FIFTH EDITION

ENTREPRENEURSHIP AND SMALL BUSINESS

START-UP, GROWTH AND MATURITY

PAUL BURNS



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The front cover of *Entrepreneurship and Small Business* features beautiful ceramics by Edinburgh based artist and entrepreneur, Lara Scobie. Her work focuses on the dynamic relationship between form and pattern and explores the unity of drawing, surface, mark making and volume. Lara studied ceramics at Camberwell College of Arts in London and has a postgraduate degree from Edinburgh College of Art. Her work has been exhibited widely and has received many awards including Premier winner of The Fletcher Challenge in New Zealand and Honourable Mention at Mino Ceramics, Japan. Lara is a fellow of the Craft Potters Association of Great Britain.

www.larascobie-ceramics.com

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PAUL BURNS

RED GLOBE PRESS

macmillan international HIGHER EDUCATION

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This edition published 2022 by

RED GLOBE PRESS

Previous editions published under the imprint PALGRAVE

Red Globe Press in the UK is an imprint of Macmillan Education Limited, registered in England, company number 01755588, of 4 Crinan Street, London, N1 9XW.

Red Globe Press® is a registered trademark in the United States, the United Kingdom, Europe and other countries.

ISBN 978-1-352-01252-1 hardback

ISBN 978-1-352-01249-1 paperback

This book is printed on paper suitable for recycling and made from fully managed and sustained forest sources. Logging, pulping and manufacturing processes are expected to conform to the environmental regulations of the country of origin.

A catalogue record for this book is available from the British Library.

A catalog record for this book is available from the Library of Congress.

Commissioning Editor: Isabelle Cheng

Associate Development Editor: Sophiya Ali

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Production Editor: Elizabeth Holmes

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In memory of

John Wilkinson

21 January 1933 – 1 October 2019



A good man and a great teacher who influenced so many lives
and touched so many hearts, including my own.

Painting by Haydn Morris, reproduced with kind permission of John's widow, Brenda Wilkinson

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PREFACE TO THE FIFTH EDITION

Entrepreneurship and Small Business has been the market-leading textbook on entrepreneurship in the UK for almost 20 years. Its strength comes from its ability to blend the theory and practice of entrepreneurship, reflecting the background of the author as an academic teacher, entrepreneur and advisor. The major strengths of the book have been retained in the fifth edition:

- The unique breadth of coverage which allows a holistic approach to the issues facing the entrepreneurial organisation (both commercial and social) as it grows;
- The way it synthesises theory and research with practice, using *Case insights* and quotes from entrepreneurs in the real world alongside up-to-date theory and best practice;
- The engaging style that makes the book so accessible and easily understood by students, without sacrificing its academic content.

NEW TO THIS EDITION

This fifth edition has been completely updated. The book has grown in size, again, this time from 19 to 22 chapters. The major change to this edition is the development of a *Digital Links* booklet which you can download by scanning the QR code in the book. The *Digital Links* booklet allows you to connect directly to appropriate videos and websites from a smartphone or computer by simply tapping the screen. It can be used alongside the textbook at points indicated in the text. Links can also be accessed directly through the e-book.

Another major new feature in this edition is the *Explore further* topic boxes. There are some 70 of these topic links that connect via the *Digital Links* booklet to over 200 videos and information websites. There are three types of *Explore further* links:

- Links to video animations that explain more complex topics, such as the *Harvard Business Review* animation explaining design thinking (Chapter 6);
- Links to video interviews and talks, often by eminent academics, such as Eric Ries, explaining the lean start-up concept (Chapter 6);
- Keeping up to date is a challenge in any textbook that sets out to be practical and current and this is achieved by links to websites that offer up-to-date information and practical help and advice, such as help and advice services (Chapter 11). There are also links to websites where online psychometric tests can be undertaken, for example the General Enterprise Tendency test (Chapter 3).

There are 128 *Case insights* from around the world, 55 of which are new to this edition. Bonus cases are available on the companion website, including one that builds a complete financial forecast. All cases have been updated and most now have video links that show company operations, many featuring the entrepreneur themselves, for example James Dyson (Chapters 2 and 16). There are also links to company websites. These can be accessed via the *Digital Links* booklet or direct through the e-book.

This edition sees a new chapter titled 'The entrepreneurial mindset' (Chapter 3), building on work in the previous edition. To go with this, the accompanying website also contains five *Get into the entrepreneurial mindset* videos where we explore the character and motivations of the entrepreneurs through in-depth interviews. These can also be accessed via the *Digital Links* booklet. This edition also contains two new dedicated chapters titled 'Lean methodologies and business model frameworks' (Chapter 6) and 'Recruiting and managing people' (Chapter 14). In addition, the seven *Meet the entrepreneur* videos featured in the previous edition have been carried over into this one and can also be accessed from the companion website or via the *Digital Links* booklet.

Chapters in Parts 2 and 3 of the book now contain specific *Start-up activities*. These apply the learning from the relevant chapter to the practical activity of developing a business model and/or business plan that will help launch a new venture.

WHO THIS BOOK IS AIMED AT

The book is aimed at undergraduate and postgraduate courses in entrepreneurship and small business management. This is a topic in its own right but it can be particularly valuable when linked to other practical courses in science such as engineering, where ideas for new products might be explored for their commercial potential, or when linked to other arts or social sciences courses where self-employment is the norm. The book covers core areas such as management, strategy, marketing, accounting and finance. However, rather than teach the subject in subject-based compartments, relevant chapters are designed to act as a holistic introduction to the topic of business studies in the practical context of a business start-up and growth. Again, students can better see the interconnections and realise that solutions to real business problems require the application of a wide range of business subjects. Relevance and practicality can also aid motivation.

For students who have previously studied business and management, an entrepreneurship course typically aims to integrate and apply most of the functional areas they have previously studied and give it a creative and practical focus. This helps them better see the interconnections in the topics they have already studied and realise that the solutions to real business problems require the application of all the areas they have studied. For these students, the *Case insights* are particularly important, while some of the chapters that cover the 'basics' of business can be skimmed over.

TEACHING AND LEARNING RESOURCES

Each chapter starts with clear learning outcomes that identify the key concepts to be covered and the key knowledge and skills that are gained by reading the chapter and undertaking the activities. At the end of each chapter there is a summary that provides an overview of the main points covered. There are a number of teaching and learning resources in the book and its companion website (www.bloomsbury.pub/burns-esb-5e) that are designed to help students navigate the wheel of learning, taking them from 'knowing how' to 'knowing why' (Figure A).

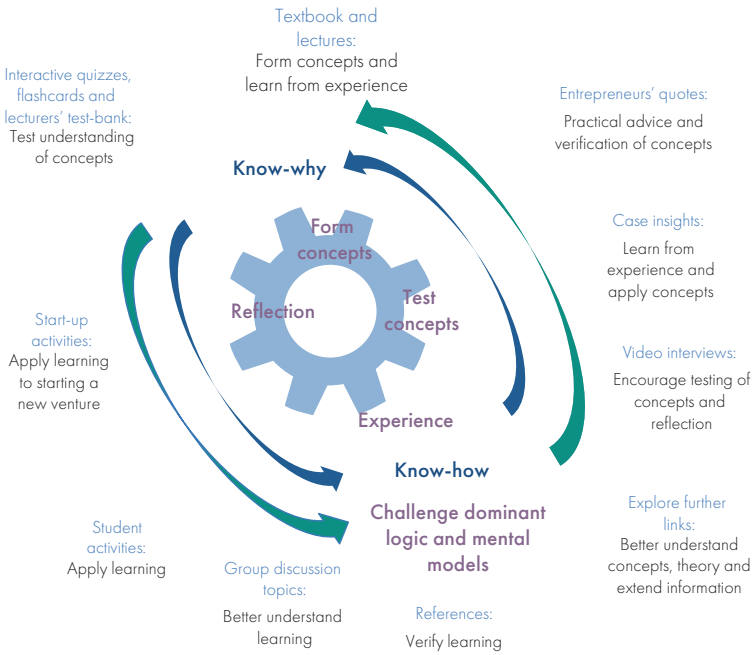
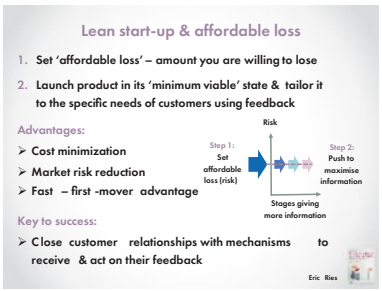


Figure A Wheel of learning for *Entrepreneurship and Small Business*

There are also a number of resources for lecturers on the password-protected side of this website. These are highlighted in the boxed sections below.

The companion website has a password-protected side for lecturers. This gives them access to professionally produced PowerPoint slides to support each chapter. These contain embedded hyperlinks to other teaching resources such as videos and websites



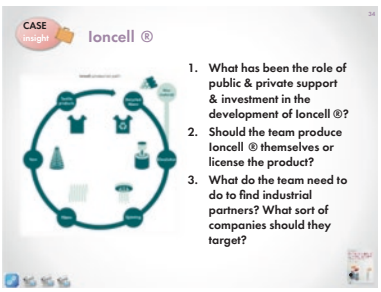
Textbook and lectures

Concepts are introduced through the textbook, usually supplemented by lectures. During the next phase of the cycle students test and experiment with the theories and concepts that they are introduced to and observe what happens through concrete experience – learning 'know-how'. In the second half of the cycle, they reflect on the observations and concepts, perhaps challenging them or forming new concepts of their own – learning 'know-why'. This is often called 'double-loop learning' – the best sort of learning which links knowing how with knowing why, linking theory with practice. So effective learning involves forming concepts, testing concepts, experience and reflection. Arguably, traditional education has focused too much on the teaching of concepts and theories – and it is difficult to break away from this in a textbook – however, the book has additional learning resources that allow students to navigate the wheel of learning. These are in the book itself and on the companion website, with additional resources being signposted throughout the *Digital Links* booklet that students can download.

Entrepreneurs' quotes

Spread throughout the book are quotes from practitioners from around the world. They are designed to illustrate and reinforce the theoretical points being made in the text with practical opinions from the real world – there is nothing like an endorsement from an entrepreneur. This is the experience element of the wheel of learning.

The password-protected side of the companion website gives lecturers access to a *Teaching and Learning Resources* handbook that contains case notes. Relevant videos and websites can be accessed via the internet or video symbol on the *Case insight* PowerPoint slide.



Case insights

Embedded in each chapter are *Case insights* that highlight good and bad practice. Most have related videos that can be accessed by students through the *Digital Links* booklet they can download and via the video symbol on the relevant PowerPoint slide. All the cases have questions designed to make students think about and/or apply the concepts from the chapter. *Case insights* can influence all stages of the wheel of learning, depending on the questions asked. There are two types:

» Some cases are simply practical verification of practices highlighted in the relevant chapter.

» Some, typically longer cases are designed to get students to apply concepts to practical situations and to get them to reflect on the implications.

There are bonus cases on the companion website, including Middle East cases, with case notes, carried forward from the previous edition of the book.

Video interviews

Students can also access on the companion website a number of video interviews with entrepreneurs:

» The new *Get into the entrepreneurial mindset* videos contain interviews with entrepreneurs featured in the *Case insights*. Based upon their psychometric profile highlighted in the case, these interviews explore the mindset of the entrepreneur – their character, how it was formed and their approach to management and decision-making – and can form the basis of class discussion.

» The *Meet the entrepreneurs* videos are carried forward from the previous edition of the book. These videos encourage the testing of concepts and allow the opportunity for students to reflect on the implications for entrepreneurship.

Explore further links

These links direct students to various online resources. They can be accessed through the *Digital Links* booklet that can be downloaded. Students have different learning preferences, and video animations are used to explain concepts and theories outlined in the book. Talks, often by academics referenced in the text, open up avenues for students to explore topics further.

There are also links to websites offering further information on practical aspects as well as assessment tools and psychometric tests that students can use themselves or apply to organisations. These links extend students' learning and encourage them to reflect on topics covered in the chapter.

Lecturers can access *Digital Links* via the internet or video symbol on the relevant PowerPoint slide.



Group discussion topics

Each chapter has topics for group discussion or essay writing. These can be used as a basis for tutorials. They are designed to make students think about and reflect on the text material and develop their critical and reflective understanding of it and what it means in the real world. The summary and discussion topics help students discriminate between main and supporting points and provide mechanisms for self-teaching.

Student activities

Student activities involve doing something, often further research or web-based tests or activities. This is the testing and experiencing phase of the cycle.

Start-up activities

Start-up activities involve applying concepts in a chapter to the practical task of finding and testing a business idea and developing a business model and/or business plan that will help launch it. This is structured, practical learning-by-doing – experiential learning.

Flashcards and chapter quizzes

The companion website contains flashcards of key terms. It also contains interactive chapter-by-chapter self-assessment quizzes. Students can work through these on their own to check their understanding of concepts.

Lecturers can access a test-bank of questions they can use to test the students' understanding of the concepts covered in each chapter.

References

Each chapter has full journal and book references, located in the Reference section at the end of the book. This verifies the learning and encourages further reading and reflection on the topics in the text, particularly when linked to talks by the author highlighted in the *Explore further* links. The website also contains a list of selected entrepreneurship journals.

ABOUT THE AUTHOR



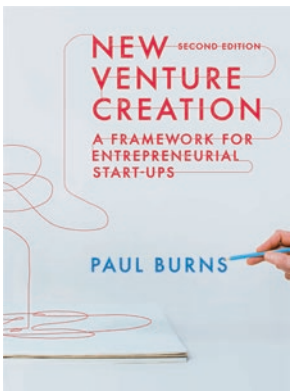
Paul Burns is Emeritus Professor of Entrepreneurship at the University of Bedfordshire Business School, UK. He had been Pro Vice Chancellor and for ten years was Dean of the Business School, stepping down in 2011 ahead of retirement in 2015. Over his 40-year career he has been an academic, an accountant and an entrepreneur – giving him unrivalled academic and practical insight into the entrepreneurial process. As well as launching and running his own business, he has helped develop hundreds of business plans and has worked with entrepreneurs, small firms and their advisors, helping launch successful businesses.

For ten years he was Professor of Small Business Development at Cranfield School of Management, UK, where, in 1983, he launched the Graduate Enterprise Programme in England, which was offered at dozens of universities. He started his academic career at Warwick University Business School, UK, where he set up their first Small Business Unit. For eight years he was Director of 3i European Enterprise Research Centre researching small firms and entrepreneurs across Europe. He has been a Visiting Fellow at Harvard Business School, USA and for three years was Visiting Professor at the Open University Business School, UK, where he developed the multi media Small Business Programme which was screened on BBC2. He is Fellow and a former President of the Institute for Small Business and Entrepreneurship (ISBE).



Paul qualified as a Chartered Accountant with Arthur Andersen & Co., where he worked with many growing businesses. He launched and ran his own business, Design for Learning Ltd., advising and training on entrepreneurship and growing firms where he worked with organisations such as the accounting firms Grant Thornton and BDO Stoy Hayward, venture capitalists 3i, and banks such as the Royal Bank of Scotland, Barclays and Lloyds. He has advised and consulted at various levels of government in the UK and overseas. He has authored dozens of books and hundreds of journal articles and research reports and Margaret Thatcher wrote the foreword to one of his books, *Entrepreneur: Eight British success stories of the 1980s* (Macmillan, 1988).

He has authored dozens of books and hundreds of journal articles and research reports. *Corportate Entrepreneurship and Innovation*, 4th edn, 2020 (Red Globe Press) was first published in 2005. It shows how strategies for encouraging entrepreneurship and innovation might be embedded in larger organisations through the concept of organisational architecture – leadership, strategies, culture and structure. It includes an online Corporate Entrepreneurship Audit that can be used to evaluate the entrepreneurial orientation of an organisation. The fourth edition was described as 'indispensable' and 'one of the best textbooks' that 'deserves to hold pride of place in any comprehensive library of entrepreneurship theory and practice', and it is praised for its 'detailed, in-depth, accessible and wide ranging' contents 'that gracefully connect the deep theoretical foundations of corporate entrepreneurship with the existential yet clear and present challenges that corporations face'.



New Venture Creation: A Framework for Entrepreneurial Start-ups, 2nd edn, 2018 (Red Globe Press) was first published in 2014. Based on its own New Venture Creation Framework, including a comprehensive set of online, interactive learning aids, it helps students through the whole process of new venture creation; including finding a business idea, developing a value proposition for customers and refining a business model that can be developed into a professional business plan. The second edition is described as 'covering all the parts of the venture creation process without resorting to shortcuts' and a '*tour de force*' as well as 'another gem from Paul Burns'.

ACKNOWLEDGEMENTS

I would like to thank all those who have helped me with this book, including the students and staff who inspired me to write it. Particular thanks go to Sophiya Ali and Isabelle Cheng at Bloomsbury, and the (anonymous) reviewers from around the world for their pertinent comments and suggestions. Thanks also to my copyeditor, Anne Halliday, for correcting my all-too-numerous errors and omissions.

My thanks go to Dr Tahseen Arshi at the American University of Ras Al Khaimah, UAE, for permission to use the Case insights on *Soraya Sikander* and *Food-ATM*, Dr Veena Tewari and Dr Kishan Kanchralapalli at Majan College, Muscat, Oman for permission to use the Case insight on *Issam Al Harthy* and finally my wife, Dr Jean Burns, for permission to use the anonymised Case insight *The London School*.

Thanks also to my wife Jean for the help she gives me with all my books. She insists that I write in plain English avoiding jargon and is an invaluable sounding board for new ideas. She also patiently helps with much-needed proofreading. Any errors or omissions, however, remain my own.

Every effort has been made to contact all copyright-holders, but if any have been inadvertently omitted the publishers will be pleased to make the necessary arrangements at the earliest opportunity.

TOUR OF THE BOOK

Case insights
Over 130 detailed cases with accompanying questions are woven throughout the book and demonstrate how small businesses address real-world issues.

Learning outcomes
Structure your learning by focusing on the key points of understanding for each chapter.

Learning outcomes

When you have read this chapter and undertaken the related activities able to:

- Critically analyse the changing social and business environment an on entrepreneurship;
- Define what is meant by entrepreneurship and understand the differ might take;
- Understand the different size definitions of firms, the importance of s global economies and the demographics of entrepreneurship;
- Understand and evaluate the factors that influence a person to start the different sorts of capital they bring to it;

Case insight 1.1 Melanie Perkins and Canva

The entrepreneurial journey

Melanie Perkins is co-founder and CEO of Canva, an online graphic design and publishing tool she launched in 2012, aged 25. With over 20 million users in 190 countries, Canva is one of only about 300 fast-growing private companies around the world that are valued at over $1 billion – called 'unicorns'. In fact, a funding round in 2020 valued the company at $6 billion. The Canva online software platform allows graphics to be created and edited for presentations, posters etc. by using a simple 'drag-and-drop' tool equipped with a library of professional design templates that can be populated with photos, illustrations and fonts. The basic program is free to use, but additional functionality can be purchased by subscribing to other products like Canva Pro

Working from home with her boyfriend, Cliff C decided to launch an online design website c which allowed high schools to design their yea Fusion Books grew so rapidly over the next co Perkins and Obrecht decided to drop out of u on Fusion Books, which has become Australia' publisher. Fusion Books became the prototype and Obrecht joined forces with co-founder Co (who had previously helped develop Google their own developers to work on the Canva co years from the first discussions with investors in funding for Canva. Over that time the team po for investment and in 2012 the team went to the secured some $3 million in venture capital fror

Entrepreneurs' quotes
A selection of quotes from entrepreneurs around the world reinforce the theoretical points in the chapter and offer practical advice for budding entrepreneurs.

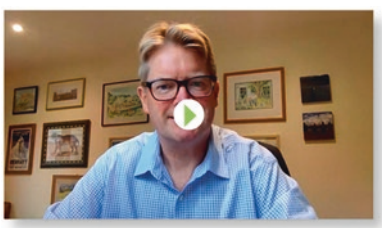
There has been a real sea change this century. The whole environment is a lot more entrepreneurial than it used to be.

Moray Wright, Chief Executive of Parkwalk Advisors, *The Sunday Times*, 18 August 2019

Digital Links
Access the Digital Links booklet by scanning the QR code in the book or visiting the companion website. This innovative platform allows you to connect directly to videos and websites from your smart device and should be used in tandem with the book.

Access the Digital Links booklet to visit the Souqalmal website and watch a video in which Ambareen Musa talks about her background and motivations.

Get into the entrepreneurial mindset
Learn what makes entrepreneurs tick with this brand new series of video interviews where various small business owners take the GET2 test to find out how enterprising they are and discuss their results with the author.

