	254	
Real Estate Taxes	3,939	3,939	
Licenses & Fees	269	289	
Equipment Depreciation	10,149	7,774	
Leasehold Amortization	2,618	2,768	
Building Rental	17,417	15,813	
Contingent Lease Rent	8,442	502	
Insurance	2,441	1,909	
Abandonment & Property	1,236	65	
Goodwill Amortization	3	0	
Total	$47,466	$33,985	
Plus: T.J.T.C. Credit	4,435	0	0
Less: Fixed Costs	47,467	33,985	35,647
Total Profit	132,996	98,793	62,334

secret recipes. With the corporation's financial backing, Pizza Delights restaurants began to spring up all over the United States at an even faster rate than before. Throughout this period of national expansion, the high degree of quality and service that was Pizza Delights' trademark was maintained.

Since 1983, Pizza Delights had introduced several new products that were "big sellers." These products included a small pan pizza (1983), a double decker pizza (1984), and an Italian turnover pizza (1985). All of these products required a great deal of refrigerator space for storage. However, according to restaurant managers, Pizza Delights had not provided the additional freezer capacity needed to store these items.

Additionally, as Pizza Delights was owned by a large food corporation, all the supplies used at company-owned restaurants had to be obtained from the parent company. These items included everything from straws and napkins to pizza dough and pepperoni. If an emergency situation occurred, such as a shortage of green peppers, the restaurants were allowed to make purchases from outside suppliers as long as these purchases, in total, did not exceed 1 percent of yearly sales for the individual restaurant. This practice was not generally encouraged by the corporation.

Franchised restaurants had more flexibility in this respect. To ensure standardization, certain items, such as printed napkins and pizza ingredients, still had to be purchased from the parent corporation. Other items, such as pizza cutters, could be purchased from outside sources. This was important for possible cost reductions, as purchasing solely from the corporation tended to inflate costs. For example, ladles to dip pizza sauce currently cost $8 when purchased from the corporation. Outside suppliers offered this item for a lower price, sometimes as much as 10 to 20 percent less than charged by the corporation.

As of 1986, the headquarters of Pizza Delights was sill in Omaha. The chain had grown to nearly 1,500 restaurants. Management planned to open 100 to 200 new restaurants per year over the next decade. To accomodate this growth, six regional offices, located in major population centers across the United States, had been added since the 1970s. These regions were subdivided into areas, which were further subdivided into districts (see Exhibit 2). Each region, area, and district had a full-time staff of managers, accountants, inspectors, and other personnel to ensure that each individual restaurant fulfilled its duties to the corporation.

This hierarchical maze created some problems for the individual restaurants, however. For example, any purchase exceeding $500 had to be approved by the area supervisor, the district manager, and the regional vice-president before the restaurant manager could proceed with the investment. This situation sometimes created a time lag of several months between requests and implementation. As a result, many of the restaurant managers had given up trying to solve certain problems and, instead, merely tolerated them.

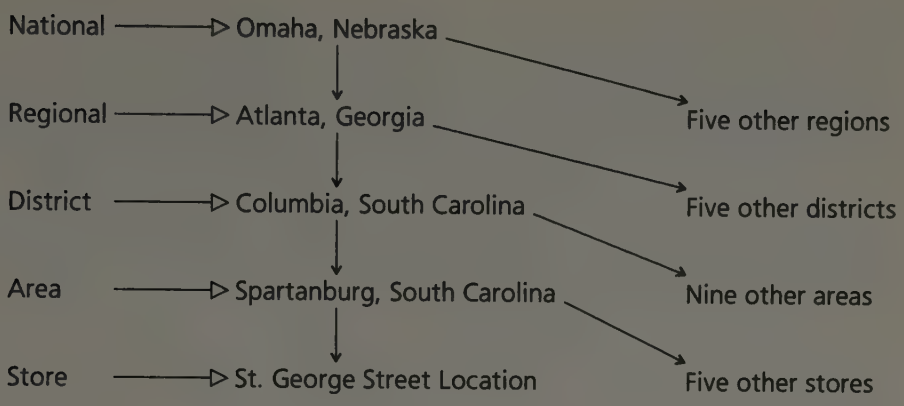


EXHIBIT 2 The Pizza Delights Hierarchy

History of the St. George Street Restaurant

The St. George Street Pizza Delights was built in 1974, primarily to serve customers in Roebuck, a small community 5 miles southeast of Spartanburg, South Carolina. It also served commuters who traveled on Interstate 85, a major traffic artery into Spartanburg.

The restaurant was modestly successful from the start, showing low to moderate profits during its first few years. As the populations of Roebuck, Spartanburg, and the surrounding areas grew, so initially did the restaurant's profits. With this population growth, however, came increased competition (and lower profits) as other fast food chains began to appear along a strip of St. George Street for several miles. By 1981, when Outbanks became manager, there were a total of three direct pizza competitors within 1 mile of the restaurant, not to mention the numerous other fast food competitors that did business in the area.

Outbanks had inherited a restaurant that had many problems. First of all, the crew at the restaurant had been described by the district manager as probably the "most lazy and inhospitable bunch he had ever met." Second, food costs at the restaurant had been astronomical. Cheese costs in particular were extremely high. High food costs were partially attributable to the fact that many of the employees were either taking home free pizzas or giving them away to their friends. In addition, the cooks were not preparing the pizzas according to Pizza Delights standards. None of the ingredients were weighed, which often resulted in more ingredients being used on the individual pizzas than were needed.

As a result of the increased competition as well as the inefficiencies in operations, the restaurant's net profits before taxes had dipped to their lowest level since 1975 ($42,680) by the time Outbanks assumed control in 1981. Outbanks attempted to alter these problems by replacing most of the staff and training the new employees himself. He also began to implement new policies to improve the efficiency of operations. Due to his extensive experience in the pizza business, as well as his ability to deal effectively with high school and college age employees, most of the more obvious problems had been solved and the restaurant's profits rose steadily under his stewardship.

The Greater Spartanburg Environment

Located in northern South Carolina, Spartanburg was a city of approximately 45,000 persons. Situated in an agricultural region that produced crops such as cotton, peaches, melons, and feed, the city was the seat of Spartanburg County and part of the tri-county region (Spartanburg, Greenville, and Pickens counties) that made up the Greenville-Spartanburg SMA (Standard Metropolitan Area). Spartanburg boasted a variety of employment opportunities for its residents in manufacturing industries such as textiles, metals, rubber, paper, chemicals, clothing, and plumbing supplies. In addition, it was the site of several colleges and universities (see Exhibit 3). Unfortunately, the area had not shared equally in the growth experienced in other parts of South Carolina and the South Atlantic region (Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, and West Virginia) in recent years.

EXHIBIT 3 Colleges and Universities in Spartanburg County

Institution	Enrollment
University of South Carolina — Spartanburg	2,778
Spartanburg Technical College	1,813
Converse College	1,078
Spartanburg Methodist College	1,067
Wofford	1,034
Rutledge College — Spartanburg	447

Source: South Carolina Statistical Abstract, 1984.

For example, the populations of the surrounding SMA and county were growing at a rate exceeding the average for the United States. However, between 1978 and 1984 this growth rate had not kept pace with the population growth experienced in the rest of South Carolina or in the South Atlantic region. In fact, the population in the city of Spartanburg had actually declined (see Exhibit 4).

Despite lackluster population growth, the Spartanburg area was relatively prosperous in comparison to the rest of South Carolina. Even so, the effective buying incomes of area inhabitants lagged behind both the total United States and the South Atlantic region. To make matters worse, Spartanburg was falling further behind national and regional averages and recently had lost some of its advantage over the rest of South Carolina (see Exhibit 5).

The outlook for retailing, particularly eating and drinking establishments, was not exceedingly bright either. Sales did increase for retailers between 1978 and 1984 in Spartanburg and the surrounding area. And, as Exhibit 6 shows, this growth rate compared favorably overall to that experienced on average in the United States. On the other hand, Exhibit 6 also shows that the rate of growth in retailing for the Greenville-Spartanburg SMA did not compare favorably to average growth rates in South Carolina and the South Atlantic states. Contrary to trends in South Carolina, the South Atlantic states, and the United States in general, eating and drinking establishments' share of total retail sales in the Greenville-Spartanburg SMA had declined substantially in the 1980s. The outlook for eating and drinking places in the city was the least favorable. Eating and drinking place sales had increased only 5 percent since 1978 whereas they had increased 73 percent on average in the United States and more than doubled in the rest of South Carolina during the same period. There were greater opportunities outside the city though, as the migration to the suburbs provided increased demand for restaurants in these locations.

Competition in the Spartanburg Area

The pizza industry had expanded rapidly in the 1980s. With this trend came increased competition for the St. George Street Pizza Delights from nationally owned pizza chains and even from companies producing frozen pizzas sold in grocery stores. In addition to being in fierce competition with seventeen local and nationally owned pizza places, the St. George Street restaurant competed with a total of 170 restaurants of other types and with several other Pizza Delights restaurants in the Greater Spartanburg area. One of these Pizza Delights restaurants was within a few miles of the St. George operation. Exhibits 7 to 9 provide average common size income statements, balance sheets, and financial ratios, respectively for traditional and fast food restaurants with less than $1 million in sales for 1985.

EXHIBIT 4 Area Population Statistics, 1978 and 1984 (population and households in thousands)

Year	Total population	% of U.S.	Total households	% of U.S.	Median age	Population by age group (%) 0–17	18–24	25–34	35–49	≥50
Spartanburg										
1978	46.9	.02%	16.7	.02%	31.2	26.8%	14.2%	14.6%	16.3%	28.1%
1984	44.9	.02%	17.4	.02%	32.2	24.5%	13.3%	17.0%	16.0%	29.2%
Change	−6.2%		+4.2%							
Spartanburg County										
1978	196.7	.09%	67.8	.09%	30.6	28.0%	12.6%	16.7%	17.2%	25.5%
1984	213.5	.09%	78.3	.09%	32.1	26.6%	11.1%	17.2%	19.6%	25.5%
Change	+8.5%		+15.5%							
Greenville-Spartanburg SMA										
1978	541.4	.25%	184.5	.24%	29.8	27.9%	13.9%	17.1%	17.1%	24.0%
1984	605.0	.25%	222.1	.26%	31.3	26.2%	12.6%	17.8%	19.5%	23.9%
Change	+11.7%		+20.4%							
South Carolina										
1978	2,934.8	1.3%	933.8	1.2%	27.7	31.2%	14.5%	15.9%	16.0%	22.5%
1984	3,353.4	1.4%	1,172.0	1.4%	29.8	28.2%	13.3%	17.6%	18.1%	22.7%
Change	+14.3%		+22.5%							
South Atlantic Region*										
1978	34,981.7	15.9%	12,186.8	15.9%	30.3	28.2%	13.4%	15.7%	16.3%	26.4%
1984	39,904.5	16.8%	14,612.2	16.8%	32.3	25.4%	12.1%	17.2%	18.5%	26.8%
Change	+14.1		+19.9%							
United States										
1978	219,768.5	100%	76,904.7	100%	30.1	28.8%	13.2%	15.7%	16.4%	26.0%
1984	238,274.7	100%	86,926.6	100%	31.7	26.3%	12.2%	17.4%	18.3%	25.9%
Change	+8.4%		+13.0%							

Source: "Survey of Buying Power," *Sales and Marketing Management,* 1979 and 1985.

* Includes Delaware, District of Columbia, Florida, Georgia, Maryland, North Carolina, South Carolina, Virginia, and West Virginia.

EXHIBIT 5 Effective Buying Incomes in 1978 and 1984

	Total EBI (in $000)	Per capita EBI	Average household EBI	Median household EBI
Spartanburg				
1978	$308,625	$6,580	$18,481	$14,721
1984	$410,214	$9,136	$23,576	$18,782
Change	+32.9%	+38.8%	+27.6%	+27.6%
Spartanburg County				
1978	$1,127,798	$5,734	$16,634	$14,702
1984	$1,943,381	$9,102	$24,820	$21,828
Change	+72.3%	+58.7%	+49.2%	+48.5%
Greenville-Spartanburg SMA				
1978	$3,203,011	$5,916	$17,360	$15,349
1984	$5,434,481	$8,983	$24,469	$21,540
Change	+69.7%	+51.8%	+41.0%	+40.3%
South Carolina				
1978	$15,425,876	$5,256	$16,519	$14,047
1984	$28,550,182	$8,514	$24,360	$20,969
Change	+85.1%	+62.0%	+47.5%	+49.3%
South Atlantic Region				
1978	$212,961,331	$ 6,088	$17,475	$14,681
1984	$408,218,168	$10,230	$27,937	$23,576
Change	+91.7%	+68.0%	+59.9%	+60.6%
United States				
1978	$1,439,815,449	$ 6,552	$18,722	$16,231
1984	$2,576,533,480	$10,813	$29,640	$25,496
Change	+78.9%	+65.0%	+58.3%	+57.1%

Source: "Survey of Buying Power," *Sales and Marketing Management,* 1979 and 1985.

Exhibit 10 shows the locations of competitors in the St. George Street area. Descriptions of Pizza Delight's major pizza competitors follow. Exhibit 11 summarizes the product, service, and pricing strategies of these competitors.

Domino's

Domino's, Inc., was the leading competitor for delivery pizza. The company's strategy was to offer its customers fast delivery service (usually less than 30 minutes) for a medium-priced pizza. Domino's sold only pizza; the firm did not include other Italian dishes on its menu. Domino's pizza was reputedly of low to medium quality.

EXHIBIT 6 Retail and Eating & Drinking Places Sales in 1978 and 1984

			Eating & drinking places		
	Total retail sales	**Sales per capita**	**Total sales**	**Sales per capita**	**% of total retail**
Spartanburg					
1978	$417,207	$ 8,896*	$41,507	$885*	9.9%
1984	$526,485	$11,725*	$43,625	$972*	8.3%
Change	+26.2%	+31.8%	+5.1%	+9.8%	
Spartanburg County					
1978	$ 635,084	$3,229	$58,911	$299	9.3%
1984	$1,015,451	$4,756	$79,688	$373	7.8%
Change	+59.9%	+47.3%	+35.3%	+24.7%	
Greenville-Spartanburg SMA					
1978	$1,911,506	$3,531	$175,057	$323	9.2%
1984	$3,117,321	$5,153	$257,667	$426	8.3%
Change	+63.1%	+45.9%	+47.2%	+31.9%	
South Carolina					
1978	$ 9,243,104	$3,149	$ .670,142	$228	7.3%
1984	$15,484,516	$4,618	$1,343,043	$401	8.7%
Change	+67.5%	+46.6%	+100.4%	+75.9%	
South Atlantic Region					
1978	$129,343,686	$3,697	$11,434,037	$327	8.8%
1984	$220,144,917	$5,517	$19,950,436	$500	9.1%
Change	+70.2%	+49.2%	+74.5%	+52.9%	
United States					
1978	$ 817,461,457	$3,720	$ 71,602,628	$326	8.8%
1984	$1,296,659,715	$5,442	$124,035,013	$564	9.6%
Change	+58.6%	+46.3%	+73.2%	+73.0%	

Source: "Survey of Buying Power," *Sales and Marketing Management*, 1979 and 1985.

* Retail sales per capita for the city are higher than for the county, SMA, state, region, and nation due to the large number of noncity resident sales.

EXHIBIT 7 Average Common Size Income Statements for Traditional and Fast Food Restaurants in the United States with Less Than $1 Million Sales for 1985

	Traditional* (N = 481)	Fast foods** (N = 301)
Sales	100.0%	100.0%
Cost of Goods Sold	43.8%	39.3%
Gross Profit	56.2%	60.7%
Operating Expenses	52.6%	55.0%
Other Expenses	1.6%	2.7%
Net Profit before Taxes	2.1%	3.0%

Source: Robert Morris Associates, *'86 Annual Statement Studies.*

* Includes restaurants selling prepared foods and drinks for consumption on the premises. Caterers and industrial and institutional food service establishments are also included (SIC 5812).

** Includes franchise operations (SIC 5812).

EXHIBIT 8 Average Common Size Balance Sheets for Traditional and Fast Food Restaurants in the United States with Less Than $1 Million in Sales for 1985

	Traditional* (N = 481)	Fast foods** (N = 301)
Assets:		
Cash & Equivalents	12.1%	14.9%
Trade Receivables (Net)	4.3%	1.9%
Inventory	7.6%	4.8%
All Other Current Assets	2.6%	2.6%
Total Current Assets	26.6%	24.2%
Fixed Assets (Net)	56.3%	53.0%
Intangibles (Net)	4.5%	6.2%
All Other Noncurrent Assets	12.6%	16.6%
Total Assets	100.0%	100.0%
Liabilities and Owners' Equity		
Current Liabilities	40.0%	38.6%
Long-Term Debt	32.8%	35.6%
All Other Noncurrent Liabilities	2.9%	2.1%
Total Liabilities	75.7%	76.3%
Owners' Equity (Net Worth)	24.3%	23.7%
Total Liabilities + Owners' Equity	100.0%	100.0%

Source: Robert Morris Associates, *'86 Annual Statement Studies.*

* Includes restaurants selling prepared foods and drinks for consumption on the premises. Caterers and industrial and institutional food service establishments are also included (SIC 5812).

** Includes franchise operations (SIC 5812).

EXHIBIT 9 Financial Ratios for Traditional and Fast Food Restaurants in the United States with Less Than $1 Million in Sales for 1985

Ratios	Traditional restaurants*			Fast food restaurants**		
	Upper quartile	Median	Lower quartile	Upper quartile	Median	Lower quartile
Current	1.3	0.7	0.3	1.2	0.6	0.3
Quick	0.8	0.4	0.2	0.9	0.4	0.1
Sales/Receivables	INF	451.0	74.9	INF	INF	507.1
Cost of Sales/Inventory	46.1	27.4	16.1	59.6	42.7	28.2
Sales/Working Capital	51.0	−38.5	−12.1	56.2	−31.4	−11.8
Times Interest Earned	4.9	2.0	0.4	5.9	2.5	1.0
Cash Flow/Current Portion of Long-Term Debt	4.5	1.6	0.7	5.4	2.4	1.2
Debt/Equity	1.0	3.2	−26.2	1.2	3.8	−14.5
Asset Turnover	5.2	3.5	2.2	5.1	3.3	2.4
Return on Equity	62.1%	23.1%	4.6%	81.6%	36.7%	15.9%
Return on Assets	17.1%	5.3%	−3.1%	20.0%	9.6%	1.0%

Source: Robert Morris Associates, *'86 Annual Statement Studies.*

INF = Infinite.

* Includes restaurants selling prepared foods and drinks for consumption on the premises. Caterers and industrial and institutional food service establishments are also included (SIC 5812). 481 establishments studied.

** Includes franchise operations (SIC 5812). 301 establishments studied.

Little Caesar's

This was a chain restaurant located in Perkins Plaza off White Rock Road and St. George Street. Little Caesar's catered to the take-out customer; it did not make deliveries or provide facilities for eat-in dining. Its pizza was of medium quality and medium priced. The chain also offered customers special Greek and Italian salads, sandwiches, and sliced pizza. To get volume, Little Caesar's frequently placed two-for-one coupons in local newspapers.

Pizza Factory

Located in the nearby Stephenson Plaza, this national chain restaurant provided take-out services as well as eat-in dining facilities for customers. Its customer service was low, however, as the restaurant had no waitresses. Pizza Factory offered customers a low-priced, medium-quality pizza, a variety of sandwiches, a salad bar, and alcoholic beverages.

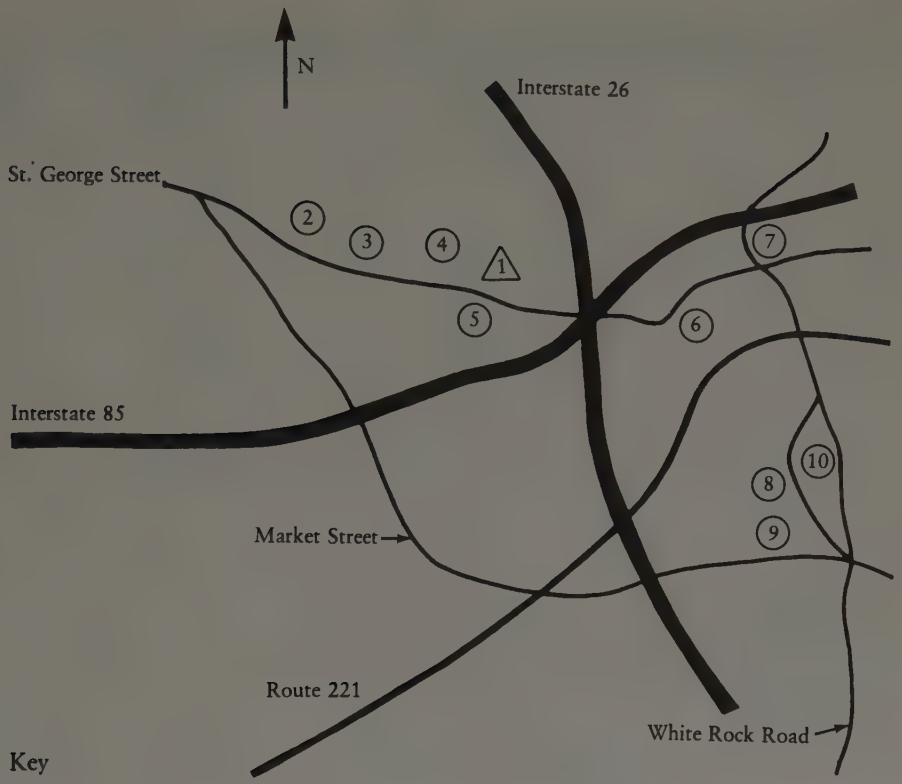


EXHIBIT 10 Locations of the St. George Street Pizza Delights and Its Competitors

Showbiz Pizza

Showbiz Pizza was a national chain restaurant catering to small children. Its dining room decor included dancing bears, games, and other attractions for children. Showbiz offered customers a medium-quality pizza to customers at a medium to high price.

EXHIBIT 11 Comparisons of Pizza Competitors

	Pizza Delights	Domino's	Little Caesar's
Services			
Eat-in	yes	no	no
Take-out	yes	yes	yes
Delivery	no	yes	no
Buffet	no	no	no
Luncheon Menu	yes	no	no
Salad Bar	yes	no	no
Service Level	high	high (delivery only)	low
Products (dinner only):			
Quality	med/high	low/med	medium
# of Pizzas on Menu	6	2	6
Types of Pizzas	2	1	1
Sizes	3	2	3
Slices	no	no	yes
Meat/Fish Toppings	6	4	6
Vegetable Toppings	6	7	7
Italian Dishes	spaghetti	no	no
Sandwiches (# × sizes)	4	0	3 × 2
Salads (exc. Bar)	no	no	3 × 3
Alcoholic Beverages	beer	no	no
Other Beverages	soft drinks, tea, milk, coffee	coke	soft drinks
Prices:			
Med. Cheese Pizza	$ 7.45	$ 6.02	$ 6.78
Med. 5–7 Toppings (#)	$10.00 (6)	—	$10.29 (5)
Med. 8–11 Toppings (#)	$10.80 (9)	$11.12 (9)	—
Lg. Cheese Pizza	$ 9.85	$ 8.17	$ 9.28
Lg. 5–7 Toppings (#)	$12.70 (6)	—	$13.52 (5)
Lg. 8–11 Toppings (#)	$13.55 (9)	$15.42 (9)	—
Toppings — Med./Lg.	$ .85/.95	$ 1.02/1.45	$ .77/.96
Italian Dishes	$ 1.99–3.39	—	—
Sandwiches	$ 2.89	—	$ 2.25–$2.69
Salads	$ 2.49	—	$ 1.20–$4.69
Alcohol (glass)	$ 0.95	—	—
Other Beverages	$ .50–$.75	$ 0.65	$ .48–$.87

Pizza Factory	Showbiz	Pizza Hut	Pizza Inn	Schiano's
yes	yes	yes	yes	yes
yes	no	yes	yes	yes
no	no	no	yes	no
no	no	no	yes	no
yes	yes	yes	yes	no
yes	no	yes	yes	no
low	high	high	high	high
medium	medium	med/high	low/med	high
6	5	10	12	6
1	1	3	2	2
3	3	3	4	3
no	no	no	no	no
9	4	7	6	5
10	6	8	7	6
no	no	spaghetti	spaghetti, lasagna	parmigiana, calzone, lasagna
4	5	3 × 2	4	6 × 2
no	1	no	1	2
beer	beer	beer	beer, wine	beer, wine
soft drinks, tea	soft drinks, tea, milk, coffee	soft drinks, tea, milk, coffee	soft drinks, tea, milk, coffee	soft drinks
$ 6.70	$ 8.09	$ 7.05–7.25	$ 5.80–7.80	$ 4.95–6.45
$ 9.55 (6)	$10.99 (6)	$ 9.80 (6)	$ 9.35–9.75	$ 9.20–10.70 (6)
$11.25 (11)	—	$10.60 (9)	$10.20–10.70 (9)	$10.20–11.70 (8)
$ 8.00	$ 9.99	$ 9.45–9.65	$ 9.00–9.50	$ 7.20–8.70
$10.96 (6)	$12.99 (6)	$12.50 (6)	$11.85–12.35 (7)	$12.20–13.70 (6)
$13.25 (11)	—	$13.35 (9)	$12.80–13.40 (9)	$13.20–14.70 (8)
$ .85./.95	$ .90/1.00	$ .90/1.00	$ .85/.95	$ .85/1.00
—	—	$ 2.09–4.49	$ 1.89–3.89	$ 3.29–6.95
$ 2.49	$ 1.39–2.59	$ 2.79–3.79	$ 0.79–2.59	$ 2.15–4.55
$ 2.59	$ 2.29	$ 2.79	$ 1.99	$ 1.79–3.49
$ 0.75	$ 0.99	$ 1.00	$ 1.00	$ 0.95–1.60
$ .55–$.75	$ .50–$.79	$ .50–$.80	$ .45–$.80	$ .65

Pizza Hut

Pizza Hut was the largest and most important competitor of Pizza Delights. Its strategy was to be a full-line pizza competitor, offering a medium- to high-priced product with correspondingly high levels of service and product quality. The company had been quite successful in introducing new pizza products, which it advertised heavily.

Although Pizza Hut did not operate a restaurant on St. George Street, its White Rock Road location was only a few miles to the east of the St. George Pizza Delights. It was more successful than the other Pizza Delights restaurant located nearby. Moreover, because of the growing population in the area, the Pizza Hut Corporation had considered building a new restaurant on St. George Street. Such a move would have a direct impact on the Pizza Delights because 30 to 35 percent of its customers were from the Roebuck area. However, after conducting a market survey Pizza Hut decided not to build a new restaurant in Roebuck in 1986, although this possibility was still under consideration for the future.

Pizza Inn

Besides Pizza Hut, Pizza Inn was Pizza Delights' most formidable competitor. Pizza Inn offered customers a variety of services including eat-in dining, take-outs, home delivery (started in early 1986), a salad bar, a luncheon buffet during the weekdays, and a dinner buffet every Tuesday. Its pizza was low to medium priced with corresponding levels of quality.

Schiano's

Schiano's was an example of the expanding pizza competition in the St. George Street area. This restaurant was under construction directly across the street from Outbanks's restaurant in the new St. George Street Plaza. Schiano's was part of a chain that offered high-quality, high-priced "New York" style pizza and extensive service. Due to its location, the restaurant was likely to be an important competitor for the St. George Street Pizza Delights. It was scheduled to open in late 1986.

Grocery Stores

The grocery stores in the area stocked a diverse line of pizzas and pizza products including microwave pizzas, store-made pizzas, and national brands of frozen pizzas. For the do-it-yourself customers grocers also offered pre-packaged pizza ingredients such as instant pizza crust, sauces, grated pizza cheese, sliced pepperoni, and so on. These take-home products were generally

of lower quality than the pizzas served in restaurants. However, they also were much lower in price (prices generally ranged from $0.79 to $4.00).

Delivery

One trend in the fast food industry, especially for pizza, had been to increase speed and efficiency. This trend was responsible for the opening of several pizza delivery stores in the Greater Spartanburg area, such as Domino's. In an attempt to penetrate this market for delivered pizza, Pizza Delights had opened a delivery store in August 1984 in Arcadia, South Carolina, just outside of the Spartanburg city limits. This store produced pizzas for delivery only. The delivery area included only those areas with a 10-mile radius of the store, excluding approximately 30 percent of the Spartanburg-Roebuck area. Since there was only one Pizza Delight delivery location, many problems had developed. To save transportation and delivery costs, the Arcadia store held orders until a large number of pizzas could be delivered to one area. This practice helped lower costs, but it hurt customer relations because delivery time sometimes exceeded one hour and pizzas were frequently delivered cold. According to market research, approximately 75 percent of the customers were dissatisfied with the current delivery service offered by the Arcadia Pizza Delights.

Products and Markets of the St. George Street Restaurant

The St. George Street restaurant did not have a specific target market, according to Earnest Outbanks. All types of people frequented the restaurant. In addition to regular customers, who composed 58 percent of the customer base, this store was convenient to shoppers of the two nearby plazas, commuters, and theater-goers. Almost 50 percent of the St. George Street restaurant's customers drove between 3 and 5 miles to the restaurant. Market research suggested that customers of the St. George Street restaurant frequented this restaurant fairly often, usually on a monthly basis.

Although pizza was the primary product, other menu items such as sandwiches, spaghetti, and a salad bar offered diversity to the customer. Exhibit 12 lists the menu items and prices for the St. George Street restaurant. Exhibit 13 provides a per item breakdown of food and beverage sales and costs for 1984–1985. Studies indicated that the quality of the pizza was the most important reason customers visited the St. George Street location, with service being high on their list as well.

EXHIBIT 12 Menu Items and Prices

Pizza*	Small	Medium	Large
Double Decker (3 varieties)	$ 8.00	$10.80	$13.55
Pan Pizzas:			
Cheese	$ 5.05	$ 7.45	$ 9.85
Delight (6 toppings)	$ 7.30	$10.00	$12.70
Super Delight (9 toppings)	$ 8.00	$10.80	$13.55
Additional Toppings	$ 0.75	$ 0.85	$ .95

(Pepperoni, Ham, Pork, Beef, Italian Sausage, Mushroom, Onion, Green Pepper, Black Olive, Jalapeno Pepper, Anchovy, Extra Cheese)

Spaghetti	Small	Regular
w/Meat Sauce	$ 1.99	$ 3.19
w/Meatballs	$ 2.39	$ 3.39
Salad Bar		
as a meal		$ 2.49
with a meal		$ 1.99
children under 12		$ 0.99
Sandwiches (4 varieties)		$ 2.89

Drinks
Soft Drinks:
Pitcher $2.25
Large $0.75
Medium $0.70
Small $0.65

Coffee $0.50
Milk $0.55
Ice Tea $0.65

Beer: Glass $0.95
Pitcher $3.95

Luncheon Specials: Monday–Friday	Alone	w/Salad Bar (one trip)
Italian Turnover**		
Cheese	$ 2.49	$ 3.88
Sausage	$ 2.49	$ 3.88
Small Pan Pizza		
Pepperoni	$ 1.79	$ 3.18
Supreme (6 toppings)	$ 2.19	$ 3.58

* Small pizzas serve 1–2 persons; Medium 3–4 persons; large 5–6 persons.
** Guaranteed to be ready in 10 minutes or your lunch is free.

Sales Fluctuations

Sales at the St. George Street restaurant were generally lowest in January, February, and March. Sales in these months accounted for only 13 percent of yearly revenues. April through June sales accounted for 24 percent of yearly

EXHIBIT 13 Gross Profit by Product Line

	1985	1984
Pizza:		
Eat-in Pizza	$204,886	$168,174
Carry-out Pizza	215,806	181,774
Net Pizza	$420,692	$349,948
Plus: Pizza Allowances	5,772	4,806
Coupon Sales	31,213	30,241
Total Prom/Adv sales	36,985	35,047
Gross Pizza Sales	$457,677	$384,995
Cost of Pizza Dough	$ 20,530	$ 17,793
Cost of Toppings	38,066	30,666
Cost of Cheese	47,944	41,698
Cost of Paper-Pizza	6,580	5,663
Freight	99	1,157
Total Pizza Cost	$113,219	$ 96,977
Gross Profit on Pizza	$344,458	$288,018
Beer:		
Sales	$ 13,747	$ 13,236
Costs	4,453	4,004
Gross Profit on Beer	$ 9,294	$ 9,232
Drinks:		
Sales	$ 39,599	$ 33,200
Costs	8,162	6,584
Gross Profit on Soft Drinks	$ 31,437	$ 26,616
Other:		
Salad Sales	$ 26,295	$ 27,012
Pasta Sales	9,069	9,873
Sandwich Sales	5,615	4,805
Other Prom/Adv. Reven.	5,278	5,482
Total Other Sales	$ 46,257	$ 47,172
Cost of Other Sales	18,572	20,649
Gross Profit on Other Sales	$ 27,685	$ 26,523

sales, and 31 percent of annual sales occurred between October and December. The highest sales period was between July and September when 32 percent of annual sales were realized. September, which accounted for 18 percent of annual sales alone, typically was the best month for the restaurant. The high sales levels in September were due to Roebuck High School's weekly football games. After the games, spectators and students often met for an evening snack at Pizza Delights.

Sales also fluctuated during the week (see Exhibit 14). Monday was the slowest day accounting for 8.5 percent of weekly sales. Friday's sales were the highest (23.4 percent).

Lunch sales were always low. The best day for lunchtime sales was Friday, but even on this day lunch sales averaged only 3.3 percent of weekly revenues. The slowest day for lunch was Tuesday, which accounted for a mere 1.8 percent of weekly sales. When the Italian turnover pizza was introduced as a strictly lunchtime item, the Pizza Delights Corporation felt that lunch sales would increase. However, this has yet to happen at the St. George Street location; sales simply shifted from the small pan pizzas to the Italian turnovers.

Advertising and Sales Promotion

Pizza Delights advertising could be divided into three types: national, co-op, and local ads. National advertising was done countrywide, targeting mass markets to familiarize people with the Pizza Delights name as well as its products. Co-op advertising was done on a district-by-district basis and included mention of the individual restaurants and products. Both types of ads were financed by the restaurants on a percentage-of-sales basis. This arrangement applied to company-owned and franchised restaurants. Neither company-owned nor franchised restaurants had any input into these decisions and basically just implemented whatever campaign the corporation recommended.

Local ads were paid by the individual restaurants and placed in local papers. Franchise owners had greater discretion than managers of company-

EXHIBIT 14 Daily Sales Breakdowns

	Lunch		Dinner	
	$	%	$	%
Monday	198	1.9	692	6.6
Tuesday	186	1.8	716	6.8
Wednesday	191	1.8	874	8.3
Thursday	260	2.5	1390	13.3
Friday	350	3.3	2105	20.0
Saturday	308	2.9	1761	16.8
Sunday	205	1.9	1277	12.1
Average Sales per Week		$10,513		

owned restaurants concerning the types and amounts of local promotions used. The St. George Street restaurant's advertising expenses amounted to over $29,000 in 1985. As shown in Exhibit 1 this represented a substantial increase over advertising expenses for 1983 and 1984.

All national and co-op advertising for the Pizza Delights chain restaurants were coordinated by an advertising firm in Washington, D.C. A sample announcement of a new national promotional campaign for the Italian turnover is provided in Exhibit 15. The main component of the co-op advertising for the

EXHIBIT 15 Promotional Announcement to Spartanburg Pizza Delight

Hot News from Your Friends at Beaumont Green Advertising

TO: Pizza Delights Managers & Employees/Spartanburg
DATE: February 26, 1986
SUBJECT: Advertising for the Italian Turnover

Background
Many of you will recall the tremendous success that the introduction of the small pan pizza had on our business in 1983. In 1986, the opportunity to stimulate both trial and frequency at lunch lies mainly in the area of menu expansion. Therefore, the Italian Turnover has been developed. This new product will increase your sales and profits at lunch. You have all shown your operational strength with the Double Decker Pizza introduced in 1984. Let's make the Italian Turnover the success story of 1986!

Television
Starting March 14, 1986, and running through May 1, 1986, three new TV commercials focusing on the Italian Turnover will be run.

Radio Promotions
A radio promotion has been developed and implemented. This promotion is provided free of charge in exchange for Italian Turnovers for giveaways. Details of the promotion are provided below:

WASQ-FM will encourage listeners to be the "X" number caller that spotted the WASQ logo on one of the Italian Turnover outdoor billboards. Winners receive two Italian Turnovers and two medium soft drinks. There are to be three giveaways per day, Monday through Friday, for a total of 60 giveaways.

Outdoor
There will be #18, outdoor boards strategically placed in the area. The message will be "Turn over a new lunch with the Italian Turnover," which is the main print advertising theme for the introduction of the Italian Turnover. These boards will be posted from March 26, 1986, to May 10, 1986.

Greater Spartanburg area restaurants was a monthly four-color, free-standing insert in the city newspaper. This ad usually was accompanied by coupons for selected items, allowing customers a 15 to 20 percent discount off regular prices. The bulk of the Greater Spartanburg area co-op advertising was done in the fall when sales tended to be the highest.