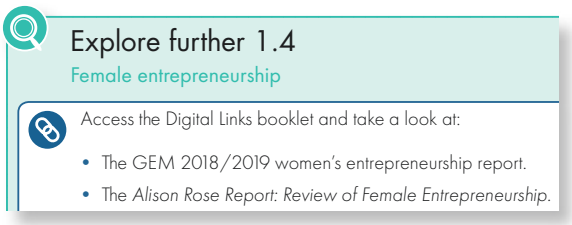


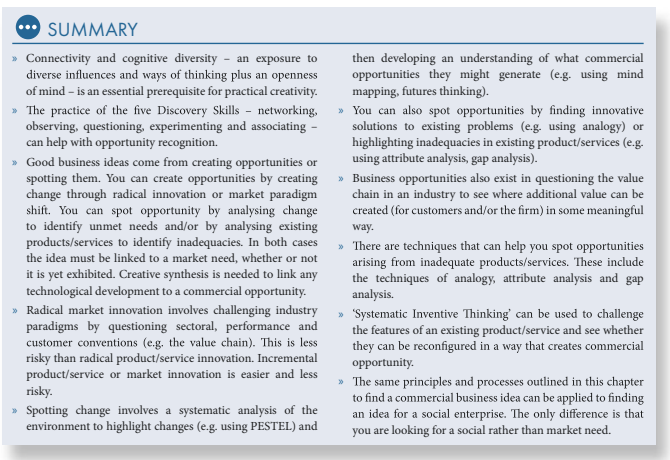
Get into the entrepreneurial mindset. Access the Digital Links booklet to watch an interview with Julian Thomas exploring his mindset and his reactions to the GET2 results.

Meet the entrepreneur
These videos offer you a fascinating insight into the real-life ups and downs of actual entrepreneurs.



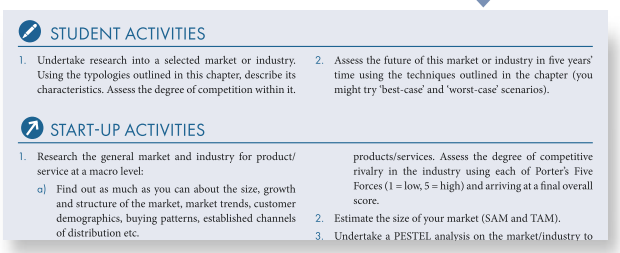
Explore further
Deepen your learning with links to extra resources such as animations, interviews, TED Talks, assessment tools and psychometric tests.



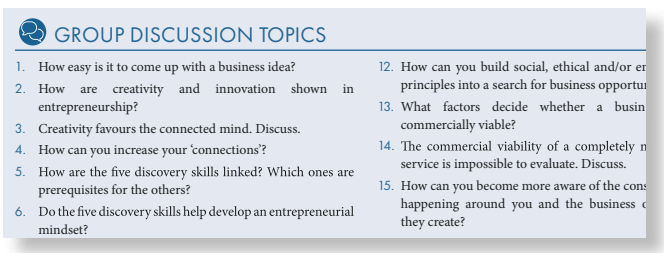


Summaries
Consolidates the chapter material and serves as a handy revision tool.

Student activities
This interactive feature offers brief self-assessments and research activities you can undertake to put key concepts into practice.



Start-up activities
Apply concepts in the chapter to the practical task of identifying and testing a business idea and developing a business plan that will help launch it.



Group discussion topics
allow you to think about the text material and develop your critical and reflective understanding of it and what it means in the real world.

GET INTO THE ENTREPRENEURIAL MINDSET

Head to the *Digital Links* booklet via the companion website to watch these five entrepreneurs discuss the character traits they have cultivated over the years and how these skills have helped them navigate the highs and lows of the small business environment. The entrepreneurs also talk to the author about their individual results from the GET2 test which measures entrepreneurial tendencies.



Julian Thomas, Founder and Director, Figaro Brands

Julian is the founding partner at Figaro Brands which launched in 2009. Figaro Brands is a brand design consultancy that targets companies selling to non-consumer markets that do not have their own marketing departments. Julian has over 20 years of industry experience and has managed and developed some of the leading brands in the UK and overseas including British Airways, Muller and Boots.



Habil Ibrahim, Founder and Director, Cajuu Ltd

Habil founded Cajuu in 2018 with the aim of adding value to cashews. For over 40 years Habil's family have been working with farmers across southern Tanzania to ethically source the finest cashews. Habil started bringing this amazing product over to the UK and has worked to create a range of cashew-based snacks with unique flavours. Cajuu is now in over 80 stores across the UK and EU and growing rapidly



Lara Scobie, Ceramic Artist

Lara is an Edinburgh based ceramic artist specialising in individual slip-cast vessels and bowls made in porcelain and parian clay. Her work focuses on the dynamic between form and pattern. Lara is a fellow of the Craft Potters Association of Great Britain and a professional member of Contemporary Applied Arts, London. She also has extensive teaching experience having taught ceramics and design at Duncan of Jordanstone College of Art for over 20 years



James Kennedy, Founder, Petalon

James Kennedy founded the bicycle manufacturing business Kennedy City Bicycles in 2013 and now runs Petalon with his wife, Florence. Petalon is a floristry delivery company that was born out of East London in 2014. James manages the commercial and financial side of the business is responsible for the tremendous amount of work done on the farm to make it a liveable and workable space



Florence Kennedy, Founder, Petalon

Florence founded Petalon in 2014 with her husband, James. When James needed to send a bunch of flowers one day, they both realised there wasn't much choice if you wanted to send something beautiful and unique for a fair price. Surrounded by James's bicycles, Petalon was born, with the aim of offering beautiful yet affordable flowers, in a more conscious way. Florence designs the weekly bouquets and oversees all creative decisions.

Get into the entrepreneurial mindset! Visit the companion website at **bloombury.pub/burns-esb-5e** and watch video interviews with these entrepreneurs and discover how their personality traits have contributed to their ability to face challenges and thrive.

MEET THE ENTREPRENEURS

Accompanying this book are seven in-depth video case studies with successful entrepreneurs, covering a range of businesses and geographical locations. These videos interrogate the entrepreneurs on the experiences and challenges they have faced starting and managing their own businesses, and offer students an invaluable insight into life as an entrepreneur.

Following the lifecycle of each business, the videos have been divided into four sections that mirror the structure of the book. The videos draw out issues that have been discussed across different chapters, and allow a useful exploration of both common themes shared by all businesses as well as industry-specific issues. The accompanying questions invite you to critically analyse and compare what you have learned.

The full videos for each entrepreneur are also available on the companion website, if you would like to hear their story from start to end uninterrupted.

AJ Asver, co-founder, Scoopler/JustSpotted, USA



AJ is co-founder of the real-time search engine Scoopler and the celebrityspotting website JustSpotted. Having grown up in the UK, AJ travelled to San Francisco in 2008 to turn his business dreams into reality. Spotting a clear business opportunity, AJ's original business idea shifted and so Scoopler became JustSpotted. Within three years of operation, JustSpotted was successful enough to be noticed and eventually bought by none other than search giant Google. In 2014, AJ left Google, after working there for three years, with plans to embark on a new start-up in the music space.

Cassandra Stavrou, co-founder, Propercorn, UK

www.propercorn.com



Propercorn started in Cassandra's kitchen when she was just 25. After realizing that all '3pm slump' snacks either left her feeling guilty or dissatisfied, Cassandra set out to make a gluten-free popcorn range without the compromise. It would be "popcorn done properly". Starting out with cold calls and endless nights packing boxes at her business partner, Ryan's, flat, Propercorn now has a team of 30 based in London and exports to six countries in Europe. Since first launching in the Google London headquarters in October 2011, Propercorn has emerged as one of the fastest growing brands in the UK, with Cassandra working tirelessly to create a dynamic business, grounded in passion and excitement for popcorn.

John Loughton, founder, Dare2Lead, UK

www.dare2lead.co.uk



John is a social entrepreneur, campaigner and motivational speaker. John founded award-winning leadership development company Dare2Lead in 2011, at the age of 23. John ran his first campaign aged 11 and has engaged world leaders such as Queen Elizabeth, the UN Secretary General and the President of the European Parliament, working in over 35 countries. In 2013 he was named Outstanding Youth of the World.

A business with strong social objectives, Dare2Lead is passionate about unlocking the success potential of organizations through corporate and management training while also making a positive difference in society by empowering young people through emerging leadership and development programmes. Their range of leadership development programmes combines real-life experiences of leadership and success alongside proven leadership and management tools. Their client base includes governments, NGOs, large corporates, small businesses and a range of public bodies.

www.alllife.co.za



Ross Beerman, co-founder and CEO, AllLife, South Africa

Ross has worked both in South Africa and internationally in the financial services sector. He worked in Corporate Finance and M&A in the USA, and returned to South Africa in 1998 to work in private equity. In 2001, Ross founded Theta Specialised Finance, a principal acquirer of distressed credit instruments, which was sold to a strategic buyer at the end of 2003. In 2004 Ross co-founded AllLife with the intent to provide life insurance to people living with HIV, based on the premise that properly designed systems and processes, combined with great people, could cost-effectively intervene to help clients manage their health and change their mortality. AllLife has delivered life insurance to tens of thousands of HIV+ people and has recently begun leveraging its IP, systems and processes to also deliver easily accessible life insurance to diabetics in South Africa and abroad.

www.selyn.lk/





Sandra Wanduragala, founder, and Selyna Peiris, business development director, Selyn Handlooms, Sri Lanka

In 1991, Sandra Wanduragala gave up her career as an attorney-at-law to start Selyn, in rural Sri Lanka. From the start, Selyn has been a family business. Sandra built the company alongside her brother, Hilary. Her daughter, Selyna (who the company is named after), is also now involved in the business.

Selyn is Sri Lanka's only fair trade–guaranteed handloom company, and one of the country's biggest social enterprises. Selyn has revived the traditional Sri Lankan craft of handloom weaving to create its wide product range, including fabrics, garments, jewellery, home accessories and children's toys. These products are sold locally in Sri Lanka and globally in key export markets in the European Union, the USA and parts of Asia. Selyn began with 15 women in a small rural village but has now grown to around 1,000 members, 95% of whom are women. In addition to infrastructure, technical support and a guaranteed flow of work, members are offered services such as health camps, childcare facilities, and life skills, leadership and entrepreneurship development programmes. The Selyn Foundation extends beyond the business; it is a grassroots effort to relieve poverty and empower Sri Lankan youth and women by means of education, vocational training, credit-provisions and other developmental tools.

Scott Cupit, founder and managing director, Swing Patrol, UK and Australia

www.swingpatrol.co.uk



Swing-dance performer, teacher, choreographer and general enthusiast Scott founded Swing Patrol London, the dance school and events business, in 2009, based on his experience co-founding and running Swing Patrol Melbourne in his home country of Australia.

Scott has been recruited as Assistant Charleston Choreographer to Jenny Thomas on the hit UK television show Strictly Come Dancing, was crowned 2015 Dance Teacher of the Year, and has danced at both Buckingham Palace and 10 Downing Street. From a handful of students in a single venue, in just six years Swing Patrol London has grown to a team of over 54 teachers operating from over 40 venues across London, holding hundreds of social events each year and has developed corporate events and content-marketing functions. In 2014, Scott appeared on the popular UK television show Dragons' Den, and successfully secured investment from Deborah Meaden.

Stefan Botha, founder and director, Rainmaker Marketing, South Africa

www.rainmakermarketing.co.za



With several years of experience in the area of property development marketing, Stefan decided to start his own business in 2012, and so Rainmaker Marketing was born.

With a focus on building and transforming brands, Rainmaker Marketing provides a turn-key sales and marketing solution that specializes in property development marketing and hospitality branding. With a niche approach, and a comprehensive in-house team, the business has worked on large-scale property developments throughout South Africa, Mauritius and Mozambique.

DIGITAL RESOURCES

Accompanying this book is a suite of supportive resources to help both students and lecturers get the most out of their learning and teaching.

Go online to the companion website **bloombury.pub/burns-esb-5e** to access further teaching and learning materials to support each chapter.



Resources to help instructors teach with the book include:

» Instructor manual: A useful chapter-by-chapter guide on how to strategically plan lessons. This manual contains *Case insight* notes, links to useful websites, teaching notes for *Meet the entrepreneur* video cases and more.

» PowerPoint slides: Detailed PowerPoint slides with embedded multimedia content that maps on to each chapter in the book.

Resources to help students deepen their learning include:

» *Digital Links* booklet: A integrated digital platform that hosts a wide range of links to compliment the *Case insights* and *Explore further links* boxes in the book. Look out for the *Digital Links* booklet symbol in the chapters to take a deeper dive into a topic. Simply scan the QR code here to access the booklet on your smart device:

» Bonus cases: Access exclusive bonus cases from around the world.

» Student test bank: An interactive bank of multiple-choice questions to check your knowledge and understanding of each chapter.

» *Get into the entrepreneurial mindset* videos: Five brand new videos where entrepreneurs explore their character traits and reflect on their enterprising tendencies.

- *Meet the entrepreneur* videos: In-depth video case studies where entrepreneurs reflect on the challenges they faced starting and managing their own businesses.
- Flashcards of key terms: A handy revision tool to test your understanding of key terminology.
- New Venture Creation framework: Start mapping out your own entrepreneurial journey with this downloadable framework and business plan.

PART 1

ENTREPRENEURSHIP

This book explores many different types of entrepreneurs in many different contexts. Entrepreneurship is essentially a practical activity that involves a wide range of business and management skills. However, it does have theoretical underpinnings as well as being informed by both good and bad practice.

Chapter 1 Entrepreneurship: The social and business revolution

This chapter explores the notion of entrepreneurship, its genesis and what it takes to become an entrepreneur. It looks at the many different types of small business and the demographics of entrepreneurship. Finally, it explains what is involved in launching a social enterprise and the conflicts inherent within it.

Chapter 2 The economics of entrepreneurship and public policy

Chapters 2 and 3 are about the theories that underpin entrepreneurship. This chapter examines the economic theories that explain it and the societal benefits it produces as well as the government economic policies that help shape entrepreneurship.

Chapter 3 The entrepreneurial mindset

This chapter explores the cognitive and behavioural theories that help us understand entrepreneurial behaviour and examines both the good and bad characteristics. It explains what is meant by 'an entrepreneurial mindset' and sets out a road map showing how it can be developed.

Chapter 4 Recognising business opportunities

This chapter outlines the skills needed to create and/or spot opportunities for both commercial and social enterprises. It shows how these skills might be used to find a good business idea. It also sets out a number of new venture typologies, depending on the degree of product/service or market innovation – from copycat to new-to-the-world businesses – and explains, in broad terms, what are the implications for the development of these very different ventures.

Chapter 5 Researching business ideas

This chapter is essentially practical, explaining how to undertake the research into markets, industries and competitors that is needed before launching any new venture. This provides clues about market gaps, market attractiveness and appropriate competitive strategies.

MEET THE ENTREPRENEURS

Access the *Digital Links* booklet via the companion website to watch interviews with various entrepreneurs on the entrepreneurial journey.

1

ENTREPRENEURSHIP: THE SOCIAL AND BUSINESS REVOLUTION

Contents

- The new normal
- Crafting the notion of entrepreneur
- New ventures and small business
- Barriers and triggers to entrepreneurship
- What it takes to be an entrepreneur
- Entrepreneurial and start-up capital
- Measuring entrepreneurial activity
- Global Entrepreneurship Monitor (GEM)
- The demographics of entrepreneurship
- Social enterprise
- Conflicts within social enterprise
- Summary
- Group discussion topics
- Student activities



Source: iStock.com/monkeybusinessimages

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Critically analyse the changing social and business environment and how it impacts on entrepreneurship;
- Define what is meant by entrepreneurship and understand the different forms it might take;
- Understand the different size definitions of firms, the importance of small firms to global economies and the demographics of entrepreneurship;
- Understand and evaluate the factors that influence a person to start a business and the different sorts of capital they bring to it;
- Understand the inherent conflicts within a social enterprise.

Case insights

1.1 Melanie Perkins and Canva
1.2 Joseph Cyril Bamford and JCB
1.3 Florence Kennedy and Petalon
1.4 Ambareen Musa and Souqalmal
1.5 Jack Ma and Alibaba
1.6 Lowell Hawthorne and Golden Krust
1.7 John Bird and *The Big Issue*

Explore further links

1.1 The reality of being an entrepreneur
1.2 National start-up and SME statistics
1.3 GEM national reports
1.4 Female entrepreneurship

THE NEW NORMAL

What is the new normal? We know things have changed. In the first half of the twentieth century the focus was on size. Big business and mass production offered efficiency and economies of scale. It would bring well-being, if not wealth, and job security. This was how the Western democracies would keep the common man, not only in food, shelter and life's necessities, but also in his place. Big business came to dominate Western economies (Audretsch and Thurik, 2000). It spawned its own professional elite, called managers. Big business became respectable. It even became a recognised academic discipline. Harvard Business School awarded its first Master's degree in the discipline in 1910. At the beginning of the twentieth century, the focus remained on big business and how it could become more efficient and profitable through tighter controls. Scientific techniques were used to predict trends in demand and long-term planning was the order of the day. The skills of entrepreneurship were largely ignored (Crainer and Dearlove, 1998).

Then something started to change. What had been slow, predictable change started to accelerate. Centralised command and control no longer worked well. It was too slow to react, too bureaucratic. Planning becomes problematic if you cannot predict the future, and strategic management faces completely new challenges as the linear models based on knowledge and information used for decades seem increasingly unrealistic. By the end of the twentieth century big firms were finding it difficult to cope with the rapidly changing environment. Large firms and even the public sector became leaner and fitter in a bid to become more flexible and reduce overhead costs and risk. They cut budgets, closed plants, downsized or 'rightsized', deconstructed – and went out of business. Small, entrepreneurial firms started to re-emerge and shape the future.

> *As Darwin well understood, it is the species most responsive to change that is the best equipped for survival.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 21 May 2017

Rapid change – social, political, technological and environmental – had become endemic, continuous and, above all, unpredictable, sometimes resulting in discontinuous or revolutionary shifts that had the potential to cause chaos. The fall of the USSR in the 1980s saw new political and economic alignments. The rise of terrorism led to wars in Afghanistan and Iraq. The Arab Spring of 2011 led to disruption and unrest in many countries in the Middle East, including the civil wars in Syria and Libya. These led to increasing levels of migration into Europe, causing, in turn, political unrest, even violence, and the rise of populist right-wing political parties. The easing of banking regulations led to the banking crisis of 2008 which saw disposable income in many countries shrink, particularly among the poorest and most vulnerable, leading to even more political unrest. Pandemics have been with us since history began (most recently HIV/AIDS, SARS, swine flu, Zika and Ebola), but the economic consequences of the latest one – the 2020 outbreak of Covid-19 – are still being felt with recession and rising unemployment. All the time we see growing income and wealth inequality. By 2015, the world's richest 1 per cent owned more wealth than the other 99 per cent put together (Hardoon et al., 2016). There continues to be unprecedented volatility in just about every global market, from commodities to exchange rates, from stock markets to bond markets. And on top of all this the environmental crisis caused by global warming continues to unfold. The past is no longer a good predictor of the future and change can happen overnight and affect anybody and everybody. Change is changing.

> *The digital revolution marks the greatest disruptive transformation in the history of mankind.*
>
> Mukesh Ambani, Chairman of MD Reliance Industries, *The Sunday Times*, 26 July 2020

Underpinning this volatility is globalisation which has meant near-universal connectivity between economies and people – an increasingly complex world full of interconnections formed by a truly global marketplace. We may be able to travel the globe cheaply and easily, but new technologies allow instant communication with almost anywhere, at any time. We all know what others are doing – instantly. In these highly connected systems small changes tend to be amplified – whether in interpersonal relationships, politics or markets. Actions in one part of the world can have unexpected and rapid consequences in another part of it. And globalisation has meant that no business is safe from the chill winds of competition, a wind that is unforgiving of frailty and no respecter of past reputations. A business start-up in Taiwan might spell future disaster for an established company in the UK. New commercial opportunities still emerge but competition is now as much about survival as growth. There may be ample opportunities, but they only go to those who can spot them first, are swift to adapt and are open and willing to change.

The reality is that change has always been with us. The ancient Chinese saw change as endless and an essential feature of our universe – a pattern of cyclical coming and going, growth and decay, winter and summer, the yin of night and yang of day. Somehow the West had forgotten this, believing instead that it could create stability and certainty, that change was a series of discrete events that moved us from one stable

> *There has been a real sea change this century. The whole environment is a lot more entrepreneurial than it used to be.*
>
> Moray Wright, Chief Executive of Parkwalk Advisors, *The Sunday Times*, 18 August 2019

state to another. Economists based theories on it and they, along with politicians and managers, focused on the ways that change could be controlled and managed systematically. Large firms crave stability and the opportunity to exploit markets they dominate through oligopoly or monopoly power. But change cannot be stopped. Large firms are not so much the future of business but the natural consequence of businesses being set up by entrepreneurs and growing. Unfortunately, like many things in life, they have a natural life expectancy and prolonging this is not always beneficial. What is needed, constantly, is renewal – new, entrepreneurial start-ups that can challenge the statusquo, a process called 'creative destruction' by Austrian political economist, Joseph Schumpeter. These firms create and exploit change. For them, change is not something to be avoided, but something that is normal and to be embraced.