The St. George Street location also did a variety of sales promotions. A child who read five books in one month would receive a free small pan pizza. The restaurant also did birthday parties and allowed participants the opportunity to create their own pizzas in the kitchen. Two other promotions that the St. George Street restaurant ran in the past were "family night" and "football night." Family night was a dinner promotion in which a family could buy a large pizza and a pitcher of soft drinks for $9.95. This was a companywide promotional effort that was discontinued because of low response on a national level. However, this promotion was a huge success at the St. George Street restaurant. The football promotion involved taking small pan pizzas to the Roebuck High School game and selling them with a soft drink for 99 cents. This promotion also was discontinued because the district office felt that it would ruin Pizza Delight's high-quality/high-service image. Despite the district office's concerns, the football night promotion received tremendous consumer response, usually producing sales of around $800 per game.

Internal Operations

Order Processing

The layout of the St. George Street restaurant is shown in Exhibit 16. Orders were processed as follows.

After taking an order the waitress punched it into one of the computer terminals located near her station or the cash register. Tickets were printed out on printers located over the cook's make table and at the waitress station. If the order was for a pan pizza, the cook had to walk 20 feet to the walk-in cooler and get a dough shell. If the order was for a double decker pizza, the dough was rolled out on the table at that time. The pizza, whether regular, double decker, or pan, was then made on the table and placed in the oven.

The ticket was then moved to an order stand at the end of the make table where an employee-in-charge would place it on a ticket holder. When sales volume was extremely high, such as on the weekends, the movement of the ticket led to problems and lost pizzas. After the pizza was cooked, it was given to the customer at the cash register where payment was also received, in the case of to-go orders. For in-store orders, the waitress would take the pizza and the ticket out to the customer.

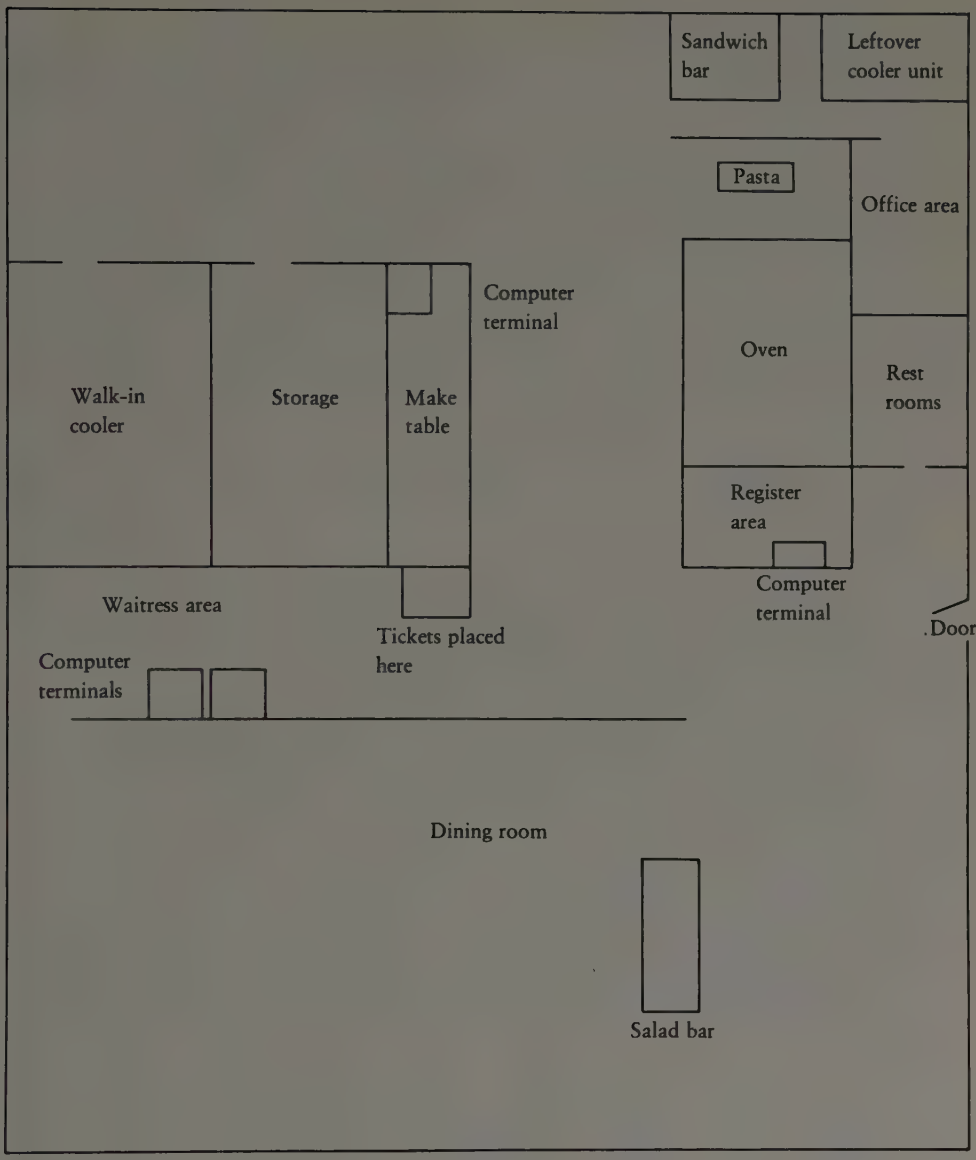


EXHIBIT 16 Restaurant Layout

Operating Concerns

Outbanks realized that there were several major problems at his restaurant that needed to be corrected. All of these problems troubled him but none had yet been solved.

Most of Outbanks's concerns stemmed from the physical facilities at the restaurant itself. Cooler space at the restaurant was inadequate. Frequent opening and closing of the cooler kept items from staying cold. This led to several problems in trying to maintain high-quality products. For example, customers consistently complained that the beer was too warm; perhaps explaining why beer sales had not increased like other items had. Keeping beer cold was not the only concern. According to Outbanks, because pizza ingredients and other foods were not kept cold enough, inventory spoilage was very high ($175–200 per month) and increasing. To make matters worse, each Friday and Saturday when sales reached their weekly peak, employees had to shuffle other items around in the walk-in freezer to make room for the dough shells. This situation often caused older stock to be used last; leading to even more spoilage.

Outbanks had spoken to the district manager about purchasing a new walk-in cooler for the restaurant but had no idea how long it would take for the Pizza Delights hierarchy to approve the purchase. The new walk-in cooler was estimated to cost approximately $11,000.

Outbanks' restaurant had several other capacity problems that needed correcting. The restaurant used a conveyor-type oven in its operations. The oven was only two years old and in good repair. It had two conveyors. The upper conveyor was kept in operation at all times; the lower conveyor was used only during peak periods. Both conveyors were 10 feet long. Up to four uncooked pizzas could be loaded on first 2 feet of each conveyor. The oven itself was 6 feet long and could accomodate up to six pizzas at a time, per conveyor. The last 2 feet of the conveyors were used to allow the pizzas to cool off before serving. The conveyor oven allowed a more uniform quality pizza than the traditional oven. However, for preparing other items such as spaghetti or hot sandwiches, the traditional oven had an advantage over the conveyor oven.

Another limitation was that the speed of the conveyors that passed through the oven could not be adjusted up or down. As a result, the pizzas and other products could not be cooked any faster than the conveyor allowed. Although cooking time for the conveyor-type oven was faster (eight minutes for cooking and one minute for cooling) than traditional pizza ovens under normal circumstances, it limited the number of products that could be produced on an extremely busy night. With traditional ovens, on the other hand, it was possible, to "stack" cook the pizzas. This procedure, while lowering the quality of the final product (e.g., burnt pizzas) and sometimes creating confusion among the workers, did allow many more pizzas to be cooked during the

course of an evening. Outbanks had considered purchasing another conveyor oven at an installed price of $12,500 but had not discussed this idea with the area supervisor or with Leonard Lloyd. By contrast, a traditional oven would cost $8,200 installed.

Limited dining room and parking capacity also constrained sales. The dining room consisted of twenty-two tables, which could seat eighty-eight customers. During peak sales nights customers were forced to form a line out the door waiting for an empty table. Furthermore, the parking lot had only thirty spaces, which created havoc on Friday and Saturday nights as take-out customers tried to rush in and out, while families and friends slowly ushered their way into the line for dining-in. Due to the limited parking, employees were required to park in a dirt field behind the restaurant. Outbanks estimated paving the field would allow fifteen extra parking spaces for customers at a cost of $8,000.

Employees

Outbanks's staff included two assistant managers, Pete Gorman and Betty Franks. Gorman, a 36-year old ex-high school teacher, had been an assistant manager at another Pizza Delights for several years prior to joining Outbanks's staff. He was considered a stringent, rule-oriented manager, who was trying to do everything in his power to gain a head manager position. Franks was a recent graduate of Clemson University. She had brought many innovative ideas to the restaurant, including the idea to weigh-out the cheese instead of using cheese cups as had been done previously. Outbanks had not totally accepted this idea, but because he knew of a manager in another location who had cut his cheese costs by 10 percent using this technique, he decided it was worth a second look. The assistant managers were responsible for supervising the restaurant when Outbanks was not working and for helping him with other managerial chores such as purchasing, inventory, scheduling, and so on. Both assistant managers were required to work a minimum of fifty-five hours per week. Assistant managers were paid $5.80 per hour for the first fifty-five hours worked and time-and-one-half for any additional hours after that.

In addition to Outbanks, Gorman, and Franks, the St. George Street restaurant employed seventeen hourly workers, including six waitresses, seven cooks, two dishwashers, and two "employees-in-charge" (EICs). The majority of these employees worked on a part-time basis. All employees were evaluated every six months, and they automatically received a 10¢ per hour raise regardless of performance.

The waitresses were paid on an hourly basis, below the minimum wage. Nonetheless, with tips included, their overall wage usually amounted to well above the hourly minimum wage of $3.35. The waitress was responsible for

seating customers, taking orders, and serving the meal to the customer. Because waitresses were continuously in contact with the consumers, they played a vital role in providing the excellent service that Pizza Delights was famous for.

The cooks were hired at or slightly above the minimum wage. Their duties included doing the prep-work, cooking the food, and ensuring the cleanliness of the facility. They also played a vital role in the business by assuring that the food prepared was of the highest quality possible.

The dishwashers usually were hired at minimum wage and promoted to cook after a few months. Besides washing dishes, their duties included keeping the dining room and other work areas as clean as possible.

The EICs were those cooks or waitresses that, through experience and expertise, had shown that they could handle additional responsibilities. Paid in excess of $4.00 per hour, they were responsible for the supervision of the cooking process and the daily bookkeeping. Thus, they were instrumental in ensuring product quality.

Commenting on his employees Earnest Outbanks once said, "The St. George Street Pizza Delights is a high-quality restaurant because everyone from me to the dishwashers works as a team to provide the best product, with the best service to our customers." This was in stark contrast to the way the restaurant had been operated prior to Outbanks assuming the manager's position in 1981. Despite the improvements made in this area Outbanks also realized that, in general, employee commitment was low due to the fact that the cooks and waitresses were generally young college or high school students who often had conflicting responsibilities, such as school or another job.

Labor Costs

By company policy, all labor costs were computed daily. Pizza Delights had established a labor grid that stipulated how many employees were needed each hour the restaurant was open based on normal per-hour sales. One labor grid was used during lunch hours (11 A.M. to 4 P.M.) and another was used for dinner hours (4 P.M. to closing). These grids are provided in Exhibit 17. Outbanks also used the average break times of employees to compute his daily labor costs. At the end of the day, the actual number of hours were compared to the suggested labor grid hours. Any variances had to be explained to the district manager.

The number of employees needed per sales dollar was higher during lunch hours because of the lower per item price of lunchtime products, and because of the extra demands in providing a ten-minute guarantee for serving the small pan and Italian turnover pizzas.

Since the introduction of the Italian turnover pizza, Pizza Delights required that a minimum of ten employees be present during the guaranteed

EXHIBIT 17 Projected Labor Schedule: Lunch and Dinner

Lunch		Dinner	
Projected sales per hour	**Projected labor needs (# of workers)**	**Projected sales per hour**	**Projected labor needs (# of workers)**
$ 0– 41	2	$ 0– 95	2
42– 61	3	96–143	3
62– 87	4	144–190	4
88–119	5	191–211	5
120–156	6	212–255	6
157–180	8	256–295	8
181–202	9	296–338	9
203–245	10	339–379	10
246–298	11	380–423	11
299–342	12	424–461	12
343–387	13	462–507	13
388–450	14	508–547	14
451–519	15	548–589	15
520–614	16	590–631	16
615–695	17	632–673	17

Notes:

Average total hours of breaktime per week

Monday	Tuesday	Wednesday	Thursday	Friday	Saturday	Sunday
2.6	2.6	2.9	3.5	4.6	4.2	1.9

Average hourly pay scale per position

Assistant Managers	$5.80
Employees-in-charge	$4.10
Cook	$3.45
Waitresses	$2.30 plus tips
Dishwasher	$3.35

hours of 11 A.M. to 1:30 P.M., Monday through Friday, to better promote the new product. No minimum was specified for the weekends, however. Before it was introduced, the St. George Street restaurant operated quite efficiently with a total of twenty-eight employee hours between 8 A.M. and 4 P.M. on Monday, Tuesday, Wednesday, Saturday, and Sunday; thirty-three total employee hours on Thursdays; and thirty-eight total employee hours on Fridays. These hours had increased to almost fifty-five hours per day on average during the weekdays, due to Pizza Delight's new policy after the Italian turnover pizza was introduced. Because Outbanks had not realized any additional profits from the Italian turnover, he wondered if he could operate the restaurant as profitably as he did before it was introduced.

Lloyd's Greer Area Pizza Delights Franchise Operations

With a population of approximately 10,000 persons in 1985, Greer, South Carolina, could be categorized as a typical small southern town. The inhabitants of this small community were very family-oriented. The town was custom-made for a restaurant providing a high level of customer service as Lloyd's original Pizza Delights franchise did.

Eating out was not very common in Greer in the early 1970s partly because there were only two places in town to eat (a diner and a truck stop) and partly because the residents generally preferred to eat at home. However, in the mid-1970s the attitudes of the population began to change as several fast food restaurants were opened. Grabbing a hamburger or some chicken after church or after a Little League game became fashionable and convenient.

Lloyd's Pizza Delights restaurant was the most recent fast food restaurant built in the community. The restaurant was company-owned during its first three years of operation. Recognizing the potential of the restaurant, Lloyd, an area businessman, purchased the franchise from Pizza Delights in 1981 for $375,000, plus $1.2 million for the right to use the company's brand name.

In his first year of operation Lloyd increased the seating capacity at the restaurant from 65 to 150 people. He felt that the demand for pizza in the Greer area could easily accomodate a dining area of that size. Sales revenues increased 7 percent that year. However, the restaurant did not operate at full capacity.

In 1982, disenchanted by the slow growth in sales, Lloyd decided to offer customers more specials and new dining options. Two-for-one coupons were placed in the local newspapers on a regular basis. Taking advantage of his two ovens and massive dining area, Lloyd also began to offer a lunch buffet during the weekdays to attract students from a nearby community college. Sales revenues increased by 10 percent almost overnight and many customers began inquiring about the possibility of a Sunday buffet. Lloyd's decision to extend the buffet to Sundays allowed him to capture a significant share of the after-church market, increasing sales during a time of the week when sales had traditionally been low.

The first Greer franchise restaurant was very successful with sales increasing by about one-third since 1982. The only direct pizza competitor for the Greer restaurant was Papa Joe's. This restaurant offered relatively little service and relied almost entirely on take-out business.

Inspired by his success at the Greer location, in 1983 and 1984 Lloyd purchased the franchises to two additional Pizza Delights restaurants in two small rural communities, both approximately 5 to 10 miles outside of Greer. Both of these restaurants followed the same strategy as the Greer restaurant and both were profitable. Lloyd had been able to retain the managers who had previously worked for the Pizza Delights Corporation by giving them a minority ownership position in these restaurants.

Lloyd's Plan

Although Lloyd had not worked out all the details of how the St. George Street restaurant should be operated he had made some initial inquiries at the Pizza Delights' district office in Columbia, South Carolina, to determine if purchasing the restaurant would be feasible. The district office quoted Lloyd a price of $725,000 for the physical facilities plus an annual payment of 12 percent of the restaurant's net profits before taxes. The Pizza Delights brand name was valued at over $1.0 million. However, Lloyd knew he would not have to pay this fee because he had already purchased the brand rights for the Greer restaurants.

Lloyd hoped that many of the same strategies he had used at the Greer restaurants would be feasible at the St. George Street location. He wanted to offer a buffet-style dinner or lunch to customers at least once or twice a week. He also wanted to try to offer more in the way of coupon and promotional gimmicks to attract more customers and smooth out sales. Outbanks had wanted to attempt such a move for several years but had been constrained by the corporation's policies. Franchising would solve this problem at least partially.

All these policies had been quite successful in Greer, and Lloyd saw no reason why these successes would not be transferable to the Roebuck-Spartanburg area despite the differences between the two locales. In addition, Lloyd toyed with the idea of setting up a delivery service at the St. George Street location. Spartanburg was a college town, and Lloyd expected that such a service would be welcomed by students in the area. If a delivery operation was started it would require two half-time employees paid at the minimum wage, plus the purchase of two used cars for approximately $5,000 apiece. Gas, maintenance, depreciation, and other related operating expenses associated with the vehicle were estimated at 20¢ per mile.

Lloyd felt that these proven strategies, combined with new ideas and Outbanks' managerial abilities, would ensure success for the St. George Street location.

Franchise Ownership and Financing Arrangements

Lloyd was prepared to invest $250,000 in the St. George Street restaurant and planned to borrow the rest of the needed capital from one of the financial institutions in the area. In 1986 the prime rate for commercial borrowing was 7.5 percent. However, Lloyd realized that he would probably be required to pay a premium of at least 1.5–2.5 percent over prime.

After talking with a Spartantburg banker, Lloyd learned that he would need a minimum of 25 percent equity to back the franchise and would be

required to give the bank a first mortgage on the restaurant, as well as pledge all his personal assets as security. The loan itself would probably be a term loan amortized over fifteen years with a balloon payment after three to five years. Lloyd figured that payments for a straight fifteen-year amortized loan of $500,000 at 10 percent interest would amount to $5,373 per month or almost $65,000 per year.

The Spartanburg banker also informed Lloyd that franchise loans frequently were not approved by her bank, citing an example of another Pizza Delights franchise in Greenwood, South Carolina, that recently was denied a loan. Exhibits 18 and 19 provide the income statement and balance sheet for the Greenwood Pizza Delights franchise.

Lloyd was not particularly worried by the banker's pessimism, however, as the types of loans sought differed (the Greenwood franchise wanted capital for equipment purchases and for building a new restaurant); the local area environments differed (Greenwood was a rural community more like Greer than Spartanburg in terms of population and area demographics); and the financial performance of the St. George Street restaurant was stronger. Lloyd also had a successful track record in business and had never experienced problems obtaining financing in the past; he saw no reason why it would be different this time around.

Although all the details had not been discussed, as part of the proposed franchising plan Outbanks was expecting to receive a one-quarter to one-third interest in the store, plus his normal salary, for services rendered. Outbanks also expected to have complete control over the day-to-day operations of the restaurant. With respect to strategy and policy matters, Outbanks believed that both he and Lloyd would have an equal voice. Such an arrangement, Outbanks felt, was similar to the deal Lloyd had made with the managers at his franchise restaurants in Greer.

Outbanks also expected to be required to cosign the note and pledge his personal assets as collateral. His financial commitment to the franchise would be considerably less than Lloyd's though, as Outbanks had only around $25,000 to $30,000 to invest.

Earnest's Dilemma

After weighing the pros and cons of the situation in his mind, Outbanks still was not sure whether he should join Lloyd in the franchising venture or stay with the company and try to progress up the corporate ladder. Outbanks did understand that his restaurant was currently making hefty profits (Exhibit 1), profits that he was not sharing in. He also understood that he was responsible for most of the restaurant's current success. Moreover, he admired Lloyd for his success with the Greer Pizza Delights franchises. On the other hand, Out-

EXHIBIT 18 1985 Income Statement for the Greenwood Pizza Delights

Sales:		$638,284
Food in	$322,928	
Food out	239,260	
Food Delivery	14,064	
Food Subtotal	$576,252	
Beverages in	$ 61,612	
Beverages Delivery	120	
Beverages Subtotal	$ 61,732	
Premiums	300	
Cost of Goods Sold:		$184,400
Food Cost	$167,600	
Beverage Cost	16,800	
Premiums	0	
Gross Profit		$453,884
Operating Expenses:		$303,560
Advertising	$ 22,000	
Auto & Delivery Expenses	600	
Payroll	198,325	
Repairs	19,403	
Utilities & Telephone	3,504	
Operating Supplies	10,320	
Other Operating Expenses	22,408	
Operating Profit		$150,324
Administrative Expenses:		$131,080
Royalty Fee	$ 19,000	
Insurance	12,450	
Interest	7,770	
Depreciation	27,250	
Rent	42,000	
Taxes & Licenses	4,000	
Other Administrative Expenses	18,610	
Net Profit before Taxes		$ 19,244

banks wondered if Lloyd's plans, which had worked so well in Greer, would achieve comparable levels of success in the St. George Street restaurant. He also knew that Pizza Delights was growing rapidly and that there might soon be an area supervisor position open for a young, energetic manager with a proven track record.

Personal problems also caused Outbanks to wonder whether he would continue to have the time, money, and motivation to devote to such a venture.

EXHIBIT 19 1985 Balance Sheet for the Greenwood Pizza Delights

Assets:		$119,820
Cash in Bank	−$ 14,200	
Cash on Hand	1,000	
Investments	2,700	
Accounts Receivable	1,500	
Inventory	7,500	
Total Current Assets	−$ 1,500	
Automobiles	$ 17,500	
Less Depreciation	− 9,500	
Net Automobiles	$ 8,000	
Equipment	$150,000	
Less Depreciation	− 70,000	
Net Equipment	$ 80,000	
Leasehold Improvements	$ 10,200	
Less Depreciation	− 3,000	
Net Leasehold	$ 7,200	
Total Fixed Assets	$ 95,200	
Deposits	$ 220	
Insurance Reserve Fund	1,700	
Prepaid Insurance	3,000	
Prepaid Rent	4,200	
Franchise Fees	17,000	
Total Other Noncurrent Assets	$ 26,120	
Liabilities:		$ 63,950
Accounts Payable	$ 650	
Other Current Liabilities	13,300	
Total Current Liabilities	$1 13,950	
Long-Term Liabilities	$ 50,000	
Equity		$ 55,870
Liabilities + Equity		$119,820

A major dispute, with his now estranged wife, had greatly taxed Outbanks' mental and physical endurance. This dispute, which Outbanks expected to end in divorce, was also likely to deplete his financial resources once it had been settled.

Despite all the problems Outbanks had to contend with, as he began to prepare for closing time he knew it was time to fish or cut bait. He resolved that he would give Lloyd his decision before the end of the following week.

CASE 6

Hopscotch — A New Game in Town

Sarah B. Baskette

The 1986 Christmas season was over and the results were in. Jane Mallard knew she had to take off her operations hat for awhile and put back on the raising capital hat for that inevitable second round of financing. She had started the children's toy catalog, *Hopscotch,* one year ago, and now, with significant results as facts rather than forecasts, Mallard was reconsidering her original strategy, incorporating the experiences of the past twelve months and deciding how to proceed during the coming year.

Hopscotch is a high-end, mail order catalog business that sells unique toys, gifts, and games for children. The products, not typically found in toy stores or other children's catalogs, are selected to fulfill the creative and imaginative needs of growing children. They offer a refreshing alternative to the mass-merchandised, high-tech toys advertised on television. The items

This case was researched and written for class discussion by Sarah B. Baskette of Eastern Michigan University. Presented at the North American Case Research Association. The names and pertinent data have been changed for company protection and case effectiveness. Copyright 1988. Used with permission of Sarah B. Baskette.

generally fall into three categories: educational with learning games and toys; traditional with old-time toys of lasting value and shared memories; and whimsical, silly, trendy toys just for the fun of it. Aimed at busy professional parents and grandparents, the message to the customer is that shopping for children should and could be fun and easy.

History of the Company

Mallard conceived of the *Hopscotch* catalog while working in the investments area of a large consumer products firm located in a major Midwestern city. She developed the business plan and hired a market research firm to conduct focus groups to test the concept. The focus group results were positive and informative showing, for example, the importance of grandparents as purchasers of children's toys and gifts.

After conferring with her attorney, Mallard established *Hopscotch* as a subchapter S corporation. Mallard was issued 51 percent of the 10,000 shares of authorized stock for $1 per share leaving 49 percent available for distribution to investors. The initial investors were Mallard herself, supportive family, and friends. The financial backing made it possible for Mallard to leave her position at the consumer products firm and devote full-time to launching *Hopscotch*. After the results from the first *Hopscotch* catalog were available, four private "sophisticated investors" or "angels" made significant investments in the company. By the end of the 1986, Mallard held 70 percent of the issued and outstanding stock.

The first catalog was produced in the spring of 1986 with fifty products for sale. Using names rented from five mailing lists, 30,000 "books" were

EXHIBIT 1 Hopscotch Spring Mailing, 1986

Mailing list	Number of books mailed	Number of responses	Percent response
Hopscotch*	2,500	119	4.8%
List A	5,000	162	3.2%
List B	7,000	171	2.4%
List C	5,000	92	1.8%
List D	5,500	85	1.5%
List E	5,000	61	1.2%
Total:	30,000	690	2.3%

* Hopscotch list includes names from advertising and catalog requests.

mailed throughout the country. The response rate was 2.3 percent with an average order of $38. The second catalog was mailed in time for Christmas. It was a complete catalog with 145 items for sale. Concentrating on a major test of the market, more than 280,000 catalogs were mailed nationally using thirty-five rented mailing lists. The response rate was 1.6 percent with an average order of $37. The response rate from the house list, the list of actual customers, was 9.7 percent. (See Exhibits 1 and 2) By the end of December 1986, the house list had grown to include 5,100 names. While headquartered in the Midwest, *Hopscotch* received the most orders from California, Illinois, and New York, bellwether states beyond the immediate region. (See Exhibit 3.)

The Industries

The Catalog Industry

The $50 billion catalog industry has been expanding rapidly at an annual rate of 15 percent over the past ten years. As the industry matures, however, the rate of growth is expected to slow to the 10 percent annual growth experienced in other retail businesses. With the trend away from the general merchandise catalogs like Sears and Montgomery Ward toward specialty catalogs that fill marketing niches, new catalogs have been entering the market causing a catalog glut. In 1984, over 6,500 catalog marketers sent 8.5 billion consumer books to U.S. households compared to 4,500 catalog marketers mailing 4.7 billion books in 1980. (See Exhibits 4 and 5.) At the same time, the percent of consumers who purchase at least one item through catalogs has stabilized at about 45 to 50 percent.

The reasons for this rapid growth in the recent past are many. The catalog industry basically provides a selection and shopping service that appeals to people who put a premium on their time. Women, for example, have started working outside the home in record numbers during the past decade. As a result, these women are earning money but have little time to spend shopping. With credit cards and toll-free, long distance numbers, customers can shop at their convenience avoiding parking hassles, wrong sizes and check-out lines. In addition, the computer age has made it possible for the catalog companies to develop and maintain extensive mailing lists, permitting statistical analysis and information about customers that simulates the personal relationship of small town merchants. In this way, the specialty catalogs can efficiently and effectively target selected segments of the market.

The latest trend in the specialty catalog business has been to open retail stores located in the expensive shopping promenades and malls. Unlike the warehouse image of *L.L. Bean,* these new stores were opening to create synergy with the primary business of the catalog. *Banana Republic, The Sharper Image,*

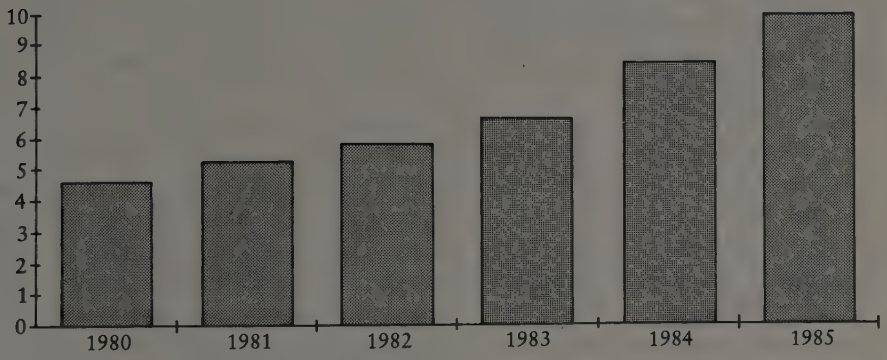
EXHIBIT 2 Hopscotch Christmas Mailing, 1986

Mailing list	Number of books mailed	Number of responses	Percent response
Hopscotch A	690	67	9.7%
Hopscotch B	6,125	269	4.4%
List A	8,000	233	2.9%
List B	15,000	417	2.8%
List C	10,000	276	2.8%
List D	6,000	155	2.6%
List E	10,000	248	2.5%
List F	6,000	123	2.1%
List G	5,000	99	2.0%
List H	6,000	118	2.0%
List I	10,000	186	1.9%
List J	6,000	109	1.8%
List K	6,000	103	1.7%
List L	6,000	102	1.7%
List M	10,000	165	1.7%
List N	6,000	93	1.6%
List O	9,975	126	1.3%
List P	6,000	72	1.2%
List Q	8,750	96	1.1%
List R	10,000	109	1.1%
List S	6,000	64	1.1%
List T	15,000	158	1.1%
List U	10,000	105	1.1%
List V	18,500	199	1.1%
List W	6,000	58	1.0%
List X	5,000	48	1.0%
List Y	5,000	46	0.9%
List Z	6,000	56	0.9%
List AA	5,000	45	0.9%
List BB	6,000	55	0.9%
List CC	6,000	55	0.9%
List DD	6,000	54	0.9%
List EE	6,000	54	0.9%
List FF	6,000	53	0.9%
List GG	5,000	36	0.7%
List HH	6,000	42	0.7%
List II	6,000	39	0.7%
List JJ	5,000	26	0.5%
Total	280,040	4,359	1.6%

EXHIBIT 3 Geographical Distribution of Customer Orders, 1986

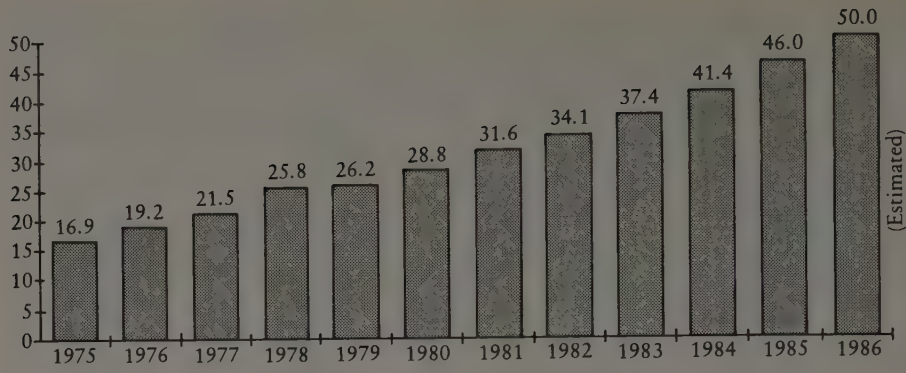
Rank	State	Number of orders	Percent of total
1	California	671	13.3%
2	Illinois	631	12.5%
3	New York	424	8.4%
4	Pennsylvania	263	5.2%
5	Texas	242	4.8%
6	New Jersey	202	4.0%
7	Massachusetts	182	3.6%
8	Connecticut	181	3.6%
9	Florida	172	3.4%
10	Michigan	167	3.3%
		3,135	62.1%

Brookstone, and *Royal Silk* were all trying to make both operations work for one another. The lists of names and potential new catalog customers generated by the retail stores — *Brookstone's* president said that 25 percent of the company's mail order list is generated through its stores — make the new retail ventures particularly attractive to the catalogers.



Source: Direct Marketing Association, Inc.

EXHIBIT 4 Catalogs Distributed to U.S. Households (billions)



Source: Maxwell Scroge Publishing, Inc.

EXHIBIT 5 Consumer Mail Order Sales Volume ($ billions)

By promoting the well-known success stories of *The Sharper Image, Banana Republic,* and *Royal Silk,* the industry has drawn in hopeful entrepreneurs of all kinds. The myth was that entrepreneurs could start successful catalog businesses in their spare time by operating from the basement with very little capital. The reality is that starting a successful catalog business in a highly competitive environment with sophisticated and demanding consumers takes significant human and financial capital. The *Wall Street Journal* (June 10, 1988) reported that current estimates are that a capital base of at least $1 million to $1.5 million is required to develop a catalog business from the concept to breakeven. And while up-front capital costs to develop the house list and unique image are large, it takes at least three to five years to reach a breakeven level. The basic ingredient for success besides money, people, and computers is "a solid concept, a unique selling proposition," Prakash Melwani, founder of *Royal Silk,* believes.

According to *Entrepreneur* magazine and catalog guru, Jo Von Tucker, a new catalog company has to mail at least 100,000 "pieces" or "books" in its first year to attain a true test of the market. A good response would be in the 1 percent range although a catalog requires a 3 percent to 6 percent response rate to breakeven. The house list, those customers that actually buy from the catalog, should have a much higher response rate of 7 to 12 percent. The house list with its repeat customers is a catalog company's greatest asset. While the average order size varies with the type of merchandise sold, $90 per order is an industry average and $45 per order is typical of children's toy catalogs. The normal return on investment ranges from 10 to 35 percent with an expected 10 to 15 percent net income before taxes.

The Toy Industry

By 1986, the growing toy industry had reached $12 billion in sales. With the emergence of the baby echo boom (the baby boom generation's children), toy sales are projected to grow 10 percent annually through the 1990s. The mail order segment of the toy industry has been gaining in market share growing at an annual rate of 15 percent with no abatement in sight.

By the mid-1980s, more than 60 percent of women between the ages of 18 and 64 were in the work force. Many women from the baby boom generation were starting families at a later age and having fewer children than previous generations. Thus by 1985, 41 percent of the births were first children who traditionally have more money spent on them than their younger siblings. The birth rate is increasing at the rate of 1 percent per year and consumers are spending more on their children — $250 per child in 1985 compared to $125 per child in 1980.

Competition

Children's toy catalogs include the major companies such as *Just for Kids, Toys to Grow On,* and *Childcraft.* The largest children's toy catalog company, *Childcraft* had sales of $27 million in 1985, a 25 percent increase from the previous year, when it was purchased by Grolier Inc. for $15 million. A major new entrant was *My Child's Destiny,* which mailed the first catalog in July 1984. Roy Raymond and his wife had successfully established and sold the lingerie catalog company, *Victoria's Secret,* and with the proceeds of $4 million sale, they started *My Child's Destiny* as both a catalog and a retail store in San Francisco. The first year, they budgeted $300,000 for print advertising. By the fall of 1986, the word on the street was that *My Child's Destiny* was having financial difficulties due to inadequate inventory control and unrealistic growth plans. People wondered whether their mailing list, estimated at 50,000 names, would become available for sale.

Marketing

The focus of the marketing at *Hopscotch* was to develop the in-house customer list. Marketing efforts were targeted at the particular demographic group that fits the characteristics of the primary customer group — the young, well-educated, professional parents who have disposable income but little time to shop. Other important customer groups were grandparents, day care centers and schools.

1. Advertising

Hoping to gain free promotional exposure, Mallard had budgeted only a small amount, $2,500, for direct advertising in the print media during the first year. Direct advertising had gone into special sections on children in major newspapers and parent publications that were emerging in major cities. *Hopscotch* did gain free publicity in some parent publications for offering alternative toys. The response rate for orders from those names gained through advertising was 4.5 percent. Most specialty catalog companies advertise heavily in targeted magazines such as *Parents, Better Homes and Gardens, The New Yorker,* etc. The cost of placing a print advertisement could range from $100 in a small local journal to $2,500 in a major national magazine.

2. Mail List Rentals

At best, only half of the target market will buy products through catalogs. The most effective method of quickly building a customer list is to rent or trade names of known mail order buyers from other catalog companies, the more competitive, the better. Mail list brokers develop the mailing plan and arrange for the rental and transference of the mailing lists. The rental rate for names from the mailing lists of specialty catalogs runs about $75.00 per 1,000 names. The names and addresses are shipped on mailing labels to be applied to the catalog and used only once. Respondents from these rented lists, people who actually order from the catalog, become part of the *Hopscotch* house list. In this way, these rented names of known mail order buyers provide the most precise form of consumer target marketing. Direct competitors will not rent their names to one another. They will, however, consider trading names in increments of 5,000 or more.

3. Back-End Marketing

The lifetime value of a customer is compared to the cost of acquiring that customer's name. The assumption in the catalog business is that a customer will order not just one time, but repeatedly year after year. To encourage customer loyalty and ultimately reorders, Mallard concentrated on the back-end marketing, that special attention given to a customer after the order has been placed. Each order was processed as quickly as possible. A special thank you was included in every package along with colored tissue and a balloon, leading one customer to write that "the packaging and presentation was a happy surprise. Hope to do more business with you in the future." It was a fundamental policy that the customer was always right and every effort would be made to resolve any problems that might arise. This long-term view of the business meant that some orders were unprofitable.