Over the last 30 years or so, entrepreneurs establishing new ventures have done more to create wealth than firms at any time before them – ever! Ninety-five per cent of the wealth of the USA has been created in the last 40 years. Entrepreneurs have come to be recognised as a vital part of economic wealth generation, loved by governments because of their ability to create jobs. Their businesses have become catalysts for economic, and sometimes social, change. Of the 100 largest public companies in the United States, 31 were founded by an entrepreneur during the post-war era, creating over 4 million jobs; and 29 per cent of US firms on the Global FT 500 list were founded after 1950 (Sanandaji and Sanandaji, 2014). Entrepreneurs have become the heroes of the business world, embodying ephemeral

Case insight 1.1 Melanie Perkins and Canva

The entrepreneurial journey

Melanie Perkins is co-founder and CEO of Canva, an online graphic design and publishing tool she launched in 2012, aged 25. With over 20 million users in 190 countries, Canva is one of only about 300 fast-growing private companies around the world that are valued at over $1 billion – called 'unicorns'. In fact, a funding round in 2020 valued the company at $6 billion. The Canva online software platform allows graphics to be created and edited for presentations, posters etc. by using a simple 'drag-and-drop' tool equipped with a library of professional design templates that can be populated with photos, illustrations and fonts. The basic program is free to use, but additional functionality can be purchased by subscribing to other products like Canva Pro and Canva for Enterprise. This undercuts prices charged by companies like Adobe whose photography and graphic software are expensive and whose programs are more technically advanced and difficult to use.

The idea for Canva originally came to Perkins when she was a 19-year-old commerce and communications student at the University of Western Australia. She became frustrated trying to learn how to use design software and realised that fellow students felt the same way. The software was not user-friendly.

Working from home with her boyfriend, Cliff Obrecht, she decided to launch an online design website called Fusion Books which allowed high schools to design their yearbooks online. Fusion Books grew so rapidly over the next couple of years Perkins and Obrecht decided to drop out of university and focus on Fusion Books, which has become Australia's largest yearbook publisher. Fusion Books became the prototype for Canva. Perkins and Obrecht joined forces with co-founder Cameron Adams (who had previously helped develop Google Wave) and hired their own developers to work on the Canva concept. It took three years from the first discussions with investors in Australia to secure funding for Canva. Over that time the team polished their 'pitch' for investment and in 2012 the team went to the USA where they secured some $3 million in venture capital from a range of US investors. Perkins gave this advice to those thinking of starting a business:

> *'If I listened to all naysayers, knew the stats about how many start-ups fail or realized everything I would have to learn to make Canva work, I never would have got started ... Solve a real problem that many people experience. If you find a problem that people care about, then it will make every other aspect of running a business much easier.'* (Entrepreneur Magazine, *March 2019*)

Access the *Digital Links* booklet to visit the company website and watch a video of Melanie Perkins telling the story of how Canva was started and grew to what it is today.

Questions:

1. What prompted Melanie Perkins to start this business and what facilitated its growth?
2. What personal qualities and resources did Melanie Perkins need to start her own business?

qualities that many people envy – freedom of spirit, creativity, vision and zeal. They have the courage, self-belief and commitment to turn dreams into realities. At the same time the most successful have become millionaires.

However, the fact is that most start-ups are born to stagnate and die, rather than to become the large corporations of tomorrow. Most employ nobody other than the founder and struggle to provide them even with a living wage. The UK's self-employed earned less in 2015 than they did 20 years ago, with average weekly earnings falling from £300 in 1995 to £240 in 2015 – some 40 per cent less than the typical employed person (Resolution Foundation, 2016). The reality is that there is no such thing as a typical entrepreneur.

CRAFTING THE NOTION OF ENTREPRENEUR

The Oxford English Dictionary defines an entrepreneur as 'a person who attempts to profit by risk and initiative'. But this definition, while emphasising two characteristics, could cover a wide range of professions, including that of a paid assassin. The difference is more than just one of legality. The question to ask is: how do they make profit? The notion of entrepreneur has been crafted over many centuries, starting with Cantillon (1755), and has seen many different emphases (see Table 1.1). Over 200 years ago the French economist Jean-Baptiste Say (1803) said: 'entrepreneurs shift economic resources from an area of lower productivity into an area of higher productivity and greater yield'. But where does the perception of the opportunity to shift these resources come from? There are two generally accepted explanations of where entrepreneurial opportunities come from – the Schumpeterian view and the Kirznerian view:

- Schumpeterian view – In this view opportunities emerge out of the entrepreneurs' internal disposition to *initiate or create change*. They are the innovators who 'shock' and disturb the economic equilibrium during times of uncertainty, change and technological upheaval. With Schumpeter the emphasis is on the entrepreneurs' actions leading to 'creative destruction' of an established economic order.
- Kirznerian view – This view emphasises opportunity recognition and implies that entrepreneurial profits are secured on the basis of *knowledge and information gaps* that arise between people in the market – called 'information asymmetry' – all based within the general equilibrium or neoclassical model of economics, originally derived from Marshall (1890). In this view, entrepreneurs are alert, discovering opportunities by acting as an arbitrageur or a price adjuster in the marketplace. They spot opportunity rather than create it. Israel Kirzner's work is based on that of Frank Knight, who discussed entrepreneurship's role in wealth creation with an emphasis on the ability to cope with risk and uncertainty.

In the real world, both Schumpeterian and Kirznerian approaches seem to be used by entrepreneurs – they both create and spot opportunities – and a few studies tell us when, how and by whom these approaches might be used (e.g. Craig and Johnson, 2006; Samuelsson and Davidsson, 2009). Indeed, Kirzner (2009) himself concluded that both approaches are needed to understand the nature of dynamic market processes.

Reconciling these views, we can say that entrepreneurs create value by exploiting some form of change – either shifting resources or, more directly, improving productivity. They can create this change themselves or spot it happening. In Chapter 4 we use the terms 'create opportunity' or 'spot opportunity' in our approaches to finding a business idea. Entrepreneurs can exploit change in technology, materials, prices or demographics. They provide an essential source of new ideas and experimentation that would otherwise remain untapped in the economy (Acs and Audretsch, 2005). We call this 'process innovation' and this is an essential tool for entrepreneurs and one that creates wealth for an economy. We shall examine it in greater detail in the next chapter. Entrepreneurs create new demand or find new ways of exploiting existing markets. They identify a commercial opportunity and then exploit it. They are agents of change. In essence, an entrepreneur is best defined by their actions:

> *An entrepreneur creates and/or exploits change for profit by innovating, accepting risk and moving resources to areas of higher return (profit).*

Table 1.1 The antecedence of modern entrepreneurship

DATE	AUTHOR	CONCEPT OF ENTREPRENEUR
1755	Cantillon	Introduced the concept of entrepreneur from '*entreprendre*' (ability to take charge).
1803, 1817	Say	Emphasised the ability of the entrepreneur to 'marshal' resources in order to respond to unfulfilled opportunities.
1871/1981	Menger	Noted the ability of entrepreneurs to distinguish between 'economic goods' – those with a market or exchange value – and all others.
1893	Ely and Hess	Attributed to entrepreneurs the ability to take integrated action in the enterprise as a whole, combining roles in capital, labour, enterprise and entrepreneur.
1911, 1928, 1942	Schumpeter	Envisioned that entrepreneurs proactively 'created' opportunity using 'innovative combinations' which often included 'creative destruction' of passive or lethargic economic markets.
1921	Knight	Suggested that entrepreneurs were concerned with 'efficiency' in the use of economic factors by continually reducing waste, increasing savings and thereby creating value, emphasising their ability to cope with risk and uncertainty effectively and implicitly understanding the opportunity-risk-reward relationship.
1948, 1952, 1967	Hayek	Continued the Austrian tradition of analytical entrepreneurs, attributing to them capabilities of discovery and action, recognising the existence of information asymmetry which they could exploit.
1973, 1979, 1997, 1999, 2009	Kirzner	Attributed to entrepreneurs a sense of 'alertness' to identify opportunities and exploit them accordingly.
1974	Drucker	Attributed to entrepreneurs the capacity to 'foresee' market trends and make a timely response.
1975, 1984, 1985	Shapero	Attributed a 'judgement' ability to entrepreneurs to identify 'credible opportunities' depending on two critical antecedents – perceptions of 'desirability' and 'feasibility' from both personal and social viewpoints.

Source: Based on Etemad (2004), pp. 12–15.

Even with this definition the notion of entrepreneur is not always clear cut. Notice that it says nothing about starting a new venture or owning the enterprise that exploits change or what they do with the profits generated. Entrepreneurs can undertake these activities for established, larger firms while remaining in salaried employment, content for the profits (and risks) of their work to go to their employers. These are called 'intrapreneurs' and we look at them specifically in Chapter 22. Entrepreneurs can be content for the profits of their work to go to social purposes rather than their own benefit. These are called 'social entrepreneurs' and their businesses are social enterprises (the legal forms are explained in Chapter 11). Those entrepreneurs who work within the public sector (e.g. government, local councils, schools, health authorities and police forces etc.) are called 'civic entrepreneurs'. Social and civic entrepreneurs have primarily social and/or civic objectives and may be willing to invest their own time and even risk their own capital for little or no financial return, with any profits generated being ploughed back to meet those social and/or civic objectives. The terms are often linked through the voluntary, community and not-for-profit sectors that straddle the public and private sectors, often working on the delivery of government initiatives. We look at social and civic entrepreneurs later in this chapter and refer to them throughout the first two parts of the book.

NEW VENTURES AND SMALL BUSINESS

While our definition of entrepreneur says nothing about starting a new venture or owning the enterprise, these are often taken as proxies for entrepreneurship – not least for public policy, which often focuses on 'new' or 'small' business (Chapter 2). Businesses can take a number of different legal forms – sole traders, partnerships or limited liability companies (see Chapter 11). We need to pick our way through some distinctions.

Sole traders and partnerships

For sole traders (also called 'sole proprietors') and partnerships there is no legal difference between the owner and the business entity. These people are also called 'self-employed' – their remuneration depends directly on what they sell or produce – although many people work for themselves without formally registering as being self-employed. They are independent and control their business in the way we have defined entrepreneurs. In 2019 sole traders made up 59 per cent of UK businesses and partnerships a further 7 per cent, with many partnerships having self-employed partners. Three types of businesses usually fall within this categorisation:

» Salary-substitute firms that simply generate an income for the founder comparable to what they might earn as an employee (e.g. plumbers, store owners etc.).

» Lifestyle firms that allow the founder to pursue a particular lifestyle while earning an acceptable living doing so (e.g. sports instructors, artists etc.).

» Gig-workers are workers with temporary, short-term work (or 'gigs') obtained from companies by searching out opportunities on smartphone-based apps. They are effectively controlled by the company they work for and do not fit our definition of entrepreneur. Often it is the only way they can work for the firm paying them. Their claim of independent working is often disputed, and their existence owes more to tax and regulatory avoidance (see Case insight 17.3 on Uber). Arguably these are not real sole traders.

The motivation of founders in these businesses is about providing sufficient family income, and self-employment (or gig-working) is the conventional and accepted way of pursuing their life-options. None of these businesses are likely to grow to any size, but they do form the backbone of most societies.

Owner-managed businesses

Entrepreneurs who own and manage their business are often referred to as 'owner-managers'. This term therefore covers a wide range of businesses from sole traders and partnerships to limited liability companies. Limited liability companies are separate legal entities, and managers of companies owning over 50 per cent of the share capital, and thereby controlling the business, are also called owner-managers, albeit they are employed by the company. The term is also used loosely when a small group of managers own and control the business. If those owners are members of a family the firm is referred to as a 'family business' (see Chapter 21).

Growth business

Most businesses, whatever their legal form, do not grow to any size. Over 95 per cent of small firms in Europe employ less than ten people. In the UK 76 per cent (over 4 million) of all business have no employees. These comprise sole traders, partnerships with only self-employed partners and companies with only an employee/director. Truly entrepreneurial firms are the ones that bring innovative ideas and new ways of doing things to the market, often shaking up and disrupting markets and industries. Two sorts of growth-orientated firms are often highlighted:

» Gazelles are those businesses with growth of over 20 per cent per annum. In the UK it is estimated that there are some 14,000 gazelles – 5 per cent of businesses with 10+ employees (ONS, 2019b). And these businesses are responsible for the majority of employment growth.

» Unicorns are those businesses that achieve a stock market valuation of over $1 billion.

These firms may be few in number but they have a disproportionately large impact on the economic well-being of a country, particularly in terms of employment (Autio, 2007).

Of course there are many firms that fall in the middle of these extremes, doing well but perhaps not growing rapidly or to any great size. They might fulfil a valuable economic need, but there may be a limit to the size of the market they serve. Often the entrepreneurs launching these sorts of ventures go on to become serial entrepreneurs – selling-on one successful business then founding and growing another. They may be capitalising on their ability to spot a business opportunity rather than manage an established business. As you can appreciate, entrepreneurs and the small firms they manage are not homogeneous. Each small firm is different and every small firm is organic – it will change over time and in different circumstances.

Case insight 1.2 Joseph Cyril Bamford and JCB

Importance of family firms

Stories of successful entrepreneurs always make good reading. Joseph Cyril Bamford gave his initials to the ubiquitous yellow hydraulic excavator and digger seen on just about every building site or road work site – the JCB. In fact, JCB became one of the few post-war British industrial success stories. By the time of Joseph Bamford's death in 2001 the company employed over 4,500 people across three continents and had a turnover of £833 million. Over 70% of JCB production is for overseas markets.

Joseph Bamford came from a Staffordshire engineering family which had been making agricultural equipment since mid-Victorian times. When he returned to civilian life after the Second World War he decided to start up on his own doing what he knew best. Starting his business with only a welding set he bought for £1, he began producing tipping farm trailers from a garage in Uttoxeter, using wartime scrap. These sold well, but in 1948 he decided to branch out into hydraulic equipment and, in 1953, invented the famous backhoe loader that combined the two functions of excavator and shovel and became the visual embodiment of the initials JCB.

Joseph Bamford was a paternalistic employer, who provided a social club and a fishing lake next to his factory in Rocester, Staffordshire. He ran a 'tight ship' but rewarded effort. He also knew how to get PR. In 1964, when he famously paid his workers £250,000 in bonuses because the company's turnover had topped £8 million, he personally handed out the bonus to each employee, standing on the first farm tractor he had designed in 1945. Joseph Bamford helped turn JCB into one of the most successful privately owned companies in Britain. Eventually the company diversified from his central control into a group of several operating companies. He retired and gave up his position as chair of the group in 1975, handing it over to his eldest son, Anthony Bamford.



Source: J.C. Bamford Excavators Limited

When Anthony Bamford took over, the company had just one factory in Rocester. Under his leadership, JCB now has 22 plants around the world, employing over 12,000 people: 12 plants are in the UK and others are in the USA, China, Brazil and India. JCB produces over 300 types of machines which are sold through franchise dealerships in over 150 countries. With sales of £4.1 billion in 2018 (profit £447 million), it is the third-largest maker of construction equipment in the world. It remains a family business with Anthony's son Joe actively involved.

Access the *Digital Links* booklet to visit the company website and watch a video of Anthony Bamford featuring some of the company products and a *Financial Times* video which looks at why JCB has been successful when other UK family manufacturing businesses have not.

Questions:

1. JCB is a large family-owned company. What are the differences between a large family-owned company and a large publicly owned company?
2. How might these differences impact on company policy?

Small and medium-sized enterprises (SMEs)

All of these distinctions have skirted around definitions based on size – a legal definition that can be used for public policy. So what is a small firm? As with the other terms, there is no uniformly acceptable definition. Back in 1971, the Bolton Report (Bolton, 1971), which is usually held to be a definitive

report on the state of small business in Britain at the time, made heavy weather of providing a statistical definition. Recognising that one definition would not cover industries as divergent as manufacturing and service, it used eight definitions for various industry groups. However, this number of definitions clearly caused legislative problems, and in 1996 the European Commission coined the now widely used term 'small and medium-sized enterprise' (SME) and defined it simply as an organisation employing fewer than 250 people – a criterion that continues to be used for most statistical purposes (although additional criteria apply for SMEs to benefit from EU programmes, policies and competitiveness rules). It defined four size categories.

	NUMBER OF EMPLOYEES
Micro	0–9
Small	10–49
Medium	50–249
Large	250 or more

In the USA, the Small Business Administration set its 'small business' criteria based on industry, ownership structure, revenue and number of employees. However, SMEs are typically defined as employing fewer than 500 people, although it can be as high as 1,500 in some industries.

BARRIERS AND TRIGGERS TO ENTREPRENEURSHIP

The 2019/2020 GEM survey confirmed that people have many different motivations for starting a business (Bosma et. al., 2020). However, even with a good business idea, capital and the necessary business skills, many people never take the plunge into self-employment. They face barriers – some real and some psychological. Some people are just too risk averse. Fear of the unknown is a strong barrier, but increasingly paid employment is not seen as a guarantee of regular income. No longer is there such a thing as a 'job for life'. Nevertheless, if they have a family, they might fear the consequences of not having a regular income or losing what little financial capital they have.

> *We got the inspiration [for Lush] because we were broke. The previous business had gone bust. We had mortgages, three children and no money. So – make a living!*
>
> Mark Constantine, founder of Lush, *RealBusiness*, 26 May 2009

What many people need is some sort of 'trigger' that either 'pushes' or 'pulls' them into it. Some people are 'pushed' into setting up their own business because of poverty, because they are made redundant, they find they just do not fit into the company they work for or, simply, that they have no alternative. For example, the 2019/2020 GEM study found that scarcity of jobs was a strong push factor in Latin America and the Caribbean (Bosma et al., 2020). Typically, these triggers are person-, situation- and context-specific factors that push a person towards self-employment.

Many people, however, are 'pulled' into starting up a business for more positive reasons. They yearn for independence and recognition of their achievements. At least with self-employment they control some elements of their destiny. And the prospect of becoming rich might be attractive. The 2019/2020 GEM study found that income and wealth generation was a strong pull factor in a majority of countries in Asia and Pacific and the Middle East and Africa (Bosma et al., 2020). Pull factors are typically psychological – they derive from the person's character traits and the societal influences on them (see Chapter 3). It takes a degree of courage and self-belief to start your own business. When 'push' and 'pull' factors combine it is little wonder that the result is a powerful trigger to create a new venture – as long as there is that all-important business idea. This combination of push and pull factors, barriers and triggers is shown in Figure 1.1.

Many of the barriers to entrepreneurship are real, but doubts about ability can be unfounded. Entrepreneurs may be idolised in the press, but they are really just people, although they may have certain characteristics. Read et al. (2011) claim there are seven myths about entrepreneurs:

» Entrepreneurs have good ideas and you don't – Ideas are easy to come by, but we never know how successful they will be, and that includes entrepreneurs. However, there are ways to maximise the chances of launching a successful business with a product/service that customers are willing to pay for.



Figure 1.1 Barriers and triggers to entrepreneurship

- Entrepreneurs are extraordinary forecasters – They are not. They are just willing to live with uncertainty but then organise themselves to anticipate and cope with it. Indeed, sometimes they create uncertainty for others.
- Entrepreneurs are risk-takers – They may be willing to accept risk, but they don't like it and there are ways that it can be managed and minimised.
- Entrepreneurs have money and you don't – Money does not guarantee success, and many money-starved start-ups have blossomed. A good idea will usually find backers and, as we shall explain in the next section, there are other forms of capital that are important.
- Entrepreneurs are not like the rest of us – They are, and you can develop an entrepreneurial mindset and learn the business skills necessary to launch a successful business.
- Entrepreneurs are visionary – Visions evolve as opportunities emerge and reality affects them. An unrealistic vision can be just an illusion. You define your own vision and measures of success. These will change over time and may expand beyond your current imagination.
- You don't know how to take the plunge – Hopefully books like this will show you how to do just that – how to find a good business idea and launch a business with minimum risk. Entrepreneurs really are not that 'special' – and if you wanted you could become one.

WHAT IT TAKES TO BE AN ENTREPRENEUR

For anyone thinking of becoming an entrepreneur there are a number of things they need to consider, because this is not a life-choice that suits everybody. While it has probably never been easier to start a new venture, running it can be hard work. It is an all-consuming, 24-hour, seven-day-a-week activity that can cause work–life conflicts that result in stress (Jayawarna et al., 2011; McGowan et al., 2012; Volery and Pullich, 2010). So it helps enormously if the entrepreneur enjoys what they are doing – that creates emotional energy. An entrepreneur needs commitment, dedication and stamina: 'It's 90 per cent perspiration, 10 per cent inspiration' explained one entrepreneur. It can break up relationships and split families. It is risky, without guaranteed results. So, the entrepreneur needs to be able to bounce back from setbacks, because there will be many. They need determination and persistence in situations where others might give up. They need to be emotionally tough – entrepreneurship can generate a roller coaster of emotions that cause stress for many people. They need to be emotionally self-sufficient – it can be lonely. They need to be task-orientated – motivated to deliver the best product/service to their customers, all day, every day. They need to be attuned to the opportunities generated by their customers and the market they operate in. Most of all they need to be able to live with a degree of risk and uncertainty – they will always be the last one to get paid and then only if

Case insight 1.3 Florence Kennedy and Petalon

Reconciling lifestyle and business

Petalon is a flower delivery business founded by Florence Kennedy in 2014. Florence graduated from Newcastle University, UK, in 2005 and initially followed a career in marketing and communications but decided to start her own business the same year as her partner, James, launched his bike business (Case insight 20.1: Kennedy City Bicycles). The aim was to offer flowers delivered in a sustainable, environmentally friendly way – by bicycle. In the early days of Petalon, Florence would bike to the market at 4am to select flowers, go home to make up bouquets and write out messages, and then bike the bouquets to customers across East London. James also helped with the bike deliveries.

Florence worked from the same shop James had leased for his bike business and there was a website, designed by James, each week featuring two new 'bouquets of the week', based upon the seasonal flowers that Florence had bought at market. These could be ordered online. Bouquets were packaged in biodegradable or recyclable materials and subscription-based deliveries were available. The business started slowly using social media and word-of-mouth recommendation but Florence was adept at getting promotion, social media and free PR (Petalon featured in *Vogue* and *Vanity Fair*) and wrote her own florist book (*Flowers Every Day*, Pavilion Books). As deliveries spread across London she started doing weddings and workshops.

In 2016, with the book and a baby on the way, Petalon was incorporated as a limited liability company and a business manager brought in. James took over 'the commercial stuff' and dedicated florists were hired. By 2018, Petalon was offering a seven-days-a-week, next-day service to all of mainland Britain, using a carbon-neutral courier. Revenue in 2018–19 was £290,000, with a profit of £5,000. By this stage the company was donating 5% of operating profits to bee conservation charities and, for every 100 postal deliveries, offering to plant a tree in Britain. Petalon has made good use of the internet and social media, particularly Instagram. Every week people are sent pictures of the 'bouquets of the week', tips and news about upcoming workshops and classes. Their website features blogs and news about the company, Florence, James and the family.

In 2020, Florence, James and Petalon moved their base to Cornwall at the same time as they launched a crowdfunding equity appeal offering 10% of the business for £100,000 plus discounted flowers for life and free workshops (see Chapter 19). Moving to Cornwall means that bike deliveries in London have stopped, despite the fact that Petalon's customer base remains heavily London-based and even here it faces strong competition from Bloom & Wild, FLOWERBX and Freddie's Flowers. The Petalon blog shows Petalon's new home to be a small farm-holding and says that the couple are now intending to grow their own flowers. The crowdfunding pitch on Crowcube (Case insight 19.4) stated:

> *'We aim to increase our revenue by raising awareness nationally. Though we now have an infrastructure capable of offering a national delivery service, we believe that brand awareness is low outside of London. Our goal is to utilise the highly visual nature of our product and our strong Instagram engagement level to develop our online brand image. We want to build on our organic growth and are seeking investment to fund a nationwide marketing campaign.'*

We shall revisit Petalon and Florence and James Kennedy in Case insight 21.2.

Access the *Digital Links* booklet to visit the company website and watch a video of Florence Kennedy telling the story of Petalon; a video with Florence and James Kennedy explaining the reasons for starting their own business; and an interview of Florence and James Kennedy talking about their businesses and lifestyle choices.

Questions:

1. Has Florence Kennedy reconciled her lifestyle with a business that interests her and generates sufficient income?
2. What are the challenges Petalon faces going forward?

there is enough cash left over. For anyone who craves certainty, routines and a regular pay cheque, entrepreneurship is not for them. Researchers agree that entrepreneurship can be stressful (Bradley and Roberts, 2004; Cardon and Patel, 2013; Jamal, 2009; Jayawarna et al., 2011; McGowan et al., 2012; Volery and Pullich, 2010).

However, the rewards for being successful can be great, especially if the entrepreneur enjoys what they are doing. There is the freedom and independence they have on a day-to-day basis, the sense that they control their own destiny. There is the sense of purpose that launching a business brings and satisfaction that comes from this achievement – a job well done from which

> *Starting a business involves risk and hard work; if you prefer security and predictability self-employment is not for you. If you are unwilling to spend evenings, weekends and holidays working, then forget it. If you are poor at adapting to change and don't want to shoulder responsibility, the same applies. Stress is almost guaranteed ... If that prospect scares you, it's better to take a safe job.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 16 February 2020

they and others will benefit directly. For the most successful it can bring wealth and fortune. And in an uncertain, ever-changing world, self-employment can bring greater income security than employment.

All of this means that anyone thinking of becoming an entrepreneur needs to understand why. What are their motivations? What drives them? What are their fears? It is important that the business fits in with what they want from their life and lifestyle – finding the balance between work and personal life that suits them. Without an acceptable balance, the stress and pressure may be too much. What sort of business do they want it to become (salary-substitute, lifestyle or entrepreneurial)? Do they have a strong social or civic motivation? In other words, any person thinking of becoming an entrepreneur needs to be clear about the purpose of the business and the aspirations they have for it. There is no point in setting up a business intended to grow rapidly unless they are willing and able to make the additional time and resource commitment that will be needed. Finally, they need to understand their personal strengths (which they can play to), their weaknesses (which they will need to shore up) and any personal constraints or barriers that might affect the venture. As already said, this book should show how to find a good business idea and how to launch a business with minimum risk – the hard work is up to the entrepreneur.

Explore further 1.1

The reality of being an entrepreneur

Access the *Digital Links* booklet and watch a TED talk by Mark Leruste (found of The Unconventionalists, a weekly podcast, talk show and coaching and training business) about the reality of being an entrepreneur.

ENTREPRENEURIAL AND START-UP CAPITAL

Every entrepreneur invests capital in their start-up – not least from their own character and mindset. There are three kinds of capital: financial, human and social (Figure 1.2). These are considered to be 'facilitators of innovation activity', particularly in high-technology firms (e.g. Koskinen and Vanharanta, 2002; Lee et al., 2010; Thornhill, 2006). Lack of one kind of capital can often be compensated for by an abundance of another. And knowledge of deficiencies can usually be compensated for through staff

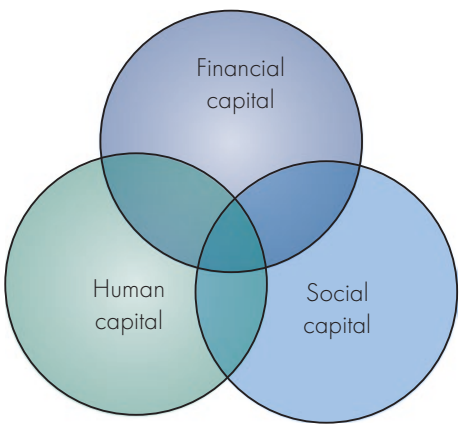


Figure 1.2 Forms of start-up capital

recruitment and/or business partnerships. The more resources the entrepreneur brings to the business, the more able they are to detect and act upon the opportunities they have found (Davidsson and Honing, 2003) – and the more likely they are to succeed (Unger et al., 2011).

Financial capital

Financial capital comprises the cash and other assets or resources that the entrepreneur (and their team) brings to the business. Perhaps unsurprisingly, research has shown that the founding of new ventures is more common when people have access to financial capital (Blanchflower et al., 2001; Evans and Jovanovic, 1989; Holtz-Eakin et al., 1994). The cash an entrepreneur has may be limited; however, it can probably go further than they think. The important thing to remember is that they do not necessarily have to buy and own a resource to be able to use it. Using resources that you do not own is called bootstrapping. Entrepreneurs often commit only limited resources themselves – the resources they can afford to lose. They also find ways of using resources that they do not own by partnering with others. Actually, minimising ownership of resources can reduce risk and give a business more flexibility, allowing it to commit and decommit quickly to new opportunities.

Human capital

Human capital comprises the skills, abilities, knowledge and experience that the entrepreneur and their team bring to the business. It is vital for any business. Knowledge and experience of a business or industry can be an invaluable source of business ideas. It can also provide an insight into the problems that will be faced once the business is launched – it is always better to learn from mistakes made at somebody else's expense. Education and training can highlight these problems and show ways to avoid or overcome them. That is why so many people take training courses before they actually start up a business – it improves their chances of success. Human capital in the form of education and track record increases the entrepreneur's credibility with financial backers. If they can demonstrate achievements, particularly in the industry that they want to start up in, it counts for a lot. It has also been shown that those entrepreneurs with more invested in their human capital are more likely to evolve and enjoy their business than those who invested less (Cassar, 2006).

Social capital

This is derived from access to personal networks of friends and commercial contacts. It is about the entrepreneur's ability to get on with people – their social skills. It is built on relationships, and this is at the core of the entrepreneurial approach to doing business – relationships with customers, employees, suppliers, the bank and landlord. It is social capital that enables you to build your credibility with all these stakeholders in your business. It is the personal touch that distinguishes entrepreneurs from the faceless, grey-suited managers of large firms. These relationships can build into an invaluable network of contacts and goodwill that can be used to generate knowledge and information on new opportunities or threats. Networking has been found to be one of the most important factors underpinning long-term business performance (Cross et al., 2005; Hoppe, 2010). It can affect profitability because it creates opportunities for social learning, spotting new business opportunities and accessing finance (Chan and Foster, 2001; Cron et al., 2006; Shane, 2000). Networks can increase flexibility and reduce, or give you early warning of, the risks a business might face. Networks also might yield up partners or ways of bootstrapping resources. They might provide a business with its first customer, or provide it with low-cost or free office space. They might provide professional advice and opinion, often without charge. They might even provide the business with the cash that the banker is so reluctant to provide.

> *Contacts are important but you have to get out there and meet people. It can be difficult when you are absorbed in running a business. But there is always something to learn from meeting someone new and a lot to learn from meeting someone old. The right contacts can become an invaluable source of learning as well as an inspiration and support.*
>
> Jonathan Elvidge, founder of Gadget Shop, *The Times*, 6 July 2002

Case insight 1.4 Ambareen Musa and Souqalmal

Social and human capital

Based in Dubai, Souqalmal is the leading price comparison website in the UAE and Saudi Arabia for financial and insurance products, as well as offering detailed information related to credit cards, personal and car loans, mortgages and bank accounts (*Souq al Mal* is Arabic for 'money market'). It was founded by Ambareen Musa in 2012. She remains CEO and has raised substantial funds to finance the company's growth.

Born in Mauritius, Ambareen Musa holds an undergraduate business degree from RMIT University in Melbourne, Australia, and an MBA from INSEAD, France. She started her first online business, an online property portal for international students to Australia, at the age of 21. Moving to London in 2004 to work for GE's financial arm, GE Money, she had various roles including marketing, financial literacy, customer advocacy and e-commerce. She led the first online financial literacy initiative in the UK, Moneybasics.co.uk. Moving to the Middle East in 2008, she worked as a consultant for Bain & Company Middle East and focused on financial services projects such as growth strategies for banks in the region. She moved on to set up the consulting arm of MasterCard Middle East and Africa, where she stayed for two years, before founding Souqalmal in 2012.

Access the *Digital Links* booklet to visit the Souqalmal website and watch a video in which Ambareen Musa talks about her background and motivations.

Questions:

1. What human and social capital did Ambareen Musa possess in 2012?
2. How did her education and experience help her in starting up Souqalmal?

MEASURING ENTREPRENEURIAL ACTIVITY

Measures of entrepreneurial activity have often focused on measurable statistics like the volume of start-ups or the stock of small firms. During much of the later part of the twentieth century the UK saw a decrease in the importance of small firms, measured in terms of employment and output. The proportion of the UK labour force classified as self-employed was at its lowest in the 1960s and the Bolton Report (1971) concluded that the small firm sector in the UK was in a state of long-term decline. Since then the situation has been reversed. SMEs have increased in terms of their number and their share of employment and turnover. In 1979 there were only 2.4 million SMEs (<250 employees) in the UK. As can be seen from Table 1.2, by 2019 this had more than doubled to some 5.9 million, representing 99.9 per cent of business. SMEs generated 60 per cent of employment (16.6 million) and 52 per cent of turnover (32.2 trillion).

Table 1.2 UK businesses, employment and turnover, by size of business (2020)

	BUSINESSES ('000)	%	EMPLOYMENT ('000)	%	TURNOVER (£MILLION)	%
No (zero) employees	4,567	76.4	4,966	17.9	315,627	7.3
Micro	1,157	19.4	4,196	15.2	615,251	14.1
Small	212	3.5	4,140	14.9	645,662	14.9
Medium	36	0.6	3,534	12.7	693,689	15.9
Large	8	0.1	10,896	39.3	2,076,740	47.8
Total	5,980	100.0	27,732	100.0	4,346,969	100.0

Source: 'Business Population Estimates for the UK and Regions', Office for National Statistics, 2020; available at: Business population estimates for the UK and regions 2020: statistical release (HTML) – GOV.UK (www.gov.uk).

The volume of start-ups in any year reflects a number of contextual factors, particularly economic. What is more, most economists would consider that vibrant economies also show a high level of exits (closing businesses) as well as entries – called 'churn'. What is important is the net 'churn' figure (entries – exits). In 2019, the UK stock of businesses increased by 3.5 per cent (+200,000 businesses). It is expected that this figure will be negative in 2020 caused by the recession resulting from the coronavirus pandemic, but, as we shall explain later in this chapter, many factors can act as triggers for entrepreneurship, not least the expected high levels of unemployment. The UK business survival rates have shown little change over time. A firm has just over 40 per cent chance of surviving for five years and just 55–60 per cent chance of surviving for three (ONS, 2019b).

This picture is repeated across most of the developed world. In 2017, SMEs in the EU (<250 employees) represented 99.8 per cent of businesses; generated 66.9 per cent of employment and 55.8 per cent of value added (European Commission, 2020a). In 2015 SMEs in the USA (<500 employees) represented 99.9 per cent of businesses and generated 47.3 per cent of employment (SBA, 2019). In most EU countries the chances of surviving three years remain fairly constant at 50–60 per cent (European Commission, 2020b). In the USA the chances of surviving five years are 45–50 per cent (SBA, 2018).

SMEs in the USA are on average larger than in the EU and there are proportionately fewer micro firms generating less employment (European Commission, 2008). The European Commission observed that entry, exit and survival rates were roughly comparable but new firms expanded more rapidly in the USA and the more productive firms had a stronger tendency to increase their market share than those in the EU. The report concluded that the US market was probably therefore more competitive than the EU and had fewer barriers to growth. Sanandaji and Sanandaji (2014) looked at the careers and backgrounds of some 1,000 entrepreneurs who founded new firms and earned at least $1 billion between 1996 and 2010 – what they called 'SuperEntrepreneurs'. They observed that the proportion of 'SuperEntrepreneurs' varied significantly across countries; Hong Kong had the highest, with about three 'SuperEntrepreneurs' per million inhabitants, followed by Israel, the USA, Switzerland and Singapore. The proportion in the USA was roughly four times higher than in Western Europe. They also noted that high rates of self-employment do not necessarily lead to high numbers of growth business (our gazelles and unicorns), observing that the USA had lower rates of self-employment than many other countries, (e.g. Greece, Turkey, Spain, Portugal and Italy) and that self-employment in Silicon Valley is half that of the average of California. The implication is that policies aimed at encouraging self-employment do not necessarily lead to growth businesses, a topic we shall return to in the next chapter.

There is evidence of productivity gaps between manufacturing-based SMEs and large companies in the developed economies, although these vary considerably with the size of the SME and across different industries. Productivity gaps are widest in manufacturing because of the larger role played by capital investment and economies of scale (see next chapter). They are narrowest in the retail sector. Based on data from 14 OECD countries between 2005 and 2014, it was found that productivity of manufacturing-based SMEs rose from 62 per cent to 75 per cent that of large companies, although in micro-businesses it averaged only 40 per cent. However, the productivity of service-based SMEs rose from 91 per cent to 111 per cent, although it averaged only 68 per cent (Marchese et al., 2019).

In the developing world it is more difficult to measure the scale of entrepreneurial activity because there is a large 'informal' or 'shadow' sector that is not recorded in official statistics. In many African countries most of the labour force is employed informally and much trade not recorded. Whether employed or self-employed, there are few estimates of the size of this sector. The most quoted study looked at 162 countries over the period 1999 to 2007. It estimated the average size of the informal sector in sub-Saharan Africa represented about 38 per cent of GDP and in Eastern Europe and Central Asia about 37 per cent. This compared to 14 per cent in high-income OECD countries (Schneider et al., 2010).

Explore further 1.2

National start-up and SME statistics

Most government websites will signpost you to statistics about start-ups and SMEs in your country. Access the *Digital Links* booklet and find statistics for the UK, Europe and the USA.

Case insight 1.5 Jack Ma and Alibaba

Millionaire entrepreneur

In 2018 Jack Ma, co-founder of e-commerce multinational Alibaba Group, announced that he would step down as chairman in 2019, handing over to Daniel Zhang, so he could focus on philanthropy. Ma had already stepped down as chief executive in 2013. Ma will remain a lifetime member of the Alibaba Partnership, a group of 36 senior staff who appoint a majority of board seats and therefore effectively control the company.

Ma started as an English language teacher. He first heard about the internet in 1994 and, when on a visit to the USA in 1995, used it to try to find out about China, discovering that there was very little information available. As a result, with the help of friends in the USA he set up a business that created websites for Chinese companies called 'China Pages'. He then worked for a company set up by the Chinese government until 1999 when he left to launch Alibaba with 18 friends, based in his small apartment in Hangzhou, China.

As the Chinese economy grew and the use of the internet in China exploded, Alibaba thrived and expanded rapidly, thanks in part to Chinese government restrictions on foreign competition. Ma's membership of the Communist Party of China meant he was well connected. Now with operations in over 200 countries the Alibaba Group has become the world's largest retailer (online sales and profits have exceeded those of all US retailers combined since 2015), one of the largest internet and AI companies, venture capital firms and investment corporations. It is a multinational internet conglomerate, specialising in e-commerce, retail, internet, artificial intelligence and technology and is one of the ten most valuable companies in the world by market capitalisation (second in Asia only to Tencent). Its US initial public offering (IPO) in 2014 was the world's largest in history.

Alibaba Group's main areas of business (and subsidiary companies) include business-to-business (the original Alibaba), consumer-to-consumer and business-to-consumer sales services (Taobao Mall and Tmall) via web portals (UCWeb, AliOS), as well as retail sites (AliExpress – similar to eBay, and Juhuasuan – a group shopping site), electronic payment services (Alipay and Ant Financial – which handle more than half of China's vast mobile-payments market), shopping comparison search engines (eTao) and cloud computing services (Alibaba Cloud).

Ma has been feted as China's greatest modern-day entrepreneur, but in 2020 the Chinese government turned against him and his companies following a speech he gave in which he criticised the overbearing regulation and state dominance of banking in China. The Chinese government immediately hit back by accusing Ma's companies of breaching various regulations and blocking the (estimated) $316 billion IPO of his financial technology company, Ant Group, just 48 hours before trading was due to begin. Then, on Christmas Eve 2020, the government ordered an investigation into 'suspected monopolistic practices' by Alibaba Group. That was followed by orders for Ant Group to scale back its operations, saying its corporate governance was 'not sound'. Alibaba's shares lost a quarter of their value in the last two months of 2020 and knocked over $10 billion off Ma's personal fortune, which dropped to $49 billion.

Access the *Digital Links* booklet to watch a video on Jack Ma's career and how he grew Alibaba.

Questions:

1. What prompted Jack Ma to start this business and what facilitated its growth?
2. Can China produce another Jack Ma or has the commercial and political environment changed too much?

GLOBAL ENTREPRENEURSHIP MONITOR (GEM)

The Global Entrepreneurship Monitor (GEM) is a harmonised assessment of the level of national entrepreneurial activity in each of the countries. The programme was launched in 1999 in ten countries. By 2020 it had grown to 115 countries, with over 200,000 annual interviews being conducted (at least 2,000 in each country). The surveys look at two things: entrepreneurial opportunity (demand) and the entrepreneurial capacity (supply) of respondents. The two are linked. Without opportunity the capacity is wasted, and vice versa. These are in turn influenced by a nation's culture, economic infrastructure, education and demography, which are also explored in the surveys. GEM categorises respondents under three headings:

» Nascent entrepreneurs who are about to start up a business or have just done so within the last three months – the stage at which individuals begin to commit resources, such as time or money, to start a business or have already just done so;

» New owner-managers who already own or manage a business that has been established and is under 3.5 years old, but where the business is generating income and paying salaries or drawings;
» Established owner-managers who already own or manage a business that has been established and is over 3.5 years old.

GEM identifies potential entrepreneurs by asking individuals if they expect to start a business within the next three years (Figure 1.3).