4. Word-of-Mouth Marketing

Ever since the first *Hopscotch* had been mailed in April 1986, a steady stream of catalog requests had come in daily. These requests represented word-of-mouth advertising that Mallard wanted to encourage. She had included a "Tell a Friend" section in the Christmas catalog but now she wanted to expand this effort.

Operations

Mallard had started *Hopscotch* in her home. The dining room was converted into an office with two desks, three file cabinets, and the computer on the dining room table. The inventory was stored in the garage and basement and orders were filled in the basement as well. Most transactions took place over the telephone, through the postman and the twice-daily UPS pick-up and delivery.

As president of the corporation, Mallard was the only full-time employee. She had an MBA in strategic planning and finance and she had experience in running a small business before joining the investments department of the major corporation. She also had three children of her own and had taught preschool and kindergarten in a rural school. A start-up situation was new to her and there were many critical details as well as major issues that her past experiences had not prepared her to handle.

She had a strong support team. Her attorney and accountant gave her guidelines to follow and requirements to meet. While Mallard did all the bookkeeping herself, the accountant set up the system with both the computerized accounting system and a manual daily log. Mallard maintained absolute control over the product selection and the product description in the copy of the catalog, but she contracted out the design, layout, and production of the catalog to a young photographer who knew that end of the business.

The employees were students who worked part-time for *Hopscotch*. They received minimum wages and no benefits other than an occasional yo-yo or t-shirt. They were responsible for accepting telephone orders, processing the orders and filling the orders and for the most part, they were enthusiastic and hardworking even though their primary loyalties lay elsewhere. At the peak of the Christmas season with 400 orders a week to process, twelve students were working twenty hours a week on four-hour shifts. The day started at 8:00 A.M. and went on non-stop until 10:00 P.M. A few of them had become genuinely interested in *Hopscotch* and had discussed with Mallard the possibility of joining the company on a permanent basis.

The products were selected on the basis of clearly defined criteria. They had to be interesting, unusual, high quality, safe and, most of all, *fun*. With her

teaching and parenting experience, Mallard had a sense of which toys and books would become dust-gatherers and which would become treasured playthings. The search for products was carried out primarily at the various trade shows: the annual toy shows during the winter especially in Nurenberg, Germany, and New York; gift shows in Chicago and Atlanta; regional craft shows and through manufacturers' representatives who soon learned the types of products that fit the *Hopscotch* image.

Once a product was selected, samples were ordered to be tested and photographed. Mallard wrote the copy for each item trying to describe its use or attraction with some humor and wit. Working closely with Mallard, the photographer created the catalog using bright colors and real kids for models. The camera-ready artwork was sent to the printer where the catalogs were printed and assembled. A mailing house then applied the labels, sorted the catalogs by zipcode and mailed them out at the bulk postage rate of $0.125 per book. The entire production process from the arrival of the samples to the mailing of the finished catalogs covered a five to six month period. Once the catalogs were in the mail, it took anywhere from two to ten days for them to reach their destinations.

Mallard had ordered the inventory she expected to need for the Christmas season in incremental purchase orders. The first order was supposed to be in the warehouse-garage by the first of September. The next order was due in by October 1 and the next by November 1. Any adjustments to the inventory orders could be made as the actual customer orders were coming in. Unfortunately, the printer felt that the catalog was a small job to be sandwiched in between larger projects. As a result of the delayed printing, the catalog was mailed one week late and that disrupted the entire inventory order system that Mallard had so carefully developed. She found she had to make decisions on increasing, decreasing, or cancelling orders before she had adequate sales information. The flurry of the Christmas season added to the difficulty of concentrating on the inventory when customer orders had to be filled. More concerned with customer dissatisfaction due to stock-outs, Mallard made the policy decision to err on the side of excess inventory. When she finished the Christmas season, there was $35,000 worth of unsold inventory. She was not too worried about it because most of the inventory could be sold in the next catalog.

In October, the city informed Mallard that running a business with employees from a residential establishment was in violation of zoning restrictions. The business would have to be moved by January 3, 1987. A member of the staff from the Department of Economic Development was sent to help relocate *Hopscotch*. Mallard had had many requests from customers to come to the store and now that she was being forced to move the operations, she hoped to find a building that could provide office and warehouse space along with a small retail area. She was unsuccessful in her search and finally, on the

advice of the DED staff member, she moved the business into the third floor of an inexpensive and unfinished warehouse complex.

The warehouse space had one small office and 3,000 square feet for storage and packing. The two flights of stairs were old and dirty and the freight elevator was large and temperamental. The lease was on a month-to-month basis at $1.50 per month per square foot with only a two-week notice required by either party. One of the other occupants came into Mallard's office shortly after the move and told her he was surprised to see the space rented because he had wanted that space to expand his own business.

Finance

Jane Mallard's primary objective was to have *Hopscotch* become the dominant factor in the high-end of the mail order toy industry. During the next two years, Mallard's goals were to increase the sales volume to $1.5 million with a $100,000 pre-tax profit. The house list would have 150,000 names and the average order size would be $50. Eventually, Mallard hoped to build *Hopscotch* into a $25 million catalog business.

Mallard was pleased with the first year's results. (See Exhibits 6 and 7.) The standard mark-up for the products was in-line with the industry norms of 90 to 110 percent. The critical response rates had been better than the expected norms.

One concern for Mallard was the relatively low average order size of $37 to $38. The products she had selected included a wide range of price points from a few $5 items on up to $250 for a ride-on wooden train set. Most items fell in the $10 to $15 range, which was too low for the overall quality image and profitability of the catalog. She needed more $20 to $30 items to improve the size of the average order. But this was not an easy task because items in this

EXHIBIT 6 Income Statement for 12 Months Ending 31 December 1986

Net Revenues	$192,000
Cost of Sales	$ 94,000
Production Costs	$239,000
Gross Profit	($141,000)
General & Administrative	$ 52,000
Net Income (Loss)	($193,000)

EXHIBIT 7 Balance Sheet at 31 December 1986

Assets:		
Current Assets:		
Cash	$ 21,000	
Accounts Receivable	$ 1,100	
Inventory	$ 35,000	
Total Current Assets:	$ 57,100	
Other Assets:		
Net Fixed Assets	$ 7,600	
Net Organization Costs	$ 4,400	
Total Other Assets	$ 12,000	
Total Assets		$69,100
Liabilities:		
Current Liabilities:		
Accounts Payable	$ 25,100	
Accrued Taxes	$ 2,000	
Bank Note	$ 20,000	
Total Current Liabilities	$ 47,100	
Total Liabilities		$47,100
Shareholders' Equity:		
Paid-in Capital	$215,000	
Loss	($193,000)	
Total Shareholders' Equity	$ 22,000	
Total Liabilities & Equity		$69,100

price range were difficult to find and customers began to balk at toys they considered too expensive. Another solution would be to focus on a different type of customer. Whereas the professional parent had been the primary target market, Mallard noted that many of the large orders were from schools and day care centers. Day care center, in particular, were a growing market.

Another concern was the inventory situation. Mallard had hoped to manage the inventory at levels within 10 percent to 15 percent of cost of sales. After the move into the new warehouse, Mallard and her employees did a careful inventory count discovering that *Hopscotch* had 38 percent of cost of sales in excess inventory. While most of the inventory could be sold in the upcoming catalogs, it still created higher debt levels and interest payments than Mallard had projected.

The average revenues per catalog were $0.62 and the average cost per catalog was $0.77. This included all the production and mailing expenses: photography, design and layout, typesetting, printing, mail list rental, labels,

sorting, handling and postage. Mallard figured that the breakeven, including the operating costs, would be achieved when average revenues per catalog reached $1.40 and average cost per catalog could be reduced to $0.40.

Hopscotch was currently capitalized with $215,000 in equity and $46,000 in liabilities. The twelve existing shareholders had been alerted that there would be further capital requirements and, while Mallard knew they would be willing to increase their equity holdings, she also knew they wanted reaffirmation in the concept by having additional investors willing to come in. Before she could approach the investors again, she had to develop a revised business plan based on her new information and consider a realistic estimate of the capital needs for the future.

What Next?

Mallard had been rushed into the move by the DED, but it seemed a precarious situation. Should she consider moving again soon? If so, should she concentrate on combining the catalog business with a retail store? Or should a retail store be separate from the warehouse and catalog operations? Would a retail store help the management of inventory? She was also concerned about the target customer. Should she shift the emphasis from individual parents to a broader market to include schools and day care centers? How would this affect the retail store decision? She also knew that it was time for her to start developing a full-time staff. These fundamental strategic decisions would have a direct impact on her marketing program and product selections. And ultimately, the decisions would change the character of her search for additional capital.

CASE 7

The Artisan's Haven

Neil H. Snyder
Brooke Garrett

The Decision to Go into Business

John and Katie Owen were confronted with a serious problem in 1973. John was fired from his job with a large chemical company in Trenton, New Jersey, for which he had worked for thirty-three years. The Arab oil embargo had caused a recession in the U.S. economy, and the nation was bracing itself for anticipated high inflation. After working for one company for so long and giving the firm his best years, John was emotionally upset over his dismissal. It was not as though he had made a big mistake or that he had done anything wrong. He was simply one of the older employees whom the company wanted

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to replace with younger, more energetic people. The recession gave the firm the opportunity it needed to make wholesale changes in personnel.

Finding a job during a recession is not easy, and for a 55-year old man whose experience is limited to one industry, it is almost impossible. John felt helpless. He did not know what to do, and his frustration turned into anger as he realized for the first time in his working life that he was just a pawn in a great game of corporation chess. After several weeks of fear, anxiety, and doubt, John reached a major turning point in his life. He knew that he never wanted to work for anyone or any firm again.

The decision not to work for others was a major one, but John still did not know what to do. Should he retire? If he did, it would not be a comfortable retirement. Should he start his own business? If so, what kind of business should it be? He knew that he did not want to be involved with chemicals. Even before he was fired, John had begun to have reservations about producing dangerous chemicals and dumping harmful waste into rivers. But his pay was good, and he did not have the time or the inclination to think about these deep questions too seriously. It was more important to John to pay his bills, to take nice vacations and, in general, to have fun.

Although John likes to take credit for the idea, Katie is the one who suggested that he consider opening a store to sell arts and crafts. John's hobby for many years had been making gold jewelry, and he had become a very good goldsmith. Katie was an amateur interior designer, and she also enjoyed doing cross-stitch and making dried floral arrangements. Starting a business to sell something they enjoyed making and knew something about seemed like a very good idea. In addition, John and Katie could work together in this kind of business, and Katie had always wanted to spend more time with John.

In 1974, they opened their first store in Trenton, New Jersey, and it was very successful. Their location was excellent, and their merchandise was high quality. Everything they did just seemed to work, and by 1980 the Owens owned six stores in New Jersey and Pennsylvania.

In 1980, John and Katie were both 62 years old, and they were more secure financially than they had ever been. When John lost his job with the chemical company, his net worth had been about $150,000, and almost all of it was tied up in his house and furnishings. His income at the time was comfortable, but not great. Now, his net worth was in excess of $1 million, and John and Katie could do many of the things they had always dreamed of doing. One thing they had dreamed of doing was retiring to a nice southern town and enjoying life.

At age 62, John and Katie decided to sell their stores in New Jersey and Pennsylvania and move to Athens, Georgia. A couple with whom they were very close had moved to Athens several years before, and John and Katie had visited them several times. They liked the town, they liked the University of Georgia, they liked the people, and they liked the climate. The move just seemed like the right thing to do.

Moving to Athens, Georgia

John and Katie settled into their new way of life in Athens very quickly. They joined a local church that consumed a fair amount of their time. Katie got actively involved in the Christian Women's Club. John joined the Lion's Club and was able to contribute a great deal of time to many of its projects.

However, one thing was missing. While they were in business, John and Katie had enjoyed making decisions and watching the bottom line of their income statement change to reflect the quality of their judgement. None of their activities in Athens provided the same sense of excitement and satisfaction that owning and operating a business had provided. After a year, John asked Katie about opening a business in Athens, and Katie agreed.

Starting over Again

In the fall of 1981, the Owens opened the Artisan's Haven in downtown Athens directly across the street from the University of Georgia, and the community responded enthusiastically. The store sold hand-made gold and silver jewelry, pottery, dried floral arrangements, woodcrafts and various other hand-made objects. Upon entering the store, customers were overwhelmed by the quality of the merchandise. It looked like it could have come out of a magazine like *Country Living* or *Southern Living*. All of the merchandise was made with great care and attention to detail.

Part of the immediate success of the new store was due to the popularity of arts and crafts at the time. But the Owens themselves were the main attraction. John and Katie seemed to be more relaxed about life, and the rapport they developed with their customers was nothing short of amazing. They offered classes to teach their customers how to make many of the items sold in the store. Katie became an interior decorator whose advice was sought by many prominent and influential people in the community. John organized the artists and crafts people in the northeast Georgia area into a guild. As a result of their work, the Owens developed a large, wealthy customer base and an excellent supply of high-quality goods to sell.

Demographics of Athens

The population of Athens and Clarke County, the county surrounding Athens, is approximately 83,000 people. Twenty-one percent of the residents are professionals, and almost a third of them are students at the University of Georgia. A recent study of household incomes in Athens revealed the following:

Household income	Number of households
Greater than $50,000	4719
$35,000–$49,999	6426
$25,000–$34,999	7691

(An average household in Athens is composed of 2.5 people.)

Competition

The Artisan's Haven has no direct competition in Athens. Traditionally, few residents in the community have shown much interest in high-quality goods and services. Cultural events such as plays and musical shows are occasional attractions. Until very recently, the best restaurants in town were steak houses that catered primarily to students, fast-food chains, and small, locally owned operations. Big events in Athens that set it apart from other communities in the area are University of Georgia football games and fraternity and sorority parties.

However, things in Athens are changing, and the wealthier residents in the community are beginning to pay attention to their quality of life. The only stores selling products that compete with The Artisan's Haven include jewelry stores, department store chains, and a few lower-end specialty shops. These stores are not considered direct competitors, because the quality of their merchandise is inferior to the quality of the merchandise sold in The Artisan's Haven. The store's closest direct competitors are in Atlanta, the state's capitol about 70 miles away, and many of Athens' wealthier residents go there routinely to shop.

Management and Personnel

John and Katie own and operate their store. In addition, they make many of the products they sell. The Owens have been very fortunate to get to know two retired, upper-middle income women who are looking for opportunities to stay busy doing things they enjoy. These two women work part-time for the Owens for nominal wages. Besides being excellent employees, their friends visit them in the store, and many of them have become regular customers.

The Owens' most important employee is Rachel Thompson. She is 57 years old. They first met her when she was a customer in the store. After they got to know her, they discovered that Rachel's hobby was interior decorating

and that most of what she bought was for friends' homes. She was not paid for any of this work. When she was approached by the Owens, Rachel was more than delighted to accept their offer of employment. Rachel's primary responsibility is to work with Katie on interior decorating jobs and to wait on customers in the store. She works about twenty hours a week.

Madeline Murray lives next door to the Owens. She is 53 years old and a very skillful craftswoman who developed her talent by doing the needlework in her home and the homes of her children, relatives, and many friends. The Owens first bought needlework from her by the piece, because it was impossible for Katie to do all of the cross-stitching and to wait on customers all day. After it became obvious to the Owens that Madeline enjoyed working with and being around them and that they enjoyed her, they invited her to join them at the store. Her job was to do needlework for sale in the store and to work with customers who wanted custom-designed needlework made for their homes. Madeline also works about twenty hours a week.

Rachel and Madeline are like part of the family. Customers frequenting The Artisan's Haven sense the warmth and friendliness of everyone in the store, and they tell John and Katie regularly how enjoyable it is to shop there.

Marketing

When the Owens first opened the store in Athens, their marketing efforts targeted local residents, tourists, and students. They used radio and newspaper advertising primarily. After several months of operation, they surveyed their customers to evaluate the effectiveness of their promotion effort. Not surprisingly, they learned that word-of-mouth and the Owens themselves were by far the most effective forms of advertising. Additionally, they learned that students were not attracted to their store in large numbers because of the prices of the goods sold and because they were not furnishing homes in which they intended to live for lengthy periods. Tourists did not flock to the store either, because Athens is not known as a tourist attraction.

The Owens decided early on that The Artisan's Haven did not need extensive print or broadcast media support. However, they did continue to run an occasional radio spot or ad in the local newspaper.

Organization

The Owens incorporated The Artisan's Haven in the beginning, because they wanted to limit their liability. They were not certain about their options in this area, so they contacted an attorney who helped them make a choice about how

to incorporate. They learned that there are major differences between a Subchapter C corporation and a Subchapter S corporation. Both offer several important features such as continuity of life, centralization of management, limited liability, and easy transferability of interest. The S corporation is usually preferred by small business owners because it is treated like a partnership for tax purposes.

Although the Owens could have incorporated The Artisan's Haven as an S corporation, they chose the C corporation. The C corporation allowed the Owens to deduct certain fringe benefits, like medical and health insurance, and to shelter earnings for later use. Because of their age, these were important issues to the Owens.

The major disadvantage of a C corporation is double taxation. The Owens were not as concerned about this issue as the others, because they were able to pay themselves attractive salaries that were tax deductible expenditures.

Finance

Exhibits 1, 2, and 3 contain pertinent financial information for The Artisan's Haven. The income statement shown in Exhibit 1 indicates that the largest expenses for the Owens are wages, travel, and rent. The 1981 data is a little misleading, because the store was in operation for only half the year. Travel is a major budget item, because the Owens travel a great deal to visit crafts people and art shows. Advertising in 1981 was a large expense item, because the Owens were establishing their name and reputation.

A Major Decision Point

In July, 1987, John Owens suffered a massive heart attack, and he was told by his doctors to restrict his activities significantly. Before the heart attack, John and Katie had discussed the possibility of selling the business. Now Katie was certain that she wanted to sell it.