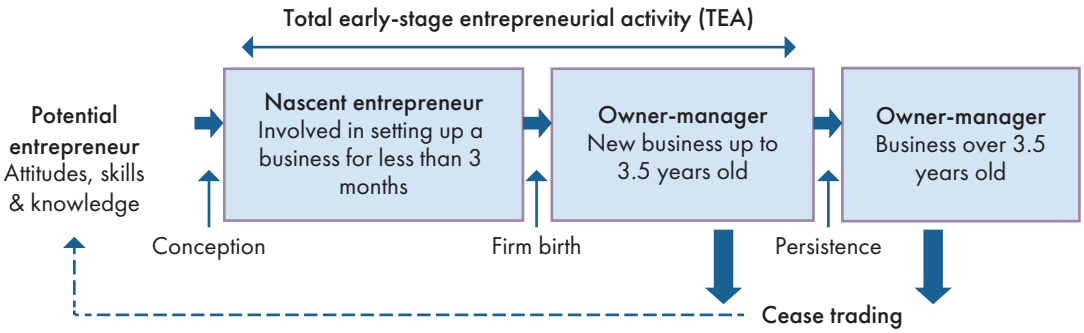


Figure 1.3 GEM entrepreneurship process and definitions

Source: Adapted from the Global Entrepreneurship Monitor 2014 Global Report *by Singer, Amoros and Moska.*

From this information a figure for total early-stage entrepreneurial activity (TEA) is calculated for each country as the percentage of the population of nascent entrepreneurs and new owner-managers (under 3.5 years). This is the measure of entrepreneurial capacity at any point of time – the propensity of individuals in a country to be entrepreneurial, given the social, cultural and economic conditions. Survey questions seek to understand the profile of TEA and how it is influenced by these conditions. The Established Business Ownership Rate (EBO) is the percentage of the population that are established owner-managers of existing businesses over 3.5 years old.

The 2019/2020 GEM global survey was based on over 150,000 working-age adults in 50 countries (Bosma et al., 2020). It showed that Latin America and the Caribbean had the highest levels of TEA (entrepreneurial capacity), while Italy, Pakistan, Poland and Japan had the lowest. Switzerland, Netherlands, Qatar, China and the UAE topped the list for ease of starting a business. In the USA over 65 per cent of participants thought they had the appropriate skills to start their own business – the highest in the countries surveyed. The global survey also confirmed the stereotype that males are more likely to start a business than females – they had higher rates of TEA. The UK TEA remained fairly steady at 8.7 per cent which compared favourably to France (3.9 per cent) and Germany (5.3 per cent) but was lower than the USA (13.6 per cent) (Hart et al., 2017).

GEM surveys allow trends in entrepreneurship to be analysed at a country level using consistent criteria. While these suggested 'some increase in entrepreneurship over the past two decades', the 2019/2020 report looked at the trends over 19 years (2001–2019) in the five countries that had participated in each of these years: Brazil, Netherlands, Spain, UK and USA. Only Spain failed to see an increase in TEA: Brazil from 14 to 23 per cent; Netherlands 6 to 10 per cent; UK from 6 to 9 per cent; USA from 11 to 17 per cent. However, it must be noted that this was a period when incomes were rising in these countries, so the unanswered question is: which variable is driving the other (Bosma et al., 2018)? It also shows that levels of EBO have increased, almost doubling in the USA, more than doubling in the UK and Netherlands and increasing more than four times in Brazil. Spain recorded the smallest increase. The report said that this suggests that these economies 'had some success in transforming the growth in entrepreneurial activity levels into an increase in sustainable established businesses'. It also noted that all but Brazil were in the top half of countries with societies that encouraged entrepreneurship.

In 2018 GEM introduced what is called a 'National Entrepreneurship Context Index' which is based upon a framework of conditions that, taken together, are supposed to encourage entrepreneurship. National experts score each country according to these criteria. The top and bottom ten countries from the 2019/2020 report, covering 54 countries, are shown in Table 1.3. The criteria are:

- Access to entrepreneurial finance;
- Government policy (support, taxation and bureaucracy);
- Government entrepreneurship programmes;
- Entrepreneurship education;
- Research and development transfers;
- Commercial and professional infrastructure;
- Ease of market entry, burdens and regulations;
- Physical infrastructure;
- Social and cultural norms.

Table 1.3 National Entrepreneurship Context Index

TOP 10 COUNTRIES	BOTTOM 10 COUNTRIES
1. Switzerland	54. Iran
2. Netherlands	53. Puerto Rico
3. Qatar	52. Paraguay
4. China	51. Guatemala
5. UAR	50. Croatia
6. India	49. South Africa
7. Taiwan	48. Madagascar
8. Indonesia	47. North Macedonia
9. Norway	46. Pakistan
10. USA	45. Morocco

GEM is an enormous research endeavour generating quantitative data that can be used for both cross-sectional analysis and, probably most importantly, longitudinal analysis, allowing individuals to be tracked from entrepreneurial aspiration ('nascent entrepreneurship') to established businesses. Obvious methodological problems exist; for example, the use of a single questionnaire across all the countries is clearly problematic. Nevertheless, data from GEM is increasingly being pored over by econometricians eager to find statistical relationships of any kind.

Explore further 1.3

GEM national reports

Access the *Digital Links* booklet and take a look at the GEM global and other national reports. The more detailed UK report is also there.

THE DEMOGRAPHICS OF ENTREPRENEURSHIP

Education

Education increases a person's human capital and numerous studies show a positive association between higher rates of education and increased levels of entrepreneurship (e.g. Delmar and Davidsson, 2000; Jiménez et al., 2015; Levie, 2007; Levie and Autio, 2008). Based on the 2016 Annual Survey of Entrepreneurs in the USA, over half (51.4 per cent) of entrepreneurs in the USA had at least a bachelor's degree while very few (3.6 per cent) had not completed high school. This varied little by gender (Kauffman Foundation, 2020). In China, the 2012 Global Entrepreneurship Monitor report showed that 31 per cent of prospective entrepreneurs had degrees or were graduates, 27 per cent were from community colleges and 80 per cent had prior work experience (Xavier et al., 2013). It also showed that entrepreneurs tended to be quite young with an average age of 31 years.

And the higher the level of educational attainment, the more successful the business seems to be. In the study of 'SuperEntrepreneurs', 84 per cent of these highly successful entrepreneurs were found to have a college degree, compared to 47 per cent of self-employed entrepreneurs, and they were five times more likely to hold a PhD than the general population (Sanandaji and Sanandaji, 2014). A review of high-growth firms in the UK and USA found that the education, experience and management skills of the founder were particularly high – typically they had degree-level qualifications and often an MBA (Department of Business, Enterprise and Regulatory Reform, 2008). The report also highlighted the importance of experience, observing that half of the US entrepreneurs had previously founded a business, while two-thirds of the UK entrepreneurs had previously held a position as a company director. You might indeed question these findings given that so many well-known entrepreneurs left school at the age of 16, but similar research in many countries tends to support these conclusions.

Gender

Despite the trend of increasing female participation in the workforce, gender inequality in leadership positions is pervasive in most societies (EIGE, 2015; Hoyt and Murphy, 2016) and studies show that the characteristics of successful leaders more strongly associate with male or masculine qualities (Eagly and Heilman, 2016). The same is true for entrepreneurship. The 2019/2020 GEM report showed that the TEA (total early-stage entrepreneurship activity) rate for women was lower than for men in all countries except Saudi Arabia, Qatar and Madagascar (Bosma et al., 2020). The highest rates were in sub-Saharan Africa (21.8 per cent) and Latin America (17.3 per cent) and the lowest rates were in Europe (6 per cent) and MENA regions (9 per cent) (Elam et al., 2019).

In the UK, *The Alison Rose Review of Female Entrepreneurship* observed that only one in three entrepreneurs were female and only 5.6 per cent of UK women run their own business (1.5 million) compared to 15 per cent in Canada, 11 per cent in the USA and 9 per cent in Australia and the Netherlands (Rose, 2019). Women in the UK are about half as likely as men to start their own business and are also under-represented in firms that grow (Marlow et al., 2013). Other studies have confirmed that female-owned businesses are likely to perform less well than male-owned businesses, however performance is measured – be it by turnover, profit or job creation (Department of Business, Enterprise and Regulatory Reform, 2008; Fairlie and Robb, 2009). This characteristic is not confined to the UK. While in the UK only 7 per cent of 'gazelles' were founded by women (or teams which include women), in the USA the rate was even lower at 6 per cent (Department of Business, Enterprise and Regulatory Reform, 2008). What is more, they have a higher churn rate (i.e. more start-ups but also closures) than male-owned businesses, although women are less likely to attribute closure to 'business failure' and more likely to cite 'personal reasons' (Marlow et al., 2013).

The reasons for these characteristics are many and various, some may be self-determined, related to lifestyles choices and family roles. Some studies have indicated that women have lower amounts of capital – human, social and financial – than men and this inhibits their ability to start and grow businesses (Brush, 2008; Fairlie and Robb, 2009; Parker, 2009). In the UK, Rose (2019) estimated that women start businesses with 53 per cent less capital than men. Women appear to make trade-off

> *Not all women want to get to the top of the board. They want to reach a certain level with a fantastic job, but with time for family and life outside the business. Being at the top is not always the best position.*
>
> Mary Perkins, co-founder of Specsavers, *The Guardian*, 28 October 2011

decisions between work and other areas of their lives sometimes using self-employment as a temporary measure which might include family commitments and a wider career path. They devote less hours to the business, often working part time and/or from home (Carree and Verheul, 2009; Fairlie and Robb, 2009; Marlow et al., 2013; Verheul et al., 2009). There are also differences in sector and industry choice which affect performance and growth. For example, women-owned businesses tend to be concentrated in the retail and service sectors – sectors with high 'churn' rates (Carter and Shaw, 2006; Department for Business, Innovation and Skills, 2013; Marlow et al., 2013). Brush (2008) said this was because they tend to start businesses that 'fit the feminine image'. She also observed that women frequently choose areas of business that tend to have higher failure rates and higher financial barriers. We look at issues of gender bias in financing in Chapter 19.

Explore further 1.4

Female entrepreneurship

Access the *Digital Links* booklet and take a look at:

- The GEM 2018/2019 women's entrepreneurship report.
- The *Alison Rose Report: Review of Female Entrepreneurship.*
- The *Women in Enterprise* report.

Immigrants and ethnic minorities

There is a strong link between immigration to a foreign country and entrepreneurship. Often immigrants have few alternatives other than self-employment, but perhaps of more surprise is the link with growth businesses. In 2017 the Centre for American Entrepreneurship found that first- or second-generation immigrants had founded 43 per cent of the US Fortune 500 companies – 52 per cent of the top 25 firms and 57 per cent of the top 35 firms (Center for American Entrepreneurship, 2017). These are some of the biggest companies in the USA employing over 12.8 million people worldwide with well-known founders like Jeff Bezos (Amazon), Sergy Brin (Alphabet), Walt Disney (the Walt Disney Company), Henry Ford (Ford Motor Company), Estée Lauder (Estée Lauder, Clinique), Elon Musk (Tesla, Space X) and Eduardo Saverin (Facebook). Immigrants also make disproportionate contributions to technology, patent production and academic science. In 2016, all six American winners of the Nobel Prize in economics and scientific fields were immigrants and since 2000 immigrants have been awarded 40 per cent (31 of 78) of the Nobel Prizes won by Americans in Chemistry, Medicine and Physics (NFAP, 2016).

These are not isolated findings. In the UK, six of the most successful wholesale medicine and drug supply companies were founded by Kenyan Asians – pharmacists who came to Britain in the 1960/70s as forced immigrants and became millionaires by starting businesses (Navin Engineer, Bharat Shah, Bharat and Ketan Mehta, Vijay and Bhikhu Patel, Ravi Kari and Naresh Shah). Mahmud Kamani was born in Kenya and came to Manchester aged four with his parents where his father began selling handbags from a market stall. Today he is the billionaire owner of the online retailer Boohoo (Case insight 12.2). The 2017 UK GEM Report showed that immigrants were more likely to be early-stage entrepreneurs than the life-long residents as a whole – their TEA rate was 12.5 per cent compared to 8.6 per cent – and, taken together, people from ethnic minority and immigrant backgrounds were twice as likely as their white British counterparts to be early-stage entrepreneurs – their TEA rate was 14.5 per cent compared to 7.9 per cent (Hart et al., 2017).

Of course, many countries employ selective immigration policies that favour entrepreneurial characteristics, such as business experience and high levels of education, and it has been suggested that there is an element of self-selection here (Davidsson, 2006). However, immigrants generally tend

to be better educated than those in their host country (UNESCO, 2019). In China, overseas returnee entrepreneurs are seen as particularly important because they are usually highly educated and return to start up technology ventures (Wright et al., 2008). There are also other factors at work that mean that an immigrant is better placed to spot commercial opportunities in their new home country. We shall explore this further in Chapters 3 and 4.

Ethnic minorities tend to have high self-employment rates in most Western industrialised countries. For example, in the UK with their higher TEA rate they were more likely than their white British counterparts to be early-stage entrepreneurs (Hart et al., 2017). Ethnic-led businesses in the UK comprise 7 per cent of businesses (Department for Business, Innovation and Skills, 2013). However, the UK data for different ethnic groups is not homogeneous and generalisations are therefore dangerous. Those for Asians (Indian, Pakistani, Bangladeshi etc.) and Chinese are higher than those for white males, while those for black Africans and black Caribbean people are lower, typically more comparable to white women. With some 200,000 Asian-owned businesses in the UK, Asians are recognised as the most likely ethnic minority group in the UK to become entrepreneurs and are represented across all sectors of business. One reason for the high self-employment rate for Asians compared to black Africans and black Caribbean people appears to be family background and expectations. Traditionally, Asian families have valued the independence of self-employment. This seems to be changing, with second-generation Asians in the UK being encouraged to enter more traditional professions. However, one of the problems with looking for a pattern is that these ethnic groups are no longer homogeneous and there is a complex set of family, community and societal influences at play. We look at issues of ethnic bias in financing in Chapter 19.

> *We all had one thing in common – we came to a country where we had to make it and our families supported us. My wife didn't mind me working 14 hours a day on the business and not being home to read the children bedtime stories. But we had, and still have, a good relationship. We have no regrets.*
>
> Bharat Shah, founder of Sigma Pharmaceuticals, *Kenyan Jewels*, www.alusainc.wordpress.com, 12 August 2008

Case insight 1.6 Lowell Hawthorne and Golden Krust

Immigrant entrepreneurs

Lowell Hawthorne used to work with his family in his father's bakery in St Andrews, Jamaica. In 1981 he and many of his family emigrated to the USA where he joined the New York Police Department. Seven years later Lowell decided he wanted to start his own business, so he brought the family together and nine of them decided to start up what they knew most about – a bakery. Unable to obtain any loan finance from the banks, the family pooled their resources, which involved family members having to remortgage their houses, to find $107,000 and launch Golden Krust in 1989. In the first three years of its existence the company produced a range of Jamaican bakery products. However, it bought in the patties from a West Indian restaurant chain. It was only when the restaurant cut off supplies that Lowell was forced to find out about making patties himself – going to the UK to find out how to do it. By 1993, equipped with a baking method from Scotland, a chef named Mel and a new manufacturing plant, sales exceeded $2 million for the first time. In 1996 the company diversified into restaurants, opening seven, mainly take-out, franchise restaurants (Chapter 11) specialising in Jamaican cuisine and selling the famous patties.

Golden Krust has become the largest West Indian food chain in the USA with turnover of some $100 million. It is famous for its Jamaican patties – flaky, yellow rectangles of dough filled with spicy meat or fish – and the sauces to go with them. It still has its manufacturing base in New York, but it also operates as a restaurant franchisor with a chain of more than 125 across the USA and Canada. Most of its income comes from being a franchisor, which generates an up-front fee and a restaurant royalty of 5% on the turnover. The company also sells its patties wholesale to big distributors such as Walmart and Costco. It also offers event catering and supplies New York schools and prisons. Lowell died in 2017 but Golden Krust remains a family business.

Access the *Digital Links* booklet to visit the company website and watch a video of Lowell Hawthorne telling the story of Golden Krust.

Questions:

1. What were the motivations to launch Golden Krust and how does being a family business help or hinder it?
2. What are the barriers faced by immigrants in starting a business?

SOCIAL ENTERPRISE

Social entrepreneurs usually operate as entrepreneurs within organisations whose primary purpose is social rather than economic. The organisations they work within are called 'social enterprises'. Sometimes they are founders of the social enterprise, but sometimes, like an intrapreneur, they operate as entrepreneurs within an existing enterprise. A social enterprise is one that operates in a commercial way to achieve its social objectives, and any profits it generates are ploughed back to help achieve them. Chapter 11 explains the different legal forms a social enterprise might take. A social enterprise is often about creating social change at a community level, normally through voluntary or community groups. In the UK this has a long history, from Victorian hospitals to the modern-day hospice movement. Social Enterprise UK, a national body representing social enterprises, says a social enterprise must satisfy six criteria. It must:

- Have a clear social or environmental mission set out in its governing documents;
- Generate the majority of its income through trade;
- Reinvest the majority of its profit;
- Be autonomous of the state;
- Be majority controlled in the interests of the social mission;
- Be accountable and transparent.

> *Social entrepreneurs are not content just to give a fish or teach how to fish. They will not rest until they have revolutionized the fishing industry.*
>
> Bill Drayton, founder of Ashoka, http://www.architectsofpeace.org/architects-of-peace/bill-drayton

Based upon a large-scale survey (DCMS and BEIS, 2017), it was estimated that in 2017 there were approximately 471,000 social enterprises in the UK, (almost 9 per cent of the stock of SMEs): 371,000 (79 per cent) had no employees; 99,000 employed about 1.44 million people (an average of about 15 per social enterprise). Ninety-three per cent reported making a surplus (compared to 76 per cent of commercial SMEs). While 69 per cent said they had individual consumers of their services, 60 per cent said their customers (fee payers) were from the public sector (compared to 43 per cent commercial SMEs) and 19.2 per cent had applied for public sector contracts in the past year. Perhaps most surprisingly, 1.21 million commercial SMEs (22 per cent of the SME population) were identified as 'socially oriented SMEs' – having social/environmental goals but not using surplus/profit chiefly to further these goals.

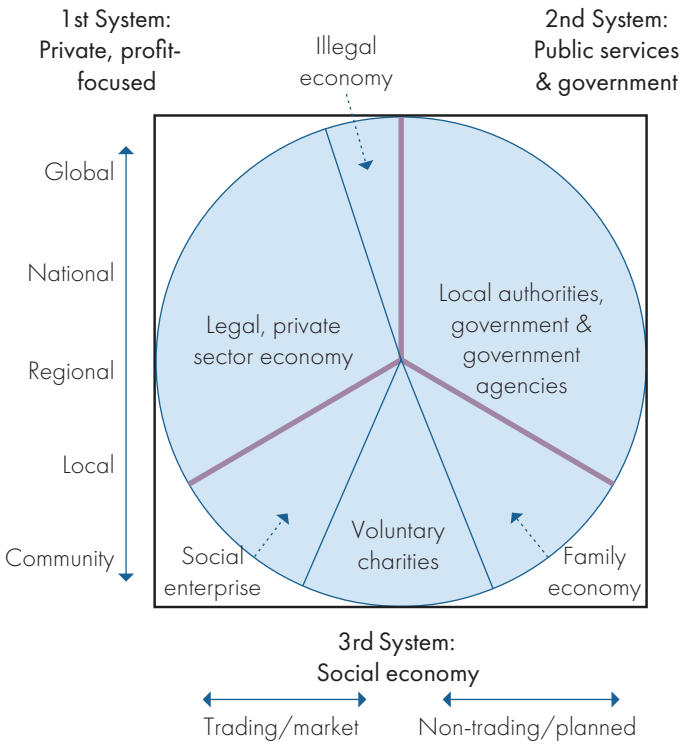


Figure 1.4 The three systems of the economy

Source: Adapted from Pearce (2003).

Social entrepreneurs have many of the qualities of commercial entrepreneurs; in particular they are innovative, often creating change by doing things differently. They operate at the intersection of the public, voluntary and private sectors, pulling together resources with the purpose of serving their social mission. Pearce (2003) tried to explain this myriad of interlinking concepts by talking about three systems of the economy – private, public and social – delineated in two dimensions – trading/non-trading and global/community-based, shown in Figure 1.4. The first system is the private sector, which concentrates on trading, with the objective of profit maximisation. But even this has its legal and illegal sectors. It operates on anything from a local to a global basis. The second system is public services and government, which operates in a planned, non-trading way. It is characterised as bureaucratic and inefficient. It also operates on anything from a local to a global basis. The third system is the social economy, which includes social enterprise, voluntary and charity organisations and the family economy. This is usually far more community-based and can be both planned and based upon market trading. The use of the word 'system', rather than sector, in this context is deliberate because it is meant to imply that each system is not homogeneous.

The GEM 2009 Social Entrepreneurship Report (Terjesen et al., 2009) showed that in the UK the highest level of social entrepreneurial activity is among the youngest age group (18–24 years) at 4.4 per cent – a result that has persisted for a number of years. However, it is the people in the oldest age group (55–64 years) that are most likely to be running established social enterprises (1.7 per cent involvement). The report shows no significant difference between women and men, and stated that those most likely to be social entrepreneurs belonged to the mixed ethnic origin group (6.3 per cent) and combined black African and black Caribbean group (7.5 per cent) – all higher than the percentage of the white population who played a part in social enterprise. The GEM results should, however, be treated with caution because the definition of social entrepreneur is so broad that it includes anybody trying to start or manage any form of social, community or voluntary activity.