Four months before the heart attack, a local entrepreneur named Don Lassiter, who was in the business of buying and selling businesses, had approached the Owens about buying the Artisan's Haven for his wife. They had told him no. At the time, the Owens were in no hurry to sell, but John's physical condition had caused Katie to become very anxious. She was concerned that John would want to keep the business and literally work himself to death. She was also worried that she could not take the pressure of running the business

EXHIBIT 1 Consolidated Income Statements for the Period Ending January 31, 1986

	1981	1982	1983	1984	1985	1986
Sales	16,610	55,673	78,736	105,928	123,683	153,186
Cost of Sales	8,305	27,837	35,968	43,441	60,201	75,806
Gross Profit	8,305	27,836	42,768	62,487	63,482	77,380
Expenses						
Rent	3,900	7,800	7,800	7,800	7,800	7,800
Wages to Officers	10,000	11,000	15,500	20,000	25,000	50,000
Other Salaries	0	0	0	4,526	9,688	10,803
Utilities	434	612	712	862	1,002	1,165
Advertising	35,000	2,000	2,000	2,000	2,000	2,000
Travel	391	774	933	1,171	1,394	1,654
Supplies	649	835	971	1,175	1,366	1,589
Insurance	145	560	560	560	560	560
Depreciation	168	535	535	535	535	535
Interest	0	278	278	278	409	409
Total Expenses	50,687	24,394	29,289	38,907	49,754	76,515
Profit before Tax	(42,382)	3,442	13,479	23,580	13,728	865
Tax	0	0	0	0	5,805	423
Net Income	(42,382)	3,442	13,479	23,580	7,923	442

EXHIBIT 2 Consolidated Balance Sheets as of January 31, 1986

	1981	1982	1983	1984	1985	1986
Assets						
Cash	0	68	5,823	16,532	22,018	20,996
Inventory	18,000	26,262	30,651	35,398	40,782	62,168
Prepaid Expenses	2,089	1,973	1,862	2,239	2,355	2,451
Total Current Assets	20,089	28,303	38,336	54,169	65,155	85,615
Long-Term Assets						
Equipment	4,675	4,675	4,675	5,752	5,752	7,860
Furniture	3,897	3,897	3,897	3,897	3,897	4,623
Less: Acc. Dep.	168	703	1,238	1,773	2,308	2,843
Total P,P&E	8,404	7,869	7,334	7,876	7,341	9,640
Total Assets	28,493	36,172	45,670	62,045	72,496	95,255

Liabilities and Stockholder's Equity

Current Maturities	278	278	278	278	278	597
Accounts Payable	2,122	7,899	10,211	14,447	17,901	21,870
Accured Expenses	1,093	1,240	1,829	1,942	2,068	2,189
Total Current Liab.	3,493	9,417	12,318	16,667	20,247	24,656
Long-term Debt	47,382	45,695	38,813	27,259	26,207	34,115
Total Liabilities	50,875	55,112	51,131	43,926	46,454	58,771
Stockholder's Equity						
Common Stock	20,000	20,000	20,000	20,000	20,000	30,000
Retained Earnings	(42,382)	(38,940)	(25,461)	(1,881)	6,042	6,484
Total Equity	(22,382)	(18,940)	(5,461)	18,119	26,042	36,484
Total Liab. and Equity	28,493	36,172	45,670	62,045	72,496	95,255

EXHIBIT 3 Sales by Quarter

Year	Quarter	Sales by quarter	Total sales
1981	3	3,246	16,610
	4	13,364	
1982	1	3,080	55,673
	2	10,397	
	3	4,512	
	4	37,684	
1983	1	5,511	78,736
	2	17,321	
	3	8,663	
	4	47,241	
1984	1	9,533	105,928
	2	25,422	
	3	10,595	
	4	60,378	
1985	1	10,021	123,683
	2	32,033	
	3	14,841	
	4	66,788	
1986	1	12,195	153,186
	2	44,906	
	3	17,961	
	4	78,124	

and taking care of John. Katie wanted to sell the business, and the sooner the better. When she raised the issue with John, he agreed.

Once they decided to sell The Artisan's Haven, John and Katie had to determine how much the business was worth and if Don Lassiter still wanted to buy it. There were other issues to be considered, too. For example, Mr. Lassiter might not be the only potential buyer. How would they contact other people who might be interested in their business?

Although they had gone through the process of selling a business several years before, neither John nor Katie knew much about the intricacies of calculating the value of a firm. They had relied heavily on their accountant, who was a close friend, to help them in that deal. The Owens were very knowledgeable about arts and crafts and people, but not finance.

The more they thought about it, the more they realized that a multitude of decisions had to be made. John told Katie that any buyer would require them to sign an agreement not to compete. Neither of them objected to that stipula-

tion. Also, there was a question about how much time John and Katie were willing to work with the new owner(s), and in what capacity, after the business was sold. Both of them were uncertain about how to approach this question, and this was not the kind of question they could rely on a financial advisor to answer.

How many more questions would they need to answer? John and Katie did not know.

APPENDIX A

Financial Statements and How to Interpret Them*

Financial statements are useful to you as the owner of a business, to your banker, to the Internal Revenue Service, and to suppliers from whom you may want credit. Here, we focus on the interests of the owner and banker.

The What and Why of Financial Statements

No matter how well prepared and capitalized you are, the time will come when you want the services of a bank. You could have a short-run cash flow problem to cover or be in the enviable position of having the right service at the right time and need money for expansion. For whatever reason, you are sure to go to a financial institution.

Because yours is a fledgling company, without the credit history of a General Motors, you will be asked to produce your financial statements. The

* Thanks are expressed to Greg Miller, MBA student, and Ray Blankenship, instructor at Western Kentucky University, for assistance on this appendix.

bank will partially base its loan decision on these statements. If you do not have these statements or, worse yet, give the impression you have no idea what the banker is talking about, your chance for getting help will be small indeed. This appendix explains what these statements are and what they show.

You and your accountant will need to construct four major financial statements: the balance sheet, the income statement, the cash flow (budget) statement, and the statement of equity. For a start-up business, only the first three statements will be important. We will first explain the balance sheet.

The *balance sheet* shows the relationship of assets to liabilities and equity at a point in time. The time dimension of the balance sheet is important. The balance sheet can be thought of as a snapshot. Its values hold only at one point of time. Technically speaking, your balance sheet changes each day as inventories change, as fixed assets are added or disposed of, as values of loans change, and so forth. In practice, a (revised) balance sheet is prepared only monthly, perhaps quarterly, or even yearly.

As implied by the title, a balance sheet has to balance. That balance is between assets on the left (or top) and liabilities plus equities on the right (or bottom). Assets are normally listed in the order of liquidity (how long before they are expected to be converted to cash), from most liquid to least liquid. Note that, although all assets are stated in dollar amounts, only cash represents a monetary asset.

Receivables are the amounts owed the firm by other companies and individuals. Inventory shows the dollar amount of the cost of inventory the firm is holding. This amount includes raw materials and work in process (for a manufacturer) as well as finished goods for sale. Assets are valued at cost (minus depreciation) for tax reporting purposes but your banker will be more interested in the ability of assets to generate earnings and, in the event of major problems, the liquidation value of assets.

The right side of the balance sheet shows the claims against the assets. These claims are the liabilities (what is owed) and the equity (stockholders' ownership) of the firm. These are listed in the order that they must be paid. Accounts payable usually must be paid within 30 days. Notes payable are often payable (due) within 90 days. Accrued amounts are wages, taxes, and so forth that are due but not yet paid. The equity of the firm is a residual amount: the difference between the assets of the firm and its liabilities (in equation form, assets − liabilities = owner's equity). So, if there is a change in the make-up of assets versus liabilities, then the equity will change. If assets decrease or liabilities increase, equity will fall. Conversely, if assets increase or liabilities decrease, the owner's stake in the firm will rise. Equity is important to a firm as a form of collateral and will increase the leverage (borrowing) available to a firm. In addition, the size of the debt indicates the amount of interest facing you. As an aside, note that in times of inflation the value of the equity (market and collateral values) may rise simply due to the increased value of the firm's assets as items are replaced with others bought at inflated costs.

The *income statement* is a report of the operations of the firm over a

period of time; normally a calendar or fiscal year. The report (sometimes called a *profit and loss statement,* or *P&L*) concludes with the amount of profits or losses incurred. An income statement usually includes the previous period as well as the period for which the statement is compiled, for comparative purposes, to see what trends might be developing in behavior of income and expenses.

The income statement begins at the top with period sales, then the operating costs are subtracted from the sales to arrive at the operating income. Costs are usually listed in order of their correlation (variability) with sales, costs varying directly with sales being first. For example, raw material usage and hence cost varies directly as level of sales varies. Next would be listed any semivariable costs, those with both fixed and variable portions. Many shopping mall leases are of this nature, a base fee plus a percent of the store's sales forms the total lease cost. Finally, any purely fixed charges are listed. A fixed charge is one that does not change from period to period with sales volume changes, such as fire insurance or loan payments. These costs may not be affected by volume of sales.

After the operating income in calculated, interest expenses are subtracted. This yields the earnings before taxes. From this, the taxes paid are subtracted to arrive at net income. For most firms this is the bottom line. From this bottom line, you learn whether you have profited or lost.

The last financial statement that a beginning firm should be concerned with is the *cash budget,* which begins with the initial cash balance. Next the cash (noncredit) inflow from sales and the cash inflow from accounts receivables are added, which yields the total cash available for use. Next, all cash disbursements are added together to find the total cash outflow for the period. Cash disbursements are any cash expenses plus any accounts payable (including mortgages) that were paid for during the period. Subtracting a period's cash outflows from its cash inflows shows the ending cash amount. (In our pro forma example, on pages 366–68, the ending cash will be listed as prenote, because if it is negative the company in the example will borrow on a note from the bank.)

The ending cash amount is compared to a predetermined cash amount that must be on hand to start the following period. If the ending cash (prenote) amount is greater than the amount planned, great! Either put that money to work in the money markets or pay off some debt. If less than planned, then you may need to borrow on a short-term note or invest more equity to remedy the condition.

Analyzing and Evaluating Financial Data

After financial statements (projected, then later actual) are constructed, you occasionally need to analyze them. Financial analysis is conducted by owners, bankers, and others to evaluate the condition and performance of the business.

You may wish to compare a new business to others — presumably well managed — in the same industry.

Because businesses come in different sizes and the composition of their parts is often more important than their size, comparative analysis is helped by converting actual or expected dollar amounts to ratios. We next present an overview of the most commonly used financial ratios. First will be the basic equation followed by an example from quarter four of our pro forma statements on the software spreadsheet.

Liquidity. This financial ratio is used to show the firm's ability to meet short-term obligations. If the short-term creditors demanded payment quickly, would the cash be available?

$$\text{Current Ratio: } \frac{\text{Current Assets}}{\text{Short-Term Debt}}$$

$$\text{Acid Test (Quick) Ratio: } \frac{\text{Current Assets} - \text{Inventory}}{\text{Short-Term Debt}}$$

Fourth-quarter *pro form* examples, beginning on page 366, give us:

Current: $7{,}465/3{,}482 = 2.14$

Quick: $(7{,}465 - 4{,}340)/3{,}482 = .90$

The difference in these two ratios is the backing out of inventory in the acid test ratio, which is done to show the amount of funds that could be raised in the shortest time possible. Although inventory is a liquid asset, it is not immediately salable at cost, and when sold it may become only receivables, not cash. If inventory must be liquidated to raise funds, it may bring only 80 cents, or even 40 cents, on the dollar.

Leverage. This financial ratio is used to compare the amounts of funds supplied by owners with the amount of financing provided by creditors; in other words, the debt situation.

$$\text{Debt to Total Assets: } \frac{\text{Total Debt}}{\text{Total Assets}}$$

Example: $9{,}108/15{,}965 = 0.57$

This ratio is also known as the *debt ratio* and states simply the amount of debt financing provided as a ratio to the assets of the company. The ratio is a good ratio for industry comparison, allowing you to judge how leveraged you are compared to the industry in general. It also gives a general idea of how attractive your firm is to potential creditors and, in turn, how likely they are to lend you additional funds if needed.

Activity. This ratio is used to tell how well the firm is employing its available resources. The first of these is receivables turnover.

$$\text{Receivables Turnover} = \frac{\text{Sales}}{\text{Average Receivables}}$$

For example, the first four-quarter credit sales (50 percent of total sales) are $(3{,}500 + 4{,}600 + 5{,}100 + 6{,}200)/2 = 9{,}700$. Average receivables are $(875 + 2{,}025 + 2{,}425 + 2{,}825)/4 = 2{,}038$. So, receivables were "turning over" at $9{,}700/2{,}038 = 4.76$ times a year. This means that the average collection period for receivables was $365/4.76 = 77$ days. There is some distortion coming from the changing level of the factors.

Next is inventory turnover, showing how efficiently this asset is used to generate sales.

$$\text{Inventory Turnover} = \frac{\text{Cost of Goods Sold}}{\text{Average Inventory}}$$

The average inventory is found by adding the quarterly inventories and dividing by 4. For example, first find the total cost of goods sold for four quarters $(2{,}450 + 3{,}220 + 3{,}570 + 4{,}340 = 13{,}580)$, then the average inventory $(2{,}450 + 3{,}220 + 3{,}570 + 4{,}340)/4 = 3{,}395)$. Thus, the inventory turnover is $13{,}580/3{,}395 = 4$.

For any sales company, this is a very telling ratio. An inventory level that is too high or too low puts the firm in a strategically unenviable position. If the ratio is extremely high (compared to the industry), we could ask if the company is maintaining sufficient stocks for the present sales level. If the stocks for sales are too low, sales may be lost because items are not available when the customer wants them. If the ratio is extremely low, the firm may be maintaining too high an inventory and thus tying up capital in inventory that could be used elsewhere in the firm. Your lender may compare your inventory turnover to the industry figure to gauge directly how well your firm is forecasting sales and indirectly how well your firm is managed.

Profitability. How well managed or lucky your company is becomes apparent through the use of profitability ratios. In business, we keep score through profits. The famous bottom line simply shows whether the company made a profit. Although you can operate for a few months without earning a profit, unless you have "deep pockets," profit dollars will soon become necessary.

The first profitability ratio is *net profit margin,* also called *return on sales.*

$$\text{Net Profit Margin:} \frac{\text{Net Profit (after taxes)}}{\text{Sales}}$$

Example: $(-335 - 227 - 110 + 3)/(3{,}500 + 4{,}600 + 5{,}100 + 6{,}200) = -669/19{,}400 = -.03$.

This example tells us what percentage of each sales dollar is being kept as profit. In the projections that follow, the profit figures are negative, reflecting start-up realities. To be meaningful to an established company this figure should be compared to the industry average. If the figure for an established firm is low (compared to the average), then it would be advisable to look at your variable costs to see if any are out of line. Examine the variable costs because those are the ones most controllable and so, most easily changed.

Return on Investment and Equity. The final two ratios that will be given are closely related. These are Return on Investment (ROI) or Assets (ROA), and Return on Equity (ROE).

$$\text{Return on Investment: } \frac{\text{Net Profit}}{\text{Total Assets}}$$

$$\text{Return on Equity: } \frac{\text{Net Profit}}{\text{Total Equity}}$$

ROI example: $-669/[(12{,}500 + 14{,}295 + 14{,}920 + 15{,}965)/4] = -.05$

ROE example: $669/[(5{,}175 + 6{,}952 + 7{,}261 + 7{,}532)/4] = -.10$

The ROI shows how efficiently assets, from owners and creditors, are being employed. Many years ago DuPont Corporation analysts pointed out that Return on Assets consists of Sales/Assets × Profit/Sales. This analysis of ROA shows the inverse relation between activity and the profit margin, so a tradeoff is necessary.

As stated earlier, one advantage of ratios is that they overcome the problem of comparing companies of different size and so are excellent measures for comparison. In ROA, the output (profit) is directly related to the input (investment). A firm earning $1 for each $10 investment is more efficient than one that earns $10 for each $500 investment.

Return on equity (ROE) tells how efficiently the equity investment in the firm is being used. All things being equal, a firm with a higher ROE is more attractive to investors than one with a low ROE. Again, the firm is earning a higher return for each dollar invested by owners. Positive leverage means that, by borrowing to supplement owner investment, there are greater profits for owners — that is, the ratio of operating profits to assets exceeds the interest rate. Negative leverage means profits/assets are less than interest rates.

Pro Forma Statements. Pro forma (according to form) financial statements are projections of the company's condition (balance sheet) and performance (profit-and-loss and cash flow statements). These statements are part of the

conclusions of the entrepreneur's business plan. Particularly, they indicate the period when the business should begin to be profitable and when and how much new financing it is expected to require. The waiting period may be zero for an acquired business, only a few weeks for an outlet of an established franchiser, a few months for a new retailer, and a few years for a manufacturer of a new product. In any event, the business plan must point toward — support or lend belief in — pro formas that the banker will insist on seeing. Forecasted sales are the main basis for all other amounts in these financial statements. The spreadsheet projections in this appendix are begun with purely hypothetical projections of sales, then they proceed through reasonable assumptions (for a retailer) about assets (in the balance sheet) needed to generate those sales, profit margins (in the income statements), and cash receipts and disbursements related to sales (in the cash budget). These pro formas in spreadsheet formula (pages 371–373) form are useful for projecting results of different manager actions. This is commonly referred to as "what if" analysis.

SAMPLE PRO FORMA INCOME STATEMENTS, BALANCE SHEETS, AND CASH BUDGETS (BUILT WITH LOTUS 1-2-3 © LOTUS DEVELOPMENT CORP.)