CONFLICTS WITHIN SOCIAL ENTERPRISE

There are inherent conflicts within a social enterprise. The first is the conflict between its social and commercial operations. The objectives of a social enterprise can be 'integrated' with its commercial operations or 'complementary' to them. An integrated model is one where surplus-generating activities simultaneously create social benefit, with one objective not getting in the way of the other. The art of integration, according to Fowler (2000), is to 'marry the development agendas with market opportunities and then manage them properly so that they are synergistic not draining' (e.g. Grameen Bank, Case insight 19.1). All too often, however, this is not the case and the one agenda 'contaminates' the other, perhaps leading to reduced efficiency and effectiveness on the commercial side or dilution of the social objectives on the other. When surpluses from the commercial activity are simply used as a source of cross-subsidy for the social objectives, rather than producing social benefits themselves, this can more accurately be called 'complementary social entrepreneurship'.

The second conflict arises around the issue of democratic accountability. It occurs particularly when the activities of the social enterprise are not integrated. A social enterprise operates at the boundary between public and private sectors, and there is an inherent conflict in the values and beliefs of the two sectors. The issues relating to social enterprise revolve around its commercial efficiency and effectiveness on the one hand and its democratic accountability on the other. There are difficulties with accounting for the two objectives and in particular making trade-offs between the two. It is the old issue of whether the (commercial) means always justify the (social) ends. It is therefore imperative for a social enterprise to decide on the core mission and realise what is peripheral – a means of achieving the ultimate mission. Unless this happens, social enterprises can avoid rigorous monitoring and democratic accountability. But this begs the question of who decides on the core mission, and how 'performance' in meeting the mission might be measured. The complex nature of the stakeholders' interests in most social enterprises means that these issues can be 'fudged' and are often the result of political influence. The danger particularly occurs when public funds are involved. Where these are channelled through another organisation there is always the possibility of commercial gain and without clear performance criteria and democratic accountability there is no way of knowing whether the public got value for money.

Fowler (2000) was concerned about these conflicts, noting particularly that it is a risky framework for the development of recipients of international development aid – non-governmental organisations. These organisations handle large amounts of public money. He doubted that they can handle the conflicts between social and commercial behaviour. He argued that retaining their moral underpinning and inspiration is vital and any involvement in income-generating activities will compromise this. He also feared that the social enterprise framework is not sustainable because they are so dependent on government aid. There is also the concern about what entrepreneurial activities the large amounts of public money they receive might be put to. Fowler is therefore more in favour of 'civic entrepreneurship', which he sees as providing 'civic, as opposed to public, legitimacy and economic viability from a broad base of citizen support'.

The third conflict concerns the nature of the objectives a social enterprise is set up to achieve. These may be clearly non-political (e.g. Maggie's, Case insight 4.12); however, they may also be

Case insight 1.7 John Bird and *The Big Issue*

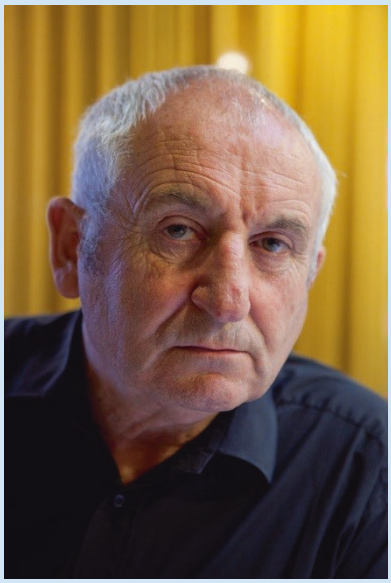
Social entrepreneur

The Big Issue is a magazine that is sold by homeless people on the streets of many UK towns and cities. It is probably the most prominent example of social entrepreneurship in the UK. Launched by John Bird in 1991, it offers legitimate self-employment to homeless people in poverty. Vendors buy the magazine for £1.50 and sell it for £3.00, keeping the profit they earn. The profits from producing the magazine go to The Big Issue Foundation, a registered charity. By 2016 *The Big Issue* had sold over 200 million copies through 92,000 vendors who earned some £115 million. It has inspired over 120 similar street papers in more 35 countries, leading a global self-help revolution. But luck, dedication and hard work have all played their part in the story of *The Big Issue*.

The founder, John Bird, was born in a two-bedroom house shared with a number of other families in a slum-ridden part of Notting Hill, London, just after the Second World War. He was the third of six boys in a poor Irish family. When his parents failed to pay the rent they were evicted and had to share a single room in his grandmother's house. By the age of five, he was made homeless and lived in an orphanage run by the Sisters of Charity between the ages of seven and ten.

He left the orphanage as a ten-year-old troublemaker and spent the next 15 years running away, sleeping rough in the streets of London, stealing and scamming. Eventually he ended up in jail. However, in his late twenties he started mixing with student 'revolutionaries' who got him interested in political activism. He joined the Socialist Labour League and the Workers Revolutionary Party (WRP), working to overthrow 'the establishment'. He started work as a printer when he left the WRP in the late 1970s, despite having no experience in the industry. He got sacked and moved from printing job to printing job, but learned a little more in each, until eventually he had sufficient knowledge to set up his own small printing works. He liked being his own boss, working around 100 hours a week in his garage to make a go of the venture. He turned his hand to writing and publishing, telling friends he was a businessman. However, almost everything he published went back to his roots, and the poverty and unfairness he had grown up with on the streets of London. The poor and homeless were a particular focus for his attention.

Luck plays a part in the story of *The Big Issue*. Bird and Gordon Roddick (co-founder of The Body Shop) were old friends and, having seen a street paper being sold by homeless people in New York, Roddick thought Bird, with his experience of homelessness, running a business and printing magazines,



Source: Lucy Kane

might be interested in launching a similar venture in London. At that time the principle was that the magazine would operate as a business with both the sellers and Bird's company making a profit. On this basis, The Body Shop provided $50,000 start-up funding. However, six months later *The Big Issue* was still losing £25,000 a month. Bird did not give in, instead addressing the problem without sentiment in a very business-like way.

It worked and by the first anniversary in 1992, the magazine had turned a £1,000 profit. But breaking even wasn't the only challenge in these early days. Sellers physically attacked Bird and his staff when they learned they would have to pay for the magazine. Bird overcame this in his typically robust way, hiring a couple of the homeless men to act as bodyguards.

The Big Issue has regular features including book, film, TV and play reviews. It was relaunched in 2012 with new columnists and an increased focus on campaigning and political journalism. It prides itself on its ability to get exclusive personal interviews from celebrities and other well-known people and is sold to consumers on its quality rather than as a means of securing a charitable donation. It now has five localised editions in the UK as well as being produced and sold in a number of countries around the world. It also gets income from advertisers and now from its website.

The Big Issue is sold exclusively by homeless people on the streets. The idea behind this is to allow these people to work to earn a living (they are self-employed), rather than begging or relying on charity. This makes the nature of the transaction somewhat unusual. When they are asked to buy, consumers

come face to face with beneficiaries and can see that they are trying to help themselves out of their situation. Vendors are given training and there is a 'Street Support Team' to help them. They are first given a small number of magazines and thereafter have to buy copies to sell on at 50% of the cover price. One key aspect of the transaction is that the consumer is asked for a limited and relatively small financial contribution. This legitimises small donations. In this way giving small amounts to a morally justified and legitimate cause is made easy. These factors have led researchers to conclude that '*The Big Issue* is rarely bought for its own sake, simply as a quality product, but that its intrinsic value to the consumer does play a role in whether or not the initiative is supported. In other words, consumers buy it because they believe that they are helping the homeless (to help themselves)' (Hibbert et al., 2002).

All vendors of *The Big Issue* magazine are connected to The Big Issue Foundation (founded in 1995). This is a registered charity funded by profits from the magazine. It derives additional income from charitable giving, grants and corporate sponsorship. The aim of the Foundation is to support vendors 'to build pathways to a better future', through employment, training, education, health care, housing and personal development. The Foundation also campaigns on social exclusion issues.

The magazine and Foundation have grown into The Big Issue Group. Big Issue Invest was launched in 2005. It is a social investment business 'supporting enterprise to drive social change'. Hailed as the UK's first 'social merchant bank', formed by social entrepreneurs, for social entrepreneurs, it offers loans and investments from £20,000 to £3 million. It manages or advises on £150 million of social funds, raised mainly from private sources, which have been used to invest some $30 million in 300 social enterprises. In 2016 The Big Issue Shop was launched. This is a shop 'curating social enterprise products' from around the world. The mission of The Big Issue Group is 'to dismantle poverty by creating opportunity, through self-help, social trading and business solutions'. It really is an example of social entrepreneurship.

Access the *Digital Links* booklet to visit *The Big Issue* website and watch a video explaining what *The Big Issue* is all about.

Questions:

1. Do you agree that The Big Issue Group is a good example of social entrepreneurship? Explain.
2. What character traits do you observe in John Bird and how have they influenced the development of *The Big Issue*?
3. Is *The Big Issue* self-sustainable? If so, why is this important?
4. What do you think about the move into banking and social trading? Why have these been kept as separate organisations?

seen as ways of encouraging some sort of 'social engineering', often originating from a government policy initiative. For example, since 2009 the UK government has encouraged the formation of social enterprises for the delivery of services such as health and social care, fostering and adoption, transport and recycling – areas that traditionally have been seen as the responsibility of the public sector. This is partly because social enterprise is seen as innovative and efficient, but it is also partly as a way of getting extra, non-government funding into the service and, in extremis, can be seen as 'privatisation', a political policy.

There are always lessons to be learned when the activities and approaches of one sector are compared to another, not least in a public sector that is often seen as overly bureaucratic. Eikenberry and Kluver (2004) acknowledged the need for the public sector to work with not-for-profit, community and voluntary organisations, observing that 'they are more than just tools for achieving the most efficient and effective mode of service delivery; they are also important vehicles for creating and maintaining a strong civil society'. Alexander et al. (1999) underlined the importance of their role as 'schools or laboratories of democratic citizenship' – training grounds for citizenship that involve people in socially beneficial activities that they would not otherwise engage in. However, sometimes politicians can use social enterprise as a way of forcing change on the public sector, and not always for the best reasons.

SUMMARY

- We are living in an age characterised by continuing, unpredictable and rapid change – change that is both incremental and discontinuous. It is an increasingly complex world full of interconnections formed by a global marketplace linked by technology allowing instant communication. While large firms find this environment challenging, small, entrepreneurial firms have thrived. The key to this success has been the ability of entrepreneurs to work with change to recognise and create opportunities.
- Entrepreneurs are defined primarily by their actions: they create and/or exploit change for profit by innovating, accepting risk and moving resources to areas of higher return.
- A small and medium-sized enterprise (SME) is one with less than 250 employees; micro up to nine employees; small up to 49 employees; medium-sized up to 249 employees.
- Most businesses are small, however defined, and they are a vital part of the economies of most Western countries. Fast-growing 'gazelles' and 'unicorns' generate most of the employment growth.
- Situation-specific 'push' and 'pull' factors affect the attractiveness of entrepreneurship but there are also many barriers, both real and psychological, to be overcome before starting a new venture. A prospective entrepreneur needs to understand their motivations and constraints and what starting a new venture might mean to their lifestyle.
- An entrepreneur brings three kinds of capital to a start-up: financial, human and social. The more capital of each sort they bring, the more likely the start-up is to succeed.
- A social enterprise operates in an entrepreneurial way to achieve social objectives, and any profit is ploughed back into the enterprise to help achieve them. They operate at the intersection of the public and private sectors – in the social economy.
- There can be conflicts within a social enterprise: between its social and commercial operations; around the issue of democratic accountability; and in the nature of the social objectives it is set up to achieve. Social enterprise can be seen as a way of diminishing the responsibilities of the state.

GROUP DISCUSSION TOPICS

1. How has the concept of 'change' changed throughout time?
2. How can entrepreneurs create change?
3. How can entrepreneurs use change to spot a commercial opportunity?
4. Is now a good time to start your own business? Explain.
5. Do you dream of starting your own business? If so, why? If not, why not? What do you think will be the main challenges you would face?
6. Is it better to start a business when you are young or when you are older?
7. What are the barriers to entrepreneurship you face and how might they be overcome?
8. What would 'push' or 'pull' you into entrepreneurship?
9. Do you think the definition of an entrepreneur in this chapter is adequate?
10. How does an entrepreneur differ from an intrapreneur or a social entrepreneur?
11. Is an owner-manager of a small firm automatically an entrepreneur? What are the implications of any difference?
12. Is it good that so many businesses close in the first three to five years?
13. Why do so many immigrants become successful entrepreneurs? What might change as they move from first to second generation?
14. Statistics show that women are less likely to start and grow a business than men. What causation factors are at play?
15. Can education and training make you more entrepreneurial?
16. Should all students at university be taught entrepreneurship?
17. What are nascent entrepreneurs? What does their number tell us that start-up statistics do not?
18. Do social enterprises reduce the responsibilities of the state?
19. Are you content to see public money going to social enterprise? Explain.
20. Would you prefer to be a social entrepreneur or a commercial entrepreneur with social values? Explain.

STUDENT ACTIVITIES

1. Explore the statistics about start-ups and SMEs in your country. What does this tell you about recent developments? Summarise your findings in a report.
2. Access the latest GEM report for your country and summarise the findings in a report.
3. Research and write a report that critically analyses the changing commercial environment in your country and how it impacts on entrepreneurship.
4. Research and write a report on the background and history of an entrepreneur who set up and grew their own business, outlining the reasons for the success.
5. Research and write a report on the background and history of an established social enterprise and outline the reasons for its success.

2

THE ECONOMICS OF ENTREPRENEURSHIP AND PUBLIC POLICY

Contents

- The economics of entrepreneurship
- Entrepreneurship and economic growth
- Invention, innovation and creativity
- Innovation intensity
- Innovation, profitability and growth
- Innovation, firm size and industry structure
- The role of government in innovation
- Innovation, location and network effects
- Social and environmental innovation
- Public policy towards SMEs
- Policy intervention
- The effectiveness of policy intervention
- Social enterprise policy
- Summary
- Group discussion topics
- Student activities



Source: Getty Images/courtneyk

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand and explain the theories linking the role of the entrepreneur in creating wealth and stimulating economic growth;
- Understand and explain the links between creativity, invention, innovation and entrepreneurship;
- Understand and explain the links between innovation, profitability and business growth and how they relate to firm size, location and industry structure;
- Understand and critically evaluate how public policy can influence the volume of commercial and social enterprise start-ups and their growth.

Case insights

2.1 Charles Babbage
2.2 Chuck Hull
2.3 James Dyson (1)
2.4 Vaccitech
2.5 Astex Therapeutics
2.6 Small Business Innovation Research initiative
2.7 Seven Stories

Explore further link

2.1 Innovation, location and network effects

THE ECONOMICS OF ENTREPRENEURSHIP

You might ask whether there are any underlying theories to explain the growth in number and importance of small firms. Marxist theory predicts that capitalism will degenerate into economies dominated by a small number of large firms and society will polarise between those who own them and those who work in them. To a Marxist, the rise of small firms is just another, subtler way for this trend to manifest itself. Small firms are dependent upon larger firms for their custom and well-being; they absorb risk and push down pay and conditions for workers because they are rarely unionised. However, the successful growth of so many small firms since the 1980s, the increasing fragmentation of industries and markets, and the increasing popularity of self-employment by choice would seem to belie this theory.

People like Fritz Schumacher (1974) would have us believe that the growth of small firms is part of a social trend towards a more democratic and responsive society – 'small is beautiful'. To him the quality of life is more important than materialism. He was very much in favour of 'intermediate technology' – simpler, cheaper and easier to use – with production on a smaller scale and more locally based. However, the technologies that fuelled the growth of small firms at the end of the twentieth century were far from simple and, for many, quality of life improved alongside material wealth.

This leads us to free-market economics. The classical theory of economics extolled the enabling role of free trade, specialisation and competition and described the directing role of the entrepreneur in terms of the factors of production: land, labour and capital (Ricardo, 1817; Say, 1803; Smith, 1776). According to this the growth of small firms can be seen as the triumph of the free market, later promulgated by politicians like Ronald Reagan and Margaret Thatcher as the 'enterprise culture'. Increasing numbers of small firms were the natural result of increased competition and a drive to prevent private and public monopoly. However, classical theory has been criticised for not explaining the dynamic upheaval generated by the entrepreneurs of the industrial age (Murphy et al., 2006). Indeed, neoclassical economics tended to ignore the uniqueness of the efforts of individual entrepreneurs, focusing more on the importance of exchange coupled with diminishing marginal utility to create demand and deliver 'perfect competition'.

So, what exactly does economic theory have to say about the creation of small firms? Traditional industrial economists would explain the growth of new firms in terms of industry profitability, growth, barriers to entry and concentration. However, they are more concerned with 'entry' to an industry, rather than whether this is by a new or an existing firm. They assume an endless supply of potential new entrants. They would say that entry to an industry is high when expected profits and growth are high. It is deterred by high barriers to entry and high concentration, when collusion between existing firms can take place. However, much of this work does not specifically consider the role of new or smaller firms. Indeed, Acs and Audretsch (1989) showed that entry by small, primarily new, firms is not the same as entry by large firms and that the birth of small firms is lower in highly concentrated industries and ones where innovation plays an important part.

By way of contrast, labour market economists have been more interested in what influences individuals to become potential entrants to an industry by becoming self-employed. Psychologists have also contributed greatly to this work, which has focused on the character or personality of the individual, the antecedent influences on them, such as age, sex, education, employment status, experience and ethnicity, as well as other societal and cultural influences. As we shall see in the next chapter, this work has proved far more interesting and informative.

ENTREPRENEURSHIP AND ECONOMIC GROWTH

The link between entrepreneurship, or more specifically the creation of new firms, and economic growth has until recently been far from clear – as far as economists are concerned. Traditional theories tended to suggest that entrepreneurship impeded rather than encouraged growth. In Chapter 1, we looked at the different definitions of an entrepreneur developed through the centuries, particularly the views of Schumpeter, Knight and Kirzner. While Knight (1921) saw the entrepreneur as someone who was willing to bear risk for a reward, Kirzner (1973) emphasised their role as an intermediary and market-

maker. Both Knight's and Kirzner's works were based on the general equilibrium or neoclassical model of economics which focused on optimising existing resources within a stable environment and treated any disruptions, such as the growth of entrepreneurial new firms that created whole new industries, as 'god sent' external forces.

By way of contrast, Schumpeter's work focused on the effect of human action on the market, highlighting the disruptive role of the entrepreneur as an innovator. And, while Kirzner (1973) added the important dimension of information, knowledge and profit-making opportunity recognition to the work of Schumpeter, it was Schumpeter who created the link between entrepreneurship, innovation and growth, describing the entrepreneur as the driver of market-based systems. He was the first person to challenge neoclassical economics. In his primary work he set out his overall theory of economic development – an endogenous process within capitalism of wrenching the economy out of its tendency towards one equilibrium position and towards a different one – a process of 'creative destruction' (Schumpeter, 1911). This fundamental phenomenon entails the development of new combinations of the means of production, which Schumpeter labels 'enterprise' but we could equally call 'innovation', while the individuals carrying them out are called 'entrepreneurs'. These new combinations 'as a rule … must draw the necessary means of production from some old combinations'.

> *It is clear that successful entrepreneurs are vital for a healthy, vibrant and competitive economy. If you look around you, most of the largest companies have their foundations in one or two individuals who have the determination to turn a vision into reality.*
>
> Richard Branson, founder of Virgin Group, from Anderson (1995)

Schumpeter was arguing against traditional economic theory which presumed that the economy always tended towards equilibrium and changes in that equilibrium could only occur through changes in the underlying conditions of the economy, such as population growth, changes in savings ratios, or external shocks, such as wars or natural disasters. The former were thought to change only slowly and the latter only occurred unpredictably. Schumpeter sought to explain the process of economic development as a process caused by enterprise – or innovation – and carried out by entrepreneurs.

For Schumpeter a normal healthy economy was one that was continually being 'disrupted' by technological innovation, producing the 50-year cycles of economic activity noticed earlier by the Russian economist Nikolai Kondratieff. Using data on prices, wages and interest rates in France, Britain and the USA, Kondratieff first noticed these 'long waves' of economic activity in 1925. Unfortunately he was executed by Stalin some ten years later because he predicted (accurately as it turned out) that Russian farm collectivisation would lead to a decline in farm production. It was therefore left to Schumpeter to study these waves in depth.

Schumpeter said that each of these cycles was unique, driven by different clusters of industries. The upswing in a cycle started when new innovations came into general use:

- Water power, textiles and iron in the late eighteenth century;
- Steam, rail and steel in the mid-nineteenth century;
- Electricity, chemicals and the internal combustion engine in the early twentieth century.

These booms eventually petered out as the technologies matured and the market opportunities were fully exploited, only to start again as a new set of innovations changed the way things were done. For the last 20 years of the cycle, the growth industries of the last technological wave might appear to have been doing exceptionally well. However, they were, in fact, just repaying capital that was no longer needed for investment. This situation never lasted longer than 20 years, and returns to investors then started to decline with the dwindling number of opportunities. Often this was precipitated by some form of crisis. After the 20 years of stagnation, new technologies emerge and the cycle starts again. By the time Schumpeter died in 1950 the next cycle of boom was starting, based upon oil, electronics, aviation and mass production. Another started in the 1980s based upon computers, software and mobile technologies, including the internet.

The other factor is that innovation – particularly technological innovation – also seems to generate growth that cannot be accounted for by changes in labour and capital. Although the return on investment may decline as more capital is introduced to an economy, any deceleration in growth is more than offset by the leverage effects of innovation. Because of this, the rich Western countries have seen their return on investment increasing, while the poorer countries have not caught up. What is more, empirical studies by Acs and Audretsch (1988) have shown that economies of scale are not a prerequisite for innovation.

But innovation does not happen as a random event. Central to the process are the entrepreneurs. It is they who introduce and then exploit the new innovations. For Schumacher (1974), 'the entrepreneur initiates change and generates new opportunities. Until imitators force prices and costs into conformity, the innovator is able to reap profits and disturb equilibrium.' By way of contrast, early classical economists such as Adam Smith saw the entrepreneurs as having a rather minor role in overall economic activity. Smith thought that they provided real capital but did not play a leading or direct part in how the pattern of supply and demand was determined.

Aghion and Howitt (1992) produced a formal restatement of Schumpeter's theory of 'creative destruction' whereby new entrants replace existing inefficient firms. Other economists have emphasised the Schumpeterian assumption that innovation-based growth needs entrepreneurs and effective selection among entrepreneurs (Acemoğlu et al., 2006; Michelacci, 2003). These theories of 'industrial evolution' have linked entrepreneurship and economic growth directly (Audretsch, 1995; Ericson and Pakes, 1995; Hopenhayn, 1992; Jovanovic, 1982; Klepper, 1996; Lambson, 1991). They focus on change as the central phenomenon and emphasise the role knowledge plays in charting a way through this. Innovation is seen as the key to market entry, growth and survival for an enterprise and the way entire industries change over time. What is more, in the UK it has been suggested that innovative businesses are the main drivers of employment (Cosh and Hughes, 2007).

Based on the work of Kirzner, Acs et al. (2004, 2005) and Audretsch (2007) expanded on the notion that the important feature of entrepreneurs is their role as 'knowledge filters', facilitating 'knowledge spill-overs' or 'knowledge transfers'. The accuracy of the information they need in order to innovate is crucial. Because this information is inherently uncertain, asymmetric (one party may have more than another) and associated with high transaction costs, it is of great value. However, Venkatarman (1997) observed that different people spot different opportunities because they possess different prior knowledge, and innovations introduced by entrepreneurs are related to their prior knowledge. As a result of these differences in knowledge, there are differences in the expected value of new ideas, and people therefore have a financial incentive to leave secure employment to start up a new enterprise in order to capitalise on a commercial idea that they believe in more than others. Once established, if economies of scale are important (Chapter 6), the enterprise must grow, simply to survive. In this way the economic performance of nations is linked to how well the potential from innovation is tapped – how well start-ups are encouraged and growth facilitated. And inherent in the process is churning – firms being displaced by newer, more innovative rivals.

These new evolutionary theories, supported by empirical evidence, therefore state that entrepreneurship encourages economic growth through innovation for three reasons:

1. It encourages competition by increasing the number of enterprises. While this increases growth in itself, it is a cumulative phenomenon because competition is more conducive to knowledge externalities – new ideas – than is local monopoly. And so entrepreneurship encourages entrepreneurship.
2. It is a mechanism for 'knowledge spill-overs' – transmission of knowledge from its point of origin to other individuals or organisations. Knowledge spill-over is an important mechanism underlying endogenous growth, and start-ups – entrepreneurs – are seen as being particularly adept at appropriating knowledge from other sources. In other words entrepreneurs spot opportunities and innovate.
3. It generates diversity and variety among enterprises in any location. Each enterprise is in some way different or unique and this influences economic growth.

Finally, it has been suggested that entrepreneurship has an important role in wealth distribution (Spencer et al., 2008). Here the distinction is made between the entrepreneurial innovation of small start-ups and the innovative activities of existing businesses, especially those that dominate the market, with new firms replacing existing firms on a regular basis. They emphasise the disruptive nature of the Schumpeterian view as leading to a redistribution of wealth and the continuing vitality of the capitalist system. Paradoxically, Schumpeter's vision was of an eventual decline in entrepreneurship and an increase in wealth concentration leading, eventually, to socialism. So far, this prediction has not proved to be true.

INVENTION, INNOVATION AND CREATIVITY

At the macro level, entrepreneurship and innovation are seen to encourage economic growth. At the micro level, innovation is the prime tool entrepreneurs use to create or exploit opportunity. Firms that grow do so because they innovate in some way. In his book *The Competitive Advantage of Nations*, Porter (1990) said: 'Invention and entrepreneurship are at the heart of national advantage', adding that 'companies achieve competitive advantage through acts of innovation'. However, entrepreneurs – or more precisely start-ups – are not the only people who try to practise innovation. For all firms, of any size, innovation has become something of a holy grail to be sought after and encouraged. But what is the difference between innovation and invention? And how are they linked to creativity?



Source: Joshua Lanzarini on Unsplash

Parkhurst (1999) defined creativity as 'the ability or quality displayed when solving hitherto unsolved problems, when developing original and novel solutions to problems others have solved differently, or when developing original and novel products'. Creativity can be directed towards many other ends; however, it underpins innovation. Amabile et al. (1996) called it the 'seed' of innovation that is important throughout the innovation process. McLean (2005) observed that without creative ideas, innovation is an engine without any fuel. And creativity is needed throughout the process of innovation.

Mintzberg (1983) defined innovation as 'the means to break away from established patterns', or in other words, doing things really differently. Kanter (1983) defined it as 'the generation, acceptance and implementation of new ideas, processes, products and services … [which] involves creative use as well as original invention'. Mellor (2005) defined it simply as either 'creativity + application' or 'invention + application'. Invention is the extreme and riskiest form of innovation. It is usually associated with the development of completely new or better product/services (e.g. the invention of the World Wide Web) or process (e.g. Henry Ford's assembly line for producing cars). But, arguably, it could also be associated with different forms of marketing and the development of completely new business models that help create new markets (e.g. the development of low-cost airline travel). However, examples abound of inventions that are not commercially successful, mainly because they did not satisfy a customer need. Thomas Edison, probably the most successful inventor of all time, was so incompetent at introducing his inventions to the marketplace that his backers had to remove him from every new business he founded. So the difference between invention and innovation is not just a question of scale, but also successful implementation.

> *There are so few new ideas, so few new things that have not been done. But although the safe place to be is copying what others are doing, I think the people who succeed will be those with the boldness to do something in a totally different way. They take an idea and reinvent it.*
>
> Rachel Elnaugh, founder of Red Letter Days, *The Sunday Times*, 23 May 2004

The reality is that there are dozens of definitions of innovation. In the face of so many, Figure 2.1 depicts innovation very simply in three dimensions, with each dimension measured on a scale that ranges from incremental to radical.

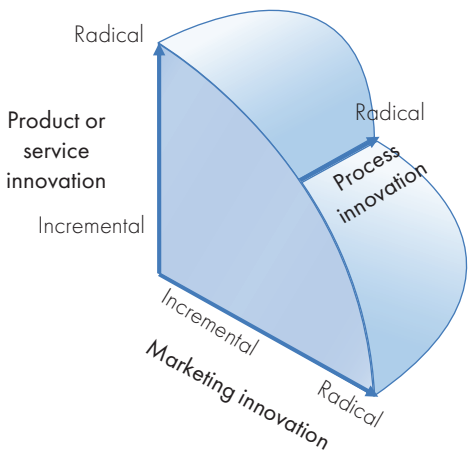


Figure 2.1 Product, process and marketing innovation

Product/service innovation

A completely new product/service or improvements in its design and/or functional qualities. The internet was a radical innovation, whereas anti-lock brakes for cars was an incremental innovation. Some radical innovations can lead to the development of whole new industries (e.g. the internet).

Process innovation

Revisions to how a product/service is produced so that it is better or cheaper (e.g. by the substitution of a cheaper material in an existing product). The robot assembly line was a radical process innovation, whereas merging two elements of assembly would be incremental.

Marketing innovation

Improvements in the marketing of an existing product/service, or even a better way of distributing or supporting an existing product/service. Selling direct to the public via telephone or internet was a radical marketing innovation, whereas guerrilla marketing or the use of social media (Chapter 10) was an incremental innovation.

Simply introducing a new product/service that has customers willing to buy it is not necessarily innovation. New cars are rarely truly innovative, despite what the marketing hype might say. However, the Model T Ford was truly innovative because it revolutionised the way cars were assembled. The Mini was truly innovative because it changed the way cars were designed and changed the way people perceived vehicle size. But how high a degree of innovation does there have to be for it to cross the line to become invention? When a sofa manufacturer produces a 'new' sofa, is that a new product? Economists would probably argue that it is not (because the cross elasticity of demand[1] is unlikely to be zero) – but the entrepreneur might disagree. What if the sofa manufacturer starts manufacturing chairs? At what point does the firm start producing genuinely new products? As Porter (1998a) observed, 'much innovation is mundane and incremental, depending more on an accumulation of small insights than on a single major technological breakthrough'. Innovation may be a hazy concept only because of the myriad forms it can take. As a result it has no quantifiable scale of measurement. What constitutes incremental or radical innovation in Figure 2.1 is a matter of judgement.

> *Great science isn't enough to make a great company. You need to be well-funded, well-led, and you need to let the scientists really focus on science.*
>
> Lisa Anson, CEO Redx, *The Sunday Times*, 4 October 2020

Case insight 2.1 Charles Babbage

Inventor vs entrepreneur

Contrary to popular misconception, the computer was not 'invented' by IBM. The principles of the computer were defined by the English scientist Charles Babbage in 1830. He invented a mechanical analytical engine or universal calculator, which was programmed by punch cards, had a store of information (memory) and a calculating engine (processor). But Babbage was forever tinkering with his designs and he could not find anyone to pay him to make the machine. He did not seem to have sufficient motivation or faith in his designs to actually make an operational machine. What is more, he was generally irritable and disagreeable – it is said that he hated humanity. He therefore never found a backer who might have invested in its development. Instead Babbage went on to try to devise a foolproof system for betting on horses.

Questions:

1. Was Babbage an entrepreneur? Explain.
2. What personal qualities did he lack?

1 Cross elasticity of demand measures the responsiveness of demand for a product to the change in price of other related products. When there is zero elasticity of demand there is no relationship between the products. Thus if elasticity is not zero, customers require some price inducement to try the 'new' product.

Case insight 2.2 Chuck Hull

Inventor vs entrepreneur

By way of contrast, Chuck Hull, who was born in 1939, has gained fame and fortune out of his invention of the 3D printer, even though it has not yet come into everyday use. In the early 1980s he was working for a company that used UV light to layer plastic veneers onto table-tops and furniture. Like others within the industry, he was frustrated by the length of time taken to produce even small plastic parts for prototypes of new product designs. He thought that if he could place thousands of thin layers of plastic on top of each other and then etch their shape using light, he might be able to produce three-dimensional objects quickly. Eventually he developed a system where light traced the shape of one layer of an object onto photopolymer – a material which changes from liquid to a plastic-like solid when light shines on it. Subsequent layers are then printed one on top of the other until the shape is complete. The whole process took a matter of minutes rather than the weeks involved in moulding and casting.

He patented his invention in 1986 and co-founded 3D Systems to commercialise the new method of production. The first commercial product was produced in 1988. 3D Systems sells 3D printers, materials and software to companies that regularly produce prototypes, such as car manufacturers and aerospace and medical equipment design companies. It has been said that one day the technology could become the biggest advance in manufacturing since the Industrial Revolution. Chuck has over 100 patents to his name and is still chief technology officer of 3D Systems, the company he founded.

Questions:

1. Is Hull an entrepreneur? Explain.
2. What personal qualities does he possess that Babbage did not?

INNOVATION INTENSITY

There is also a second dimension to innovation that is commercially very important, and that is how frequently it is practised. Arguably, a firm that practises frequent small-scale innovation is just as innovative as one that has the occasional large-scale innovation. Indeed, there is evidence that the majority of commercially significant innovations are incremental rather than radical (Audretsch, 1995). And what is also true is that the sum of many small, incremental innovations can have an enormous impact on competitive advantage (Bessant, 1999). Indeed, it has been argued that a track record of successful incremental innovation is a prerequisite of radical innovation (Dunlop-Hinkler et al., 2010). Many incremental changes can add up to a revolution. For example, Henry Ford's revolution in the car industry involved extensive incremental changes – to products and processes, component and factory design and in the way labour was organised in his factories. While radical innovation is associated with *substantially superior* competitive advantage (Dunlop-Hinkler et al., 2010), frequent incremental innovation is associated with *sustained* competitive advantage (Avermaete et al., 2003; Dong, 2015; Norman and Verganti, 2014; Salavou, 2002). Of course the two can be combined, particularly at different stages of a product/service life cycle.

> *True innovation is rarely about creating something new. It's pretty hard to recreate the wheel or discover gravity; innovation is more often about seeing new opportunities for old designs.*
>
> Neil Kelly, founder of PAV, *The Sunday Times*, 9 December 2001

The notion of innovation intensity is based upon the idea that that frequent incremental innovations in products, processes and marketing are just as desirable as infrequent radical innovations, and each is independent of the other (Burns, 2020). Figure 2.2a shows how entrepreneurship might push out this envelope of innovation. Competitive advantage is increased by pushing out the envelope, and truly innovative firms will tend to cluster along this envelope. You might also argue that the speed with which an innovation is developed and brought to the market is important, so as to capitalise on first mover advantage. The concept of innovation intensity therefore possibly requires a third dimension, as shown in Figure 2.2b.

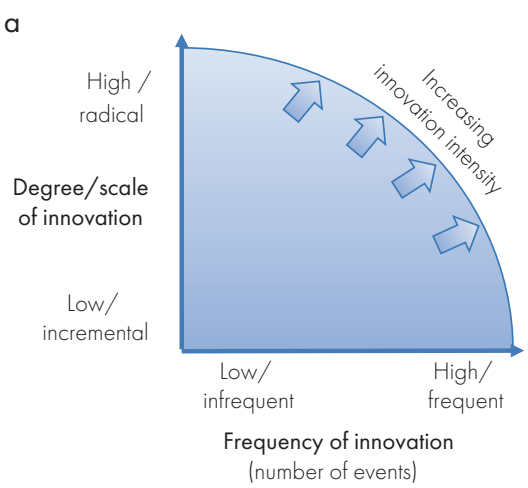


Figure 2.2a Innovation intensity (two dimensions)

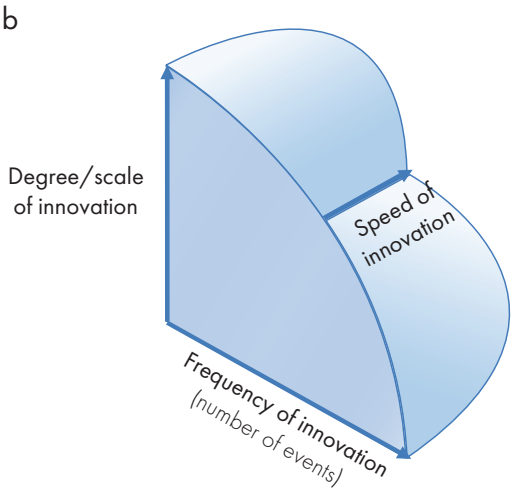


Figure 2.2b Innovation intensity (three dimensions)

Source: Burns (2020).

INNOVATION, PROFITABILITY AND GROWTH

As we have already observed, young, high-growth firms ('gazelles' and 'unicorns') are few in number but have a disproportionate importance to national economies (Autio, 2007). Definitions vary depending on how growth is measured (e.g. sales, profit, employment), but in the USA it has been estimated that they compose less than 1 per cent of all companies but generate about 10 per cent of new jobs in any year. Indeed, the top performing 1 per cent of all firms generate about 40 per cent of all new jobs (Stangler, 2010). In the UK they were estimated to represent 2–4 per cent of firms but were responsible for the majority of employment growth (Department of Business, Enterprise and Regulatory Reform, 2008). Middle-sized firms generally have a disproportionate impact on national economies. In the UK, while they represented just 1 per cent of firms they generated 30 per cent of GDP and employed more than one-third of the workforce (GE Capital, 2012). And Europe lags behind the USA, where SMEs were on average larger and expanded more rapidly (European Commission, 2008). And while a higher percentage of UK firms achieve higher growth than European firms, the UK still lags behind the USA (Department of Business, Enterprise and Regulatory Reform, 2008).

You might reasonably expect, therefore, for there to be a direct link between innovation and financial performance – greater innovation intensity leading to higher profits. You might also reasonably expect there to be a similar link with business growth – high-growth firms are more innovative than others. However, the linkages are not straightforward and finding evidence of a direct relationship is problematic because of *methodological* problems and problems surrounding the *measurement* of both innovation and growth. For example, any link with growth in profits is likely to be 'lagged', with innovation taking time – perhaps years – to feed back into growth in profits, although, as we have noted, innovation is positively associated with growth in employment (Cosh and Hughes, 2007). Then there is the issue of 'cycling' – the understandable tendency of firms to innovate in one period and then 'consolidate' in the next (Cefis, 2003) – a feature we shall return to in Chapter 18 in the context of setting strategy. Finally there is the question of causation. Even if there were an observable link, it does not necessarily prove causation: 'while small innovators may in aggregate grow faster than non-innovators this is not to suggest that innovation is a necessary, nor less a sufficient condition for growth or superior performance' (Freel, 2000).

So, with these caveats, what does the empirical evidence tell us? McGrath (2001) observed that firms following 'conventional paths' have lower financial returns, while firms taking risks have variable outcomes ranging from medium to high returns and have potential for greater long-term

profitability. Other studies have concluded that entrepreneurial risk-taking positively influences both financial performance and business growth (Dess et al., 2011; Tang et al., 2014). What is more, radical innovation leads to market domination and firm growth (Atuahene-Gima, 2005; Tellis and Golder, 2002). However, while there is some empirical support for a link between innovation and business growth (Geroski and Machin, 1992; Yasuda, 2005), a number of studies have failed to find any direct *general* relationship (Coad and Rao, 2008; Lööf and Hesshmati, 2006; O'Regan et al., 2006). You might therefore find that the evidence linking innovation with financial performance is inconclusive.

INNOVATION, FIRM SIZE AND INDUSTRY STRUCTURE

The relationship between innovation and other factors is equally complex. Just as entrepreneurs are not defined simply as owner-managers, entrepreneurial firms are not defined, necessarily, in terms of size. Schumpeter said nothing about whether innovation could be best carried out by small or large firms. To him this was irrelevant. An entrepreneur could just as easily work in a large firm as in a small one. Indeed, later in his career Schumpeter (1950) seemed to credit larger, rather than smaller, businesses more with delivering economic growth. So, is there a link between innovation and firm size?

On the face of it, empirical evidence suggests that larger firms are more likely to be innovative than smaller ones. Indeed, EU data (European Union, 2007) showed that larger firms (250+ employees) were more likely to be innovative than smaller firms (10–49 employees). Data from the UK (Robson and Haigh, 2008) showed that larger firms (250+ employees) were more likely to conduct internal research and development (R&D) and contracted-out R&D. It also concluded that larger firms were also much more likely to introduce product, process or managerial innovations than smaller firms. Large firms seem to outperform small firms where resources are important – because of capital intensity or because of scale of spending on R&D, advertising etc. In particular, they have better access to both internal and external finance than smaller companies. Indeed, for smaller companies there are just too many problems to sort out and larger firms have more resources, more money, more experience … more of everything to throw at a problem.

Overall, few small firms introduce really new products/services into their range. Even fewer introduce really new products/services into the economy as a whole. This role is more likely to be undertaken by larger firms because of the resources they command. However, small firms can, and often do, introduce products/services that are clearly differentiated from those of the 'competition', to the point where one might question whether there is any direct competition. Indeed, this ability to differentiate clearly is a major element in their success. Small firms are most likely to provide something marginally different from the competition in terms of the product/service, and thus find a gap in the market. They are also far more likely to innovate in terms of marketing and customer service (often low-cost options). However, these small innovations might be highly valued by a small group of customers and therefore highly profitable. They frequently find new routes to market first, for example 'direct' selling, via the phone, with call centres located in low-cost areas, or via the internet, offering similar advantages through the 'virtual' organisation. Small firms are often innovative in their approach to key account management and customer relationships. They find ways of networking with customers and suppliers so as to cut costs and lead times.

But studies of innovation and company size can appear contradictory. This can be because of the problem of measuring innovation. Some studies have used input measures such as R&D expenditure or number of R&D employees. However, such studies must be treated with caution because of the inability of small firms often to separate these inputs out. It has also been suggested that small firms conduct R&D more efficiently and introduce new products to the marketplace faster than big

companies. For example, a US study found that small firms produce 2.4 times as many innovations per employee as large firms (Acs and Audretsch, 1990). Other studies have used output measures such as number of patents – an accurate but limited measure of innovative activity. They can also appear contradictory because they vary across different industry sectors. Whereas large firms have greater access to resources, smaller firms have behavioural advantages – a closeness to the market, a greater willingness to take risks, an ability to act quickly. And it is in sectors or industries where these characteristics are important that small firms tend to dominate in terms of innovation.