Income statement		Assets		Liabilities		Cash budget	
			Quarter 1				
Sls	3500	Csh	300	Accs Pay	1715	Beg Bal	300
CGS	2450	Mkt Sec	0	Notes Pay	263	Csh Sls	1750
Gross Pf	1050	Acc Rev	875	T Cur Lib	1978	Rc on Acct	805
Advtg	275	Inv	2450			Tot $ Avl	2855
SGA Exp	950	T Cur Ast	3625	Mort	5682		
Depr Exp	125					Csh Exp	1404
Oper Pf	−300	P&E, Cost	5000	T Lib	7660	Pd on Acct	1225
Int Exp	179	Acum Dep	125			Mort Pay	189
Txbl Inc	−479	P&E, Net	4875	Ret on Erns	−335	Tot Csh Usd	2818
				Equity	5175	Prenote	37
Taxes	−144	Real Est	4000			Note Bal	263
Net Inc	−335	T Asts	12500	T L&E	12500	End Bal	300
			Quarter 2				
Sls	4600	Csh	300	Accs Pay	1610	Beg Bal	300
CGS	3220	Mkt Sec	0	Notes Pay	631	Csh Sls	2300
Gross Pf	1380	Acc Rev	2025	T Cur Lib	2241	Rc on Acct	1933
Advtg	330	Inv	3220			T Csh Avl	4533
SGA Exp	1060	T Cur Ast	5545	Mort	5664		
Depr Exp	125					Csh Exp	1579
Oper Pf	−135	P&E, Cost	5000	T Lib	7905	Pd on Acct	2835
Int Exp	189	Acum Dep	250			Mort Pay	189
Txbl Inc	−324	P&E, Net	4750	Ret on Erns	−562	T Used	4602
				Equity	6952	Prenote	−69
Taxes	−97	Real Est	4000			Note Bal	631
Net Inc	−227	Tot Asts	14295	T L&E	14295	End Bal	300

			Quarter 3				
Sls	5100	Csh	300	Accs Pay	1785	Beg Bal	300
CGS	3570	Mkt Sec	0	Notes Pay	901	Csh Sls	2550
Gross Pf	1530	Acc Rev	2425	T Cur Lib	2686	Rc on Acct	2323
Advtg	255	Inv	3570			T Csh Avl	5173
SGA Exp	1110	T Cur Ast	6295	Mort	5645		
Depr Exp	125					Csh Exp	1562
Oper Pf	40	P&E, Cost	5000	T Lib	8331	Pd on Acct	3395
Int Exp	197	Acum Dep	375			Mort Pay	189
Txbl Inc	−157	P&E, Net	4625	Ret on Erns	−672	T Used	5143
				Equity	7261	Prenote	30
Taxes	−47	Real Est	4000			Note Bal	901
Net Inc	−110	T Asts	14920	T L&E	14920	End Bal	300
			Quarter 4				
Sls	6200	Csh	300	Accs Pay	2170	Beg Bal	300
CGS	4340	Mkt Sec	0	Notes Pay	1312	Csh Sls	3100
Gross Pf	1860	Acc Rev	2825	T Cur Lib	3482	Rc on Acct	2319
Advtg	310	Inv	4340			T Csh Avl	5719
SGA Exp	1220	T Cur Ast	7465	Mort	5626		
Depr Exp	125					Csh Exp	1739
Oper Pf	205	P&E, Cost	5000	T Lib	9108	Pd on Acct	3955
Int Exp	209	Acum Dep	500			Mort Pay	189
Txbl Inc	−4	P&E, Net	4500	Ret on Erns	−675	T Used	5829
				Equity	7532	Prenote	−111
Taxes	−1	Real Est	4000			Note Bal	1312
Net Inc	−3	T Asts	15965	T L&E	15965	End Bal	300

(Continued)

SAMPLE PRO FORMA INCOME STATEMENTS, BALANCE SHEETS, AND CASH BUDGETS (BUILT WITH LOTUS 1-2-3 © LOTUS DEVELOPMENT CORP.), continued

Income statement		Assets		Liabilities		Cash budget	
			Quarter 5				
Sls	6600	Csh	300	Accs Pay	2310	Beg Bal	300
CGS	4620	Mkt Sec	0	Notes Pay	−387	Csh Sls	3300
Gross Pf	1980	Acc Rev	3200	T Cur Lib	1923	Rc on Acct	3068
Advtg	330	Inv	4620			T Csh Avl	6668
SGA Exp	1260	T Cur Ast	8120	Mort	5606		
Depr Exp	125					Csh Exp	1747
Oper Pf	265	P&E, Cost	5000	T Lib	7529	Pd on Acct	4480
Int Exp	157	Acum Dep	625			Mort Pay	189
Txbl Inc	108	P&E, Net	4375	Ret on Erns	−599	T Used	4669
				Equity	9566	Prenote	1999
Taxes	32	Real Est	4000			Note Bal	−387
Net Inc	75	Tot Asts	16495	T L&E	16495	End Bal	300

Abbreviations used in the above tables (in alphabetical order):

Acc Rev: accounts receivable
Accs Pay: accounts payable
Accum Dep: accumulated depreciation
Advtg: advertising
Beg bal: beginning balance
CGS: cost of goods sold
Csh Sls: cash sales
Depr Exp: depreciation expense
Gross Pf: gross profit
Int Exp: interest expense
Inv: inventory
Mkt sec: marketable securities
Mort: mortgage
Net Inc: net income
Note Bal: balance borrowed on notes
Notes Pay: notes payable
Oper Pf: operating profit
P&E, Cost: Plant and equipment cost
P&E Net: Plant and equipment net
Prenote: cash balance projected before borrowing on a note
Rc on Acct: received on account
Real Est: real estate
Ret Erns: retained earnings
SGA Exp: selling, general and administrative expense
T Asts: total assets
T Cur Ast: total current assets
T Cur Lib: total current liabilities
T L&E: total liabilities and equity
T Lib: total liabilities
Tot Csh Usd: total cash used

MORTGAGE AMORTIZATION TABLE TO ACCOMPANY PRO FORMA STATEMENTS

Quarters	Payment	Principal	Interest	Balance
1	188.74	17.74	171.00	5682.26
2	188.74	18.27	170.47	5663.99
3	188.74	18.82	169.92	5645.18
4	188.74	19.38	169.36	5625.80
5	188.74	19.96	168.77	5605.83
6	188.74	20.56	168.17	5585.27
7	188.74	21.18	167.56	5564.09
8	188.74	21.81	166.92	5542.28
9	188.74	22.47	166.27	5519.81
10	188.74	23.14	165.59	5496.67
11	188.74	23.84	164.90	5472.83
12	188.74	24.55	164.18	5448.28
13	188.74	25.29	163.45	5422.99
14	188.74	26.05	162.69	5396.94
15	188.74	26.83	161.91	5370.11
16	188.74	27.63	161.10	5342.48
17	188.74	28.46	160.27	5314.02
18	188.74	29.32	159.42	5284.70
19	188.74	30.20	158.54	5254.50
20	188.74	31.10	157.64	5223.40
21	188.74	32.03	156.70	5191.37
22	188.74	33.00	155.74	5158.37
23	188.74	33.99	154.75	5124.38
24	188.74	35.01	153.73	5089.38
25	188.74	36.06	152.68	5053.32
26	188.74	37.14	151.60	5016.19
27	188.74	38.25	150.49	4977.94
28	188.74	39.40	149.34	4938.54
29	188.74	40.58	148.16	4897.96
30	188.74	41.80	146.94	4856.16
31	188.74	43.05	145.68	4813.10
32	188.74	44.34	144.39	4768.76
33	188.74	45.67	143.06	4723.09
34	188.74	47.04	141.69	4676.04
35	188.74	48.46	140.28	4627.59
36	188.74	49.91	138.83	4577.68
37	188.74	51.41	137.33	4526.27
38	188.74	52.95	135.79	4473.32
39	188.74	54.54	134.20	4418.78
40	188.74	56.17	132.56	4362.61
41	188.74	57.86	130.88	4304.75
42	188.74	59.59	129.14	4245.16
43	188.74	61.38	127.35	4183.78
44	188.74	63.22	125.51	4120.55
45	188.74	65.12	123.62	4055.43
46	188.74	67.07	121.66	3988.36
47	188.74	69.09	119.65	3919.27

(Continued)

MORTGAGE AMORTIZATION TABLE TO ACCOMPANY PRO FORMA STATEMENTS, continued

Quarters	Payment	Principal	Interest	Balance
48	188.74	71.16	117.58	3848.11
49	188.74	73.29	115.44	3774.82
50	188.74	75.49	113.24	3699.33
51	188.74	77.76	110.98	3621.57
52	188.74	80.09	108.65	3541.48
53	188.74	82.49	106.24	3458.99
54	188.74	84.97	103.77	3374.02
55	188.74	87.52	101.22	3286.50
56	188.74	90.14	98.60	3196.36
57	188.74	92.85	95.89	3103.52
58	188.74	95.63	93.11	3007.89
59	188.74	98.50	90.24	2909.38
60	188.74	101.46	87.28	2807.93
61	188.74	104.50	84.24	2703.43
62	188.74	107.63	81.10	2595.80
63	188.74	110.86	77.87	2484.93
64	188.74	114.19	74.55	2370.74
65	188.74	117.61	71.12	2253.13
66	188.74	121.14	67.59	2131.99
67	188.74	124.78	63.96	2007.21
68	188.74	128.52	60.22	1878.69
69	188.74	132.38	56.36	1746.31
70	188.74	136.35	52.39	1609.96
71	188.74	140.44	48.30	1469.53
72	188.74	144.65	44.09	1324.88
73	188.74	148.99	39.75	1175.88
74	188.74	153.46	35.28	1022.42
75	188.74	158.06	30.67	864.36
76	188.74	162.81	25.93	701.55
77	188.74	167.69	21.05	533.86
78	188.74	172.72	16.02	361.14
79	188.74	177.90	10.83	183.24
80	188.74	183.24	5.50	0.00

Qtr. Interest Rate: 3.00%
Number of Periods: 80
Amount Outstanding: $5,700.00
Qtr. Payment: $188.74

FORMULA USED TO BUILD PRO FORMA STATEMENTS AND TABLE

Income statement		Assets		Liabilities		Cash budget	
				Quarter 1			
Sls	3000+(500*E3)	Csh		300 Accs Pay	+C7*0.7	Beg Bal	300
CGS	+C6*0.7	Mkt Sec		0 Notes Pay	+I16	Csh Sls	+C6*0.5
Gross Pf	+C6−C7	Acc Rev	+C6*0.25	T Cur Lib	+G6+G7	Rc on Acct	+C6*0.23
Advtg	100+0.05*C6	Inv	+C7*1			T Csh Avl	@SUM(I6..I8)
SGA Exp	600+0.1*C6	T Cur Ast	@SUM(E6..E9)	Mort	+H111		
Depr Exp	+E13					Csh Exp	+C9+C10+C13
Oper Pf	+C8−C9−C10−C11	P&E, Cost		5000 T Lib	+G8+G10	Pd on Acct	+C7*0.5
Int Exp	0.03*I16+INT1	Acum Dep	+E12*0.025			Mort Pay	+$E$114
Txbl Inc	+C12−C13	P&E, Net	+E12−E13	Ret on Erns	+C17	T Csh Usd	@SUM(I11..I13)
				Equity	+E17−G12−G14	Prenote	+I9−I14
Taxes	+C14*0.3	Real Est		4000		Note Bal	(−I15+300)
Net Inc	+C14−C16	Tot Asts	+E10+E14+E16	T L&E	@SUM(G12..G15)	End Bal	300
				Quarter +E3+1			
Sls	3600+(500*E21)	Csh		300 Accs Pay	+C25*0.5	Beg Bal	300
CGS	+C24*0.7	Mkt Sec		0 Notes Pay	+I34	Csh Sls	+C24*0.5
Gross Pf	+C24−C25	Acc Rev	(C6+C24)*0.25	T Cur Lib	+G24+G25	Rc on Acct	(C6*0.25)+(C24*0.23)
Advtg	100+0.05*C24	Inv	+C25*1			T Csh Avl	@SUM(I24..I26)
SGA Exp	+C24*0.1+600	T Cur Ast	@SUM(E24..E27)	Mort	+H112		
Depr Exp	+E31−E13					Csh Exp	+C27+C28+C31
Oper Pf	+C26−C27−C28−C29	P&E, Cost		5000 T Lib	+G26+G28	Pd on Acct	(C7+C25)*0.5
Int Exp	+INT2+0.03*I34	Acum Dep	+E13+E30*0.025			Mort Pay	+PAYMT
Txbl Inc	+C30−C31	P&E, Net	+E30−E31	Ret on Erns	(G14+C35)	T Usd	@SUM(I29..I31)
				Equity	+E35−G30−G32	Prenote	+I27−I32
Taxes	+C32*0.3	Real Est		4000		Note Bal	+I16−I33+300
Net Inc	+C32−C34	Tot Asts	+E28+E32+E34	T L&E	@SUM(G30..G33)	End Bal	300

(Continued)

FORMULA USED TO BUILD PRO FORMA STATEMENTS AND TABLE, continued

Income statement		Assets		Liabilities		Cash budget	
			Quarter +E21+1				
Sls	3600+(500*E39)	Csh		300 Accs Pay	+C43*0.5	Beg Bal	300
CGS	+C42*0.7	Mkt Sec		0 Notes Pay	+I52	Csh Sls	+C42*0.5
Gross Pf	+C42−C43	Acc Rev	(C24+C42)*0.25	T Cur Lib	+G42+G43	Rc on Acct	(C24*0.25)+(C42*0.23)
Advtg	0.05*C42	Inv	+C43*1			T Csh Avl	@SUM(I42..I44)
SGA Exp	+C42*0.1+600	T Cur Ast	@SUM(E42..E45)	Mort	+H113		
Depr Exp	+E49−E31					Csh Exp	+C45+C46+C49
Oper Pf	+C44−C45−C46−C47	P&E, Cost		5000 T Lib	+G44+G46	Pd on Acct	(C25+C43)*0.5
Int Exp	+INT3+0.03*I52	Acum Dep	+E31+E48*0.025			Mort Pay	+PAYMT
Txbl Inc	+C48−C49	P&E, Net	+E48−E49	Ret on Erns	(G32+C53)	T Used	@SUM(I47..I49)
				Equity	+E53−G48−G50	Prenote	+I45−I50
Taxes	+C50*0.3	Real Est		4000		Note Bal	+I34−I51+300
Net Inc	+C50−C52	T Asts	+E46+E50+E52	T L&E	@SUM(G48..G51)	End Bal	300
			Quarter +E39+1				
Sls	4600+(400*E58)	Csh		300 Accs Pay	+C62*0.5	Beg Bal	300
CGS	+C61*0.7	Mkt Sec		0 Notes Pay	+I71	Csh Sls	+C61*0.5
Gross Pf	+C61−C62	Acct Rev	(C42+C61)*0.25	T Cur Lib	+G61+G62	Rc on Acct	(C43*0.25)+(C61*0.23)
Advtg	0.05*C61	Inv	+C62*1			T Csh Av1	@SUM(I61..I63)
SGA Exp	+C61*0.1+600	T Cur Ast	@SUM(E61..E64)	Mort	+H114		
Dpr Exp	+E68−E49					Csh Exp	+C64+C65+C68
Oper Pf	+C63−C64−C65−C66	P&E, Cost		5000 T Lib	+G63+G65	Pd on Acct	(C43+C62)*0.5
Int Exp	+INT4+0.03*I71	Acum Dep	+E49+E67*0.025			Mort Pay	+PAYMT
Txbl Inc	+C67−C68	P&E, Net	+E67−E68	Ret on Erns	(G50+C72)	T Used	@SUM(I66..I68)
				Equity	+E72−G67−G69	Prenote	+I64−I69
Taxes	+C69*0.3	Real Est		4000		Note Bal	+I52−I70+300
Net Inc	+C69−C71	Tot Asts	+E65+E69+E71	T L&E	@SUM(G67..G70)	End Bal	300

				Quarter +E58+1					
Sls	3600+(600*E76)	Csh		300	Accs Pay	+C80*0.5	Beg Bal		300
CGS	+C79*0.7	Mkt Sec		0	Notes Pay	+I89	Csh Sls	+C79*0.5	
Gross Pf	+C79−C80	Acc Rev	(C61+C79)*0.25		T Cur Lib	+G79+G80	Rc on Acct	(C61*0.25)+(C79*0.23)	
Advtg	0.05*C79	Inv	+C80*1				T Csh Avl	@SUM(I79..I81)	
SGA Exp	+C79*0.1+600	T Cur Ast	@SUM(E79..E82)		Mort	+H115			
Depr Exp	+E86−E68						Csh Exp	+C82+C83+C86	
Oper Pf	+C81−C82−C83−C84	P&E, Cost		5000	T Lib	+G81+G83	Pd on Acct	(C62+C80)*0.5	
Int Exp	+INT5+0.03*I89	Acum Dep	+E68+(E85*0.025)				Mort Pay	+PAYMT	
Txbl Inc	+C85−C86	P&E, Net	+E85−E86		Ret on Erns	(G69+C90)	T Used	@SUM(I84..I86)	
					Equity	+E90−G85−G87	Prenote	+I82−I87	
Taxes	+C87*0.3	Real Est		4000			Note Bal	+I71−I88+300	
Net Inc	+C87−C89	Tot Asts	+E83+E87+E89		T L&E	@SUM(G85..G88)	End Bal		300

Note: This formula uses Lotus 1-2-3, which are copyrighted by Lotus Development Corporation.

Abbreviations used in the above tables (in alphabetical order):

Acc Rev: accounts receivable
Accs Pay: accounts payable
Accum Dep: accumulated depreciation
Advtg: advertising
Beg bal: beginning balance
CGS: cost of goods sold
Csh Sls: cash sales
Depr Exp: depreciation expense
Gross Pf: gross profit
Int Exp: interest expense
Inv: inventory
Mkt sec: marketable securities
Mort: mortgage
Net Inc: net income
Note Bal: balance borrowed on notes
Notes Pay: notes payable
Oper Pf: operating profit
P&E, Cost: Plant and equipment cost
P&E Net: Plant and equipment net
Prenote: cash balance projected before borrowing on a note
Rc on Acct: received on account
Real Est: real estate
Ret Erns: retained earnings
SGA Exp: selling, general and administrative expense
T Asts: total assets
T Cur Ast: total current assets
T Cur Lib: total current liabilities
T L&E: total liabilities and equity
T Lib: total liabilities
Tot Csh Usd: total cash used

MORTGAGE AMORTIZATION TABLE OF LOTUS 1-2-3

Quarters	Payment	Principal	Interest	Balance
1	+$PAYMT	+E111−INT1	+C107*B111	5700−F111
2	+$PAYMT	+E112−INT2	+$C$107*H111	+H111−F112
3	+$PAYMT	+E113−INT3	+$C$107*H112	+H112−F113
4	+$PAYMT	+E114−INT4	+$C$107*H113	+H113−F114
5	+$PAYMT	+E115−INT5	+$C$107*H114	+H114−F115
6	+$PAYMT	+E116−G116	+$C$107*H115	+H115−F116
7	+$PAYMT	+E117−G117	+$C$107*H116	+H116−F117
8	+$PAYMT	+E118−G118	+$C$107*H117	+H117−F118
9	+$PAYMT	+E119−G119	+$C$107*H118	+H118−F119
10	+$PAYMT	+E120−G120	+$C$107*H119	+H119−F120
11	+$PAYMT	+E121−G121	+$C$107*H120	+H120−F121
12	+$PAYMT	+E122−G122	+$C$107*H121	+H121−F122
13	+$PAYMT	+E123−G123	+$C$107*H122	+H122−F123
14	+$PAYMT	+E124−G124	+$C$107*H123	+H123−F124
15	+$PAYMT	+E125−G125	+$C$107*H124	+H124−F125
16	+$PAYMT	+E126−G126	+$C$107*H125	+H125−F126
17	+$PAYMT	+E127−G127	+$C$107*H126	+H126−F127
18	+$PAYMT	+E128−G128	+$C$107*H127	+H127−F128
19	+$PAYMT	+E129−G129	+$C$107*H128	+H128−F129
20	+$PAYMT	+E130−G130	+$C$107*H129	+H129−F130
21	+$PAYMT	+E131−G131	+$C$107*H130	+H130−F131
22	+$PAYMT	+E132−G132	+$C$107*H131	+H131−F132
23	+$PAYMT	+E133−G133	+$C$107*H132	+H132−F133
24	+$PAYMT	+E134−G134	+$C$107*H133	+H133−F134
25	+$PAYMT	+E135−G135	+$C$107*H134	+H134−F135
26	+$PAYMT	+E136−G136	+$C$107*H135	+H135−F136
27	+$PAYMT	+E137−G137	+$C$107*H136	+H136−F137
28	+$PAYMT	+E138−G138	+$C$107*H137	+H137−F138
29	+$PAYMT	+E139−G139	+$C$107*H138	+H138−F139
30	+$PAYMT	+E140−G140	+$C$107*H139	+H139−F140
31	+$PAYMT	+E141−G141	+$C$107*H140	+H140−F141
32	+$PAYMT	+E142−G142	+$C$107*H141	+H141−F142
33	+$PAYMT	+E143−G143	+$C$107*H142	+H142−F143
34	+$PAYMT	+E144−G144	+$C$107*H143	+H143−F144
35	+$PAYMT	+E145−G145	+$C$107*H144	+H144−F145
36	+$PAYMT	+E146−G146	+$C$107*H145	+H145−F146
37	+$PAYMT	+E147−G147	+$C$107*H146	+H146−F147
38	+$PAYMT	+E148−G148	+$C$107*H147	+H147−F148
39	+$PAYMT	+E149−G149	+$C$107*H148	+H148−F149
40	+$PAYMT	+E150−G150	+$C$107*H149	+H149−F150
41	+$PAYMT	+E151−G151	+$C$107*H150	+H150−F151
42	+$PAYMT	+E152−G152	+$C$107*H151	+H151−F152
43	+$PAYMT	+E153−G153	+$C$107*H152	+H152−F153
44	+$PAYMT	+E154−G154	+$C$107*H153	+H153−F154
45	+$PAYMT	+E155−G155	+$C$107*H154	+H154−F155
46	+$PAYMT	+E156−G156	+$C$107*H155	+H155−F156
47	+$PAYMT	+E157−G157	+$C$107*H156	+H156−F157
48	+$PAYMT	+E158−G158	+$C$107*H157	+H157−F158

MORTGAGE AMORTIZATION TABLE OF LOTUS 1-2-3, continued

Quarters	Payment	Principal	Interest	Balance
49	+$PAYMT	+E159−G159	+$C$107*H158	+H158−F159
50	+$PAYMT	+E160−G160	+$C$107*H159	+H159−F160
51	+$PAYMT	+E161−G161	+$C$107*H160	+H160−F161
52	+$PAYMT	+E162−G162	+$C$107*H161	+H161−F162
53	+$PAYMT	+E163−G163	+$C$107*H162	+H162−F163
54	+$PAYMT	+E164−G164	+$C$107*H163	+H163−F164
55	+$PAYMT	+E165−G165	+$C$107*H164	+H164−F165
56	+$PAYMT	+E166−G166	+$C$107*H165	+H165−F166
57	+$PAYMT	+E167−G167	+$C$107*H166	+H166−F167
58	+$PAYMT	+E168−G168	+$C$107*H167	+H167−F168
59	+$PAYMT	+E169−G169	+$C$107*H168	+H168−F169
60	+$PAYMT	+E170−G170	+$C$107*H169	+H169−F170
61	+$PAYMT	+E171−G171	+$C$107*H170	+H170−F171
62	+$PAYMT	+E172−G172	+$C$107*H171	+H171−F172
63	+$PAYMT	+E173−G173	+$C$107*H172	+H172−F173
64	+$PAYMT	+E174−G174	+$C$107*H173	+H173−F174
65	+$PAYMT	+E175−G175	+$C$107*H174	+H174−F175
66	+$PAYMT	+E176−G176	+$C$107*H175	+H175−F176
67	+$PAYMT	+E177−G177	+$C$107*H176	+H176−F177
68	+$PAYMT	+E178−G178	+$C$107*H177	+H177−F178
69	+$PAYMT	+E179−G179	+$C$107*H178	+H178−F179
70	+$PAYMT	+E180−G180	+$C$107*H179	+H179−F180
71	+$PAYMT	+E181−G181	+$C$107*H180	+H180−F181
72	+$PAYMT	+E182−G182	+$C$107*H181	+H181−F182
73	+$PAYMT	+E183−G183	+$C$107*H182	+H182−F183
74	+$PAYMT	+E184−G184	+$C$107*H183	+H183−F184
75	+$PAYMT	+E185−G185	+$C$107*H184	+H184−F185
76	+$PAYMT	+E186−G186	+$C$107*H185	+H185−F186
77	+$PAYMT	+E187−G187	+$C$107*H186	+H186−F187
78	+$PAYMT	+E188−G188	+$C$107*H187	+H187−F188
79	+$PAYMT	+E189−G189	+$C$107*H188	+H188−F189
80	+$PAYMT	+E190−G190	+$C$107*H189	+H189−F190

Qtr. Interest Rate: 0.12/4
Number of Quarters: 20*4
Amount Outstanding: (E16*0.8) + (E12*0.5)
Qtr. Payment: @PMT(B111,C107,C108)

APPENDIX B

Liability of Various Forms of Business Organizations

Mark H. Flener, J. D.

People conduct business by and through various organizational forms. Three of the most common organizational forms are (1) sole proprietorship, (2) partnership, and (3) corporation. The purpose of this appendix is to review briefly these organization options and the liability of the persons behind each one.

Corporations

The corporation is the most formal entity. For a corporation to exist, it must be "born" by following the statutory enactments necessary to create a corporation. These include, at a minimum, filing articles of incorporation and adopting bylaws. Once a corporate entity is created, the corporation is treated as a "person" for purposes of liability. The corporation can sue in its own name and can be sued in its own name. The corporation is liable for its actions, omissions, and obligations.

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Although the corporate entity is liable, one of the primary advantages espoused for forming a corporation is the limited liability of its shareholders. This limited liability is often critical for obtaining substantial amounts for equity capital. Virtually every state has a statute limiting a shareholder's liability. Generally a shareholder is not liable for actions, omissions, or debts of the corporation (Section 6.22 of the revised Model Business Corporation Act; applicable state laws may be consulted for specific information). Even when an individual owns all or the majority of the shares of a corporation, the general rule of nonliability still exists.

Even though the general rule of nonliability of shareholders has been firmly entrenched since the nineteenth century, courts have carved out numerous exceptions. Where shareholders misuse the corporate identity, courts will often disregard the corporation and allow recovery against the shareholders. Likewise, when shareholders treat the corporate assets as their own or fail to provide adequate capitalization, the shareholder may be personally liable for the actions of the corporation. Whether the courts use the "instrumentality," "alter-ego," or "piercing the corporate veil" theory, the end result is the same — liability of the shareholder.

In addition to these theories of liability, a more practical question involves the liability of shareholders in financing the corporation. Lenders to most newly formed corporations will require that the principal shareholder personally guarantee debts. Thus, if the corporation fails to pay its obligations, the lender can proceed against the individual shareholders on their guarantee.

Besides shareholders, a corporation must have officers and directors. The officers and directors of the corporation are in charge of the management of the corporation and owe various fiduciary duties to the shareholders. In general, the directors and officers must act with trust, confidence, and good faith in their management of the corporation. When they violate their duties, resulting in a loss to the corporation, the officers and directors are liable. However, when an officer or director has not personally profited from such actions, courts are very reluctant to hold him or her liable, using the "business judgment rule."

Practically speaking, however, in a small business in which there are just a few shareholders, the shareholders also serve as officers or directors of the corporation. Thus, an officer-shareholder who diverts corporate assets for his or her own benefit would not be insulated from liability by reason of the corporate entity.

Partnership

In a general partnership, each partner will be liable for the obligations and wrongful acts or omissions of the other partners in carrying out the partnership business. The Uniform Partnership Act provides that if partnership assets are

inadequate to satisfy partnership obligations, each individual partner's personal property can be used to satisfy the partnership obligation.

In a general partnership, a general partner or partners are in charge of managing the partnership. The general partners of a limited partnership are liable for the actions of the other partners in furtherance of the partnership; and if the partnership has insufficient assets to satisfy the obligations of the partnership, the general partner's personal property may be used to satisfy the partnership debts.

Conversely, limited partners in a limited partnership are at risk only to the extent of their capital contribution. A limited partner has no control over the management of the partnership but acts as a mere investor. In this regard, a limited partner is somewhat akin to a shareholder of a corporation. Indeed, a limited partnership is a statutory creature that must be created formally according to state law.

Although the general rule is that limited partners have limited liability, limited partners in certain instances may be found liable for partnership obligations. Where there has been defective compliance with creating the partnership, where the limited partner participates in management, or where the limited partner acts in a manner inconsistent with the limited nature of his or her investment, the limited partner may be held liable.

Sole Proprietorship

By far the most common business organization is the sole proprietorship. In a sole proprietorship, the owner (sole proprietor) is personally liable for the obligations of the business.

Summary

When considering the form of organization in which to conduct a business, several factors must be considered. Tax consequences and legal liability of the owners are two of the important considerations a newly created business must carefully consider. You should not automatically assume that one business entity is better than another. Each organizational form has advantages and disadvantages. In deciding the organizational form of a business, you should seek counsel from tax specialists and attorneys knowledgeable in the advantages and disadvantages of the various organizational forms.

APPENDIX C

Forms of Organization and Tax Consequences

Joel Philhours, Ph. D., CPA

The organizational forms that have different tax consequences are partnership (including sole proprietorship), C corporation, and S corporation. The partnership is a pass-through entity and does not pay income taxes. Its income must be allocated to its partners and reported on the individuals' personal tax returns. Note that the income is allocated irrespective of cash or other asset distributions to the partners.

The C corporation is the regular form of a corporation and pays taxes on its income. In addition, shareholders are taxed on dividend distributions from the corporation. Consequently, the income may be taxed twice — when earned by the corporation and again when distributed to the shareholders.

Prior to 1987, the maximum tax rate was 46 percent for corporations and 50 percent or more for individuals. The corporation had a tax advantage over a partnership if the business did not distribute its earnings but retained them for growth. With the enaction of the 1986 Tax Reform Act (TRA), the maximum

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tax rate for corporations dropped to 34 percent, and the individual rate dropped even further, to 28 percent. This change negated the tax advantage of incorporating, and in fact the partnership has a tax advantage over the corporation, regardless of whether the earnings are distributed or retained by the business.

The S type of corporation has been allowed for some time, but has taken on greater importance since the 1986 TRA raised the corporate maximum tax rate above the personal rate. The special property of an S corporation is that it is a pass-through entity and, thus, is not subject to income taxes; its income must be allocated to its shareholders and reported on their personal tax returns in the same manner as a partnership. A corporation must file the form "Election for a Small Business Corporation" within the first seventy-five days of its tax year to be granted S status for that tax year. If filed later within the tax year, S status cannot be granted until the following tax year. There are criteria for a corporation electing to be an S corporation, such as limitations on number of shareholders (thirty-five), types of shareholders (no corporations and only certain types of trusts), and types of income (passive income such as rents, dividends, and interest is restricted).

The social security tax has become a large outlay: 7.51 percent for each of employee and employer on the first $48,000 of wages. The comparable tax for a self-employed person is 13.02 percent on the first $48,000 of self-employment income. The self-employment tax has been given a 2 percent credit (the combined social security tax is 15.02 percent because it is not tax deductible) whereas the employer's part of social security tax is a business expense and is tax deductible.

In a partnership, a partner, even if active in the business, is not considered an employee for classification of wages or social security taxes — that is, payments to a partner are not deductible as wages and the partnership and partners do not pay social security taxes on those payments. However, the allocations to a partner from a trade or business partnership are classified as self-employment income, and the partner must pay self-employment taxes in addition to income taxes.

In a C or S corporation, a shareholder active in the business is treated the same as any other employee for purposes of wages and social security taxes —the wages are deductible and subject to social security taxes. The taxable income of the S corporation allocated to the shareholders is not self-employment income to the shareholders. In summary, the S corporation follows the C corporation rules, and not the partnership rules, in the categorization of wages and social security taxes and exclusion from self-employment taxes.

Tax-free retirement contributions on behalf of employees by corporation (either S or C) are allowed if the plan is qualified. Certain technical rules must be satisfied for qualification, a primary one being that the contributions or benefits under the plan should not discriminate in favor of officers, stockholders, or highly compensated employees.

A partner who does not perform personal services for the partnership may not participate in a plan of tax-free retirement contributions. A partner who performs personal services and has less than 10 percent interest in the partnership's profit or capital may have tax-free contributions made on his or her behalf by the partnership, as if an employee of the partnership. But an owner-employee (defined as owning 10 percent or more of and performing personal services for the partnership) may not have tax-free contributions made by the partnership. Instead, with partnership approval, the owner-employee may establish a Keogh plan and personally make tax-free contributions. As in the corporation plan, the partnership and Keogh plans must satisfy particular guidelines, a primary one being that it not discriminate in favor of officers, partners, or highly compensated employees. In summary, the benefit of a tax-free retirement contribution is available in both corporations and partnerships.

Certain eligibility tests are required for other employee benefit plans, such as health and accident and group-term life insurance, to be excludable from the employees' gross income. The intent of the tests is to ensure consistent and uniform treatment over a broad-section of the employees. An employee-stockholder of a C corporation is treated the same as any other employee. However, an S corporation shareholder-employee with greater than a 2 percent voting stock ownership is treated the same as a partner for the purpose of these benefit plans. And, as a partner is not an employee of the business, any "employee" benefits will be taxed to partners and those particular S corporation shareholders.

As is apparent, tax implications of legal forms of business organization are complex. One may sit down with a tax specialist and project tax liabilities as a proprietor, partnership, or corporation at different income levels. This may determine the choice of organization in early stages. Equity financing considerations will likely determine legal form if the business begins to grow substantially.

Glossary

This "specialized dictionary" contains terms primarily having a meaning in an entrepreneurial context that differs from the meaning in a general business discussion.

Asset management. Achieving full use of assets, especially to support production and sales. This results in minimal requirements for capital.

Assets. Things of value owned. In accounting, tangible assets included are cash, bank balance, inventory, accounts receivable from customers, buildings, land, and patents.

Barrier to entry. Any obstacle to a business start-up or other new entrant to a market. Common barriers are capital requirements, experience requirements, brand (or seller) loyalty by customers, and government licensing practices.

Bankruptcy. The process by which a person who cannot pay certain debts gains release from creditor claims.

Capital. Money invested for a long term, usually five years or more. The investor may be an owner or lender.

Channel of distribution. The parties used to transfer a product or service from its producer to its consumer, traditionally called *middlemen.* Franchisees may be thought of as part of a distribution channel.

Commodity. A product or service indistinguishable, in any aspect important to buyers, from offerings of rival sellers. Hence, the buyer selects a seller on the basis of price charged within a grade or class of items.

Corridor principle. A pattern of start-up ideas in which some new business experience leads to new ideas, some of which lead to a new business experience, and so on.

Costs, fixed. Costs incurred as a function of time versus the level of activity; for example, monthly insurance premiums or lease payments, minimum charge for an advertisement, or a loan.

Costs, variable. Costs incurred as a function of the number of units of product or service produced; for example, for materials or parts or the electricity to power a production machine. Costs for personnel could be fixed or variable; for example, salaries versus sales commissions or piece rate payments.

Differentiation. Objectively or subjectively distinguishing a product or service from that of rivals in its observable or perceived features. This may be accompanied by market segmentation or target marketing.

Disequilibrium. A market condition of shortage or surplus, exerting an upward or downward pressure on prices.

Economy, the. The output of private and public goods and services.

Entrepreneur. One who starts a business or substantially increases the business of an existing company, especially by product or marketing innovation.

Entrepreneurial environment. The opportunities or support to start or increase business; such as, unmet customer needs, available capital, skilled labor, or useful product ingredients.

Environments. The surroundings effecting start-ups or businesses including customers, suppliers, rivals, technology, level of business activity, and costs. Changes in these factors are especially important.

Equilibrium. The market condition in which transactions occur at stable prices with neither shortages nor surpluses.

Experience. Having a history of completed activity.

Technical.	a history of activity in production operations, engineering, or maintenance.
Industrial.	a history of activity in a type of business (in an industry); for example, tires.
Entrepreneurial.	a history of starting (new) business, or dramatically increasing business, especially through innovation.

Financing. Securing money to buy assets or pay for expenses. The sources become creditors, owners, or perhaps donors.

Focus. A narrow product line or narrow target markets. New businesses must have a narrow product focus but may sell to a broad market.

Franchise. An agreement between a party owning the right to sell goods or services and a second party intending to sell those goods or services. The first party is called a *franchiser,* and the second is called a *franchisee.*

Heterogeneous products. Products having many variations or many different characteristics; for example, furniture.

High technology. Know-how in new, complex fields, often electronics or chemistry.

Homogeneous products. Products having a narrow range of differences; for example, denim cloth or paper cups.

Inducement. In organization jargon, the persuasion, incentive, or attraction used to cause persons to join or otherwise contribute a resource to an organization, whether these persons be new managers or employees, creditors, equity investors, suppliers, or even customers.

Industrial products. Items (products or services) used in a business, not used directly by consumers.

Industry. A group of businesses competing in a product market, also called a *business;* for example, software industry or the software business. (See Trade).

Intrapreneur. One who increases or plays a key role in increasing the business of an established company, especially through product or marketing innovation.

Intrapreneurial culture. The receptivity and environment within an organization to start new kinds of activity, such as production of new products or services.

Leverage. The movement of one variable causes another to move more.

Financial. an increase in debt capital that causes profits to vary more in response to changes in operating profits.

Operating. substituting fixed operating costs for variable costs, usually by substituting machine for labor, causing operating profits to vary more in response to changes in volume.

Operating profit. Profit from business operations, excluding outside income and before interest expenses are subtracted.

Operating skill. (See Technical skill.)

Present value. Today's dollar value of a sum or stream of dollars due or receivable in the future. The future amount(s) are discounted by dividing by 1 plus a factor for risk and inflation, raised to the power of the number of years before the money is received.

Profitability. The state of operation in which revenues for a period exceed costs associated with that same period.

License. (1) An agreement between an owner of intellectual property and one intending to use that property, specifying conditions and terms by which

the rights are transferred from licenser to licensee. (See Franchise). (2) A permit issued by a government.

Lowest cost. Costs per acceptable unit of product or service available for consumption is lower than any rival's products.

Market. The transactions or exchanges between buyers and sellers, also buyers or potential buyers.

Strategy. The plan or series of actions to attain success; in business to attain customers, usually in the face of rivalry and for profits. Also, the integration of different company resources and actions to attain business goals.

Technical skill. Proficiency at production tasks, such as construction, machine setup, and maintenance.

Trade association. A group of businesses in the same trade, having banded together for mutual benefit. It may lobby the government or collect and disseminate information of interest to member companies. (See Industry.)

Trade publication. A magazine, newsletter, or other material published for practitioners of a particular kind of business.

Trade show. A collection of exhibits of products by different sellers in the same trade, such as autos, books, or software.

Transferable skill. A proficiency developed in one company that can be used in another company.

Uncertainty. A condition in which the outcome of decisions or actions are known only with some probability.

Undifferentiated products. Those that are not distinguishable from products of rival sellers, also called *commodities.*

Venture. (v.) To start new business, to launch a start-up (n.), a new business or a significant business expansion.

Venture capital. Long-term money invested in high-risk, potentially high-growth businesses, usually for ownership. A post start-up financing source.

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