Some industries are more innovating than others and within these industries firm size varies. And industry structure seems to have a significant influence on levels of innovation (Santarelli and Piergiovanni, 1996). Studies have concluded that innovation is less likely in more mature industries that are highly concentrated and therefore dominated by larger firms (Acs and Audretsch, 1988; Dolfsma and van der Panne, 2008; Symeonidis, 1996). Large firms are the dominant innovators in mature industries where you might speculate that the focus is on incremental product and cost-reducing process innovations. It is in new, less concentrated industries where small entrepreneurial firms are more important in terms of innovation. Robson and Haigh (2008) showed that sales from new-to-market or new-to-the-business products/services represent a higher percentage of turnover in small firms compared to larger ones.

Large firms seem to outperform small firms where resources are important – because of capital intensity or because of scale of spending on R&D, advertising etc. – although there are typically fewer smaller firms in high-capital-intense industries. Indeed, small firms generally have lower productivity than large firms. Scale and resource availability matters, particularly in industries or sectors that are facing disruption through innovation. For example, the retail sector is facing enormous disruption as online retailers compete against high-street shops. The biggest disruptor is Amazon – and it spent some $27 billion on R&D in 2018. How many retailers spent anything approaching this? For context, the pharmaceutical multinational GlaxoSmithKline spent about $5.8 billion.

The evidence on the relationship between the size of established firms and innovation is inconclusive (Brynjolfsson and Kahin, 2000). What seems clear is that innovative behaviour is not entirely related to firm size. Smaller firms seem to have advantages in some industries, larger firms in others. What we learn from looking at industries rather than just size of companies is that:

- Smaller entrepreneurial firms play a significant role introducing radical, disruptive innovation. They spot the opportunity, develop the innovation and move quickly into the market.
- Larger firms have a significant resource advantage over smaller firms and can be more productive generally. They have more resources of every kind to help with innovation and the costs of obtaining more resources are often lower than those of smaller firms. However, smaller firms use the resources they have for innovation more efficiently than larger firms.
- Smaller firms thrive in industries where economies of scale are less important to customers than other factors such as marketing, service quality or variety. While these are often niche markets, they can be highly profitable. If larger organisations wish to compete in these markets they must at least match the factors valued by the target market.
- Smaller entrepreneurial firms are less important in stable, mature, high-concentration industries where the innovation focus has switched to efficiency and cost reduction and the industry may well be approaching the end of its life.

It has been pointed out that the advantages of large firms are generally the disadvantages of small firms, and vice versa, and therefore collaboration or partnering between the two sizes of business can create powerful synergistic relationships (Vossen, 1998). Storey and Greene (2010) concluded that 'once account is taken of sector, the life cycle of the technology and the innovation rate (e.g. innovations per employee), then the small business emerges in particular sectors as key "agents of change"'.

Case insight 2.3 James Dyson (1)

Inventor and entrepreneur

James Dyson is the billionaire inventor of the bagless vacuum cleaner who challenged the market dominance of Hoover, and won. Now with sales of £4.4 billion and profits of £1.1 billion, his company designs and manufactures a range of household appliances such as vacuum cleaners, air purifiers, hand dryers, bladeless fans, heaters and hair dryers. The company, which is still privately owned, has grown so large that it now produces most of the motors for cleaners and hairdryers in the UK – one every 2.6 seconds. Dyson stepped down as chair of the Dyson Group in 2010 but still owns the company and remains involved with it (see Case insight 16.2). Dyson is the richest man in the UK, worth £16.2 billion, according to *The Sunday Times* Rich List 2020.

The idea for the vacuum cleaner came to him in 1979 because he was finding that traditional cleaners could not clear all the dust he was creating as he converted an old house. Particles clogged the pores of the dust bags and reduced the suction. He had developed a small version of the large industrial cyclone machines, which separate particles from air by using centrifugal force. He believed the technology could be adapted for the home vacuum cleaner, generating greater suction and eliminating the need for bags. Working from home, investing all his own money, borrowing on the security of his home and drawing just £10,000 a year to support himself, his wife and three children, he produced 5,000 different prototypes. However, established manufacturers rejected his ideas and venture capitalists declined to invest. Dyson was tenacious. In 1991, he took the product to Japan where it won the International Design Fair prize. He then licensed the manufacture of the cleaner to a Japanese company, where it became a status symbol selling at $2,000 a time. In 1993, he was finally able to obtain finance to manufacture the machine under his own name in the UK.

Dyson has gone on to invent and produce a number of other consumer products, not all of which were successful. The Contrarotator washing machine with its twin rotating drums was launched in 2000, and withdrawn in 2005 because it was too costly to manufacture. The Airblade hand dryer which is quicker than conventional dryers and kills bacteria and viruses was launched in 2006. The Supersonic hairdryer, Airwrap hair styler and Corrale hair straightener followed in 2016. He spent some £500 million developing an electric seven-seater SUV, the N526, capable of travelling around 600 miles on a single battery charge, only for the project to be abandoned in 2019 when it was realised that it would have to sell at upwards of £150,000 just to break even. Most commentators thought the project was unrealistic because of the high capital investment needed (Tesla invested $19 billion) and some described it as a 'vanity project' for Dyson.

Access the *Digital Links* booklet to visit the company website and watch a video outlining James Dyson's career and what he believes his company is all about.

Questions:

1. Is Dyson an inventor, an entrepreneur or both?
2. Was his development of an electric SUV the act of an inventor or an entrepreneur?

THE ROLE OF GOVERNMENT IN INNOVATION

Much of the early writings by economists completely ignored the role of governments in innovation. Ruttan (2006) argued that large-scale and long-term government investment has been behind the development of almost every general purpose technology in the last century – for example mass-production systems, nuclear power and aviation, space, information and internet technologies. Governments might provide grants for companies to undertake this research but many of these developments come out of universities and the governments' own research establishments.

Mazzucato (2018) argued that it is government that funds, if not undertakes, much of the riskiest early-stage innovation. For example in 2008 the United States federal government funded 26 per cent of US R&D compared to the private sector's 67 per cent. However, 57 per cent of this went to 'basic research' compared to 18 per cent in the private sector (the balance funded by universities and other non-profit organisations). The private sector has engaged more in the later stages of innovation but has often benefited greatly from the research initially undertaken or funded by the public sector. Mazzucato points out that Apple's highly successful iPhone and iPad capitalise on government investments in the technologies that underpin them: the internet, GPS (global positioning system), touch-screen and communications technologies. With the chances of a new drug getting to market only 0.01 per cent,

big pharmaceuticals are particularly poor at basic research, preferring instead to 'buy in' the research from small biotech firms or public labs and focus instead on the development and roll-out stages.

These views are echoed by many others. Janeway (2018) called it a 'three-player game', played between the state, investors and entrepreneurs:

'State investment in fundamental research induces financial speculation to fund construction of transformational technological infrastructure, whose exploitation, in turn, raises living standards'. Financial speculation creates and amplifies financial bubbles, which in turn may cause companies in the private sector to crash. However, this speculation is the vehicle for mobilising capital on the scale needed to finance new high-risk ventures. Janeway's 'three-player game' simply mirrors Schumpeter's 'perennial gale of creative destruction'.

In this 'game' the private sector is seen as best at commercialising opportunities. But there is a paradox in this because as firms grow they have a tendency to ignore further innovation, focusing instead on consolidating their monopoly power in their existing markets, leaving the field open to new, smaller companies led by entrepreneurs (Chapter 20). Janeway cites the example of Xerox's patented and highly profitable position in the copier market causing it to refuse to commit funds to turn invention into commercially significant innovation, which in turn led to many employees leaving to start their own businesses. For example, it was Xerox that invented, but failed to exploit, the mouse with its graphical user interface which was commercialised by Steve Jobs and Apple.

Case insight 2.4 Vaccitech

University spin-off

Vaccitech Oncology was founded as a university spin-off by two Oxford University professors, Adrian Hill and Sarah Gilbert, in 2016. It is a biotech company that develops vaccines. The company has been financed and supported by a large number of companies including Oxford Science Innovation (a partnership with the university), Google Ventures and Sequoia Capital. As of 2020 this first round of venture capital backing (called 'series A' funding) had raised £20 million.

Vaccines generally are designed to stimulate antibody responses to the infection. However, some diseases have proved stubbornly unresponsive to this approach. The researchers at Oxford found that these diseases require both a strong T cell-mediated as well as a humoral (involving antibodies in body fluids) response to be effective. Vaccitech uses viral vector technology to develop vaccines for seasonal influenza and a range of diseases such as hepatitis (HBV) and various cancers. Crucially, because of the methodology involved in producing the vaccines, once proven effective, they can be manufactured at scale very quickly. By 2020 the company was at advanced stages of testing for immunotherapeutic vaccines for both prostate and lung cancer. But 2020 saw the coronavirus pandemic and Vaccitech has been at the forefront of developing and testing a vaccine for Covid-19, alongside AstraZeneca, which was sufficiently confident of its success to put in place manufacturing facilities for the drug so as to ensure it was available worldwide by the end of 2020. Only time will tell if this important vaccine is successful, but if it is, the potential value of this company, both socially and financially, could be enormous.

Access the *Digital Links* booklet to visit the company website and watch a video explaining the work of Vaccitech.

Questions:

1. What was the role of Oxford University in launching Vaccitech?
2. Should universities generally see greater rewards for their scientific breakthroughs? If so, how could this be achieved?

INNOVATION, LOCATION AND NETWORK EFFECTS

There is evidence that innovation can be geographically concentrated in certain areas, particularly with respect to smaller firms, and this leads to 'clusters' of small firms that form mutually supportive networks. This is often referred to as 'innovative milieu' theory (Camagni, 1991; Keeble and Wilkinson, 1999). This theory is based on the assumption that knowledge is a crucial element in the process of innovation (Simmie, 2002) and, whereas large firms have their own R&D functions to help generate

this, small firms have to rely on networking and a process of 'socialisation' that allows them to collect information and accumulate knowledge (Capello, 1999). Geographical proximity facilitates this process of knowledge transfer, and hence these clusters of small firms can be observed (Keeble and Wilkinson, 1999; Porter, 1998b).

Within these clusters, where there is the development and sharing of a common base of knowledge, 'collective learning' is taking place. This allows the firms to coordinate their actions so as to solve the technological and organisational problems they face (Lorenz, 1996, quoted in Keeble and Wilkinson, 1999). 'Collective learning' can be either conscious – as in research collaborations – or unconscious. Unconscious learning occurs where the skills and knowledge are vested in a workforce that is shared between the small firms. These clusters therefore attract similar small firms because it is a low-cost way of gaining knowledge. The newly fast-developing 'fintech' industry in the UK, which offers various forms of crowdfunding, is predominantly located around Canary Wharf in London (see Chapter 19).

More recently the interest in geographic location has focused on high-technology industries. The importance of these industries is underlined by the fact that investment in so-called 'intangible assets' such as computer codes, copyrights and patents is now 50 per cent higher than investment in tangible assets such as plant and machinery, and it is increasing. While the USA has its own Silicon Valley, Cambridge in the UK is home to a number of high-technology clusters and is an example of both types of learning. In computing, not only are there research collaborations between Cambridge University and the firms in the cluster, but there is also a skilled workforce graduating from the university and a group of academics willing to work part time with them. Such is the strength of the cluster and importance of the university that Bill Gates endowed it with sufficient funds to finance state-of-the-art computer laboratories. Universities generally are seen as an important source of knowledge and therefore important to the development of clusters, hence the various initiatives to encourage them to work more closely with industry. Universities generate 'public knowledge' and this 'spills over' into the commercial world through conferences and seminars, consultants, the personal networks of academics and industrial researchers (MacPherson, 1998), and commercial spin-offs (Mitra, 2000). This has been the reason for developing 'incubator units' and science parks for technology-based SMEs, often located adjacent to universities.

Florida (2002; Florida and Tinagli, 2004) argued that some locations – particularly cities like London or Barcelona – attract talented, creative people he called 'the new creative class' and these people, in turn, attract creative, innovative firms. He claimed that rather than people following jobs, the jobs will follow people with the appropriate talent, creating a virtuous circle of economic growth. He asserted that the ability to compete and prosper in the new global economy 'increasingly turns on the ability of nations to attract, retain and develop creative people', arguing that this new 'creative class' is drawn to a particular sort of place: 'open, diverse communities where differences are welcome and cultural creativity is easily accessed'. Florida argued that it is tolerance that attracts the creative class and they have the talent to develop new technologies. He observed that new knowledge-based economies thrive in locations and countries that combine these three elements – technology, talent and tolerance – to provide economic growth in the way shown in Figure 2.3.

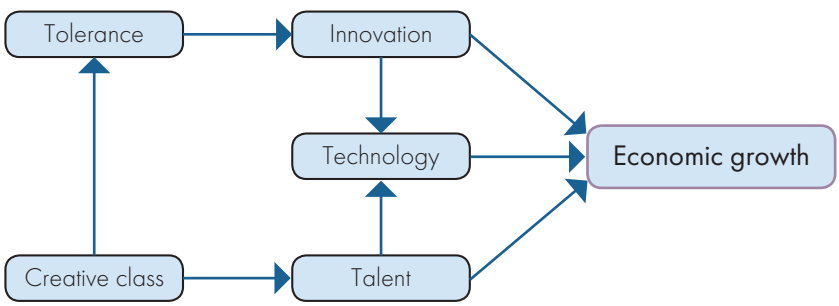


Figure 2.3 Technology, talent, tolerance and economic growth

Source: Florida and Tinagli (2004), p. 12. Reproduced with permission.

These clusters may well generate a culture or subculture that encourages creativity, innovation and entrepreneurship, and underlying the culture is a process of networking and information exchange that encourages knowledge transfer and 'spill-overs'. As we shall see in Chapter 4, networking – in all its different ways – creates 'connectivity' and underpins creativity (Johnson, 2010). The idea is that innovation is not about a 'eureka' moment but more about the recombining of pre-existing ideas to create something new. Essentially this is a social process where strangers, different cultures and disciplines meet which exposes people to new ideas, information and knowledge from diverse networks of sources. Ridley (2020) framed this idea more broadly, saying: 'Innovation happens when people are free to think, experiment and speculate', agreeing that it was more likely to happen in cities, but observing that this is where there is also trade and finance to take these innovations to market.

A creative environment is one where individuals from different disciplines with diverse ideas come into contact with each other almost serendipitously. Stimulation is continuous and contagious. Inventors meet entrepreneurs and financiers – each stimulated by the other. But you need the right environment for it to take place. Johnson uses the coral reef as the analogy for the perfect creative environment and how it encourages connectivity. The coral reef is a huge diverse ecosystem where, despite competition for resources, existence is dependent on cooperation and everything is recycled on a matrix of calcium carbonate built up by the coral. Johnson makes the point that invention is time and environment dependent. It depends on the right circumstances that give it the possibilities. So the internet depends on computers, microwave ovens depend on electricity and people depend on their environment.



Source: Getty Images/Georgette Douwma

Saxenian (1994) suggested that the success of Silicon Valley in California had a lot to do with the way entrepreneurs developed social networks, creating a decentralised, cooperative ecosystem that encouraged the exchange of ideas, learning and economic growth. She put this down, in part, to the geographic proximity of firms. This encouraged entrepreneners to mix and mingle, particularly in leisure and social venues. For example Steve Wozniak (who came up with the idea for the Apple microcomputer) met Steve Jobs at the Homebrew computer club where computer hobbyists congregated. Saxenian observed that these sorts of places have played a pivotal role in innovation from the social clubs of the Scottish Enlightenment to the coffee houses of nineteenth-century Vienna. She contrasted the success of Silicon Valley to the decline of the tech firms along Route 128 in Massachusetts, USA, despite its technological dominance at the time (it was home to Microsoft). She put this down to the lack of an ecosystem due to firms being isolated along the lengthy Route 128, meaning that firms were independent and self-sufficient. At the same time people did not circulate and meet. As a result ideas and learning did not circulate and spill over. Syed (2019) later noted how 'cognitive diversity' – the openness to and interaction of different ideas and views – was an important driver of innovation – a topic we shall return to in the next chapter when we look at the mindset of entrepreneurs.

Networks can also be a way of meeting potential partners. Partnerships, strategic alliances and joint ventures are ways of mutually exploiting business opportunities where a firm may not have all the skills or resources necessary. Numerous academic studies have shown that there are real benefits from strategic alliances and partnerships for organisations of all sizes. For example, alliances can create economic advantage by leveraging market presence (Lewis, 1990; Lorange and Roos, 1992; Ohmae, 1989). And, as we have noted, high-growth firms rely heavily on building relationships with other firms, either through supply chains or formal strategic alliances (Department of Business, Enterprise and Regulatory Reform, 2008). It will be interesting to see how far the internet, which facilitates 'global connectivity', affects the formation of geographic clusters in future years.

Explore further 2.1

Innovation, location and network effects

Access the *Digital Links* booklet to watch a video showing how London promotes itself as a center for innovation because of its attractiveness to entrepreneurs.

Case insight 2.5 Astex Therapeutics

Location and innovation

Astex Therapeutics was set up in 1999. It was founded by Dr Harren Jhoti, who left GlaxoWellcome (now GlaxoSmithKline), and two University of Cambridge professors – Chris Abell and Sir Tom Blundell. Located in Cambridge, UK, the company focused on the discovery and development of drugs, particularly in the area of oncology, using a technique called 'fragment-based drug discovery' – a technique pioneered by the founders and dubbed 'Pyramid'. It was partially seed-funded by the University of Cambridge and raised nearly £100 million of venture capital funds, working in partnership with larger pharma companies to develop a number of new drugs.

In 2011 it merged with a NASDAQ-quoted US company called Supergen, who then closed its US laboratory and concentrated its research in Cambridge, UK, where some 80 people were employed. Astex became a US-quoted company with James Manuso of Supergen as chairman and CEO until 2013 when it was bought by a Japanese pharmaceutical company called Otsuka for approximately $900 million. Its research and headquarters still operate from Cambridge with Harren Jhoti as President and CEO.

Access the *Digital Links* booklet to visit the company website and watch a video explaining the work it does and its links with Cambridge University.



Source: Courtesy of Astex

Questions:

1. How important was the link with Cambridge University for Astex when it started?
2. In the age of the internet, how important is geographic proximity to sources of knowledge in encouraging innovation? Explain.

SOCIAL AND ENVIRONMENTAL INNOVATION

Innovation need not be just about economic or monetary benefit, as traditional economists might define it. Innovation can contribute just as much to social and environmental well-being. Indeed, the two can go hand in hand, with changes in business processes leading to increased profit. The Bureau of European Policy Advisors defined social innovation as those that involve 'new ideas (products, services and models) that simultaneously meet social needs (more effectively than alternatives) and create more social relationships or collaborations … they are innovations that are not only good for society but also enhance society's capacity to act' (Bureau of European Policy Advisors, 2011).

Economists such as Raworth (2017) see social and environmental innovation becoming the norm with industrial manufacturing beginning on a 'metamorphosis from degenerative to regenerative design'. In this way, products become part of a circular economy which makes greater use of naturally renewable materials and repairs, and reuses, refurbishes and recycles existing products so as to recapture value at each stage of decomposition. Innovation can include the development of business models that include this concept of regenerative design. Raworth defined economic well-being far more broadly to encompass monetary, social and environmental well-being, saying that 'the business of business is to contribute to a thriving world'.

To be innovative a social enterprise must find ways of 'adding value' to existing structures by doing things differently or more effectively so that the added value can be applied to its objectives. Those objectives might be social or environmental but might also involve commercial objectives, at least as a constraint. And one of the added-value characteristics of successful social enterprises is their ability to network and mobilise a wide range of supporting resources, often at a low cost, in a way that an organisation with purely commercial objectives may not be able to do. These resources can then be brought together to enable the launch of the new social or environmental initiative. We look at how this might be achieved in Chapter 4. Entrepreneurial philanthropy has also long been a vehicle for social and environmental innovation (see Chapter 20).

The UK has a long history of voluntary and charitable involvement in community and social initiatives. The social entrepreneurship movement has called for these partnerships to take an even wider form, linking the public, social and business sectors to reconstruct welfare provision. This would involve not-for-profit organisations undertaking entrepreneurial ventures and the pooling of government welfare funding under the control of local communities. In an early call for a different approach, Leadbeater (1997) said what was needed was a 'new philosophy, practice and organization' of social welfare with social entrepreneurs in a pivotal role pushing through innovations. He concluded that the UK social welfare system was in need of radical reforms that empower disadvantaged people and encourage them to take greater responsibility for, and control over, their lives.

In the USA, the not-for-profit sector is much larger than in Europe, probably twice the size of that in the UK. Philanthropy, or charitable giving, is also far larger and better established, and the so-called 'welfare state' is an anathema. It is not surprising, therefore, that in the USA there is a subtle shift of emphasis towards the entrepreneurial management of not-for-profit organisations and how they compete for funds. Boschee (1998) talked about a 'tectonic shift' in the way that not-for-profit organisations saw themselves and were funded. Brinckerhoff (2000) actually said that social entrepreneurship was becoming one of the essential characteristics of successful not-for-profit organisations.

PUBLIC POLICY TOWARDS SMEs

As we have observed, entrepreneurship and innovation are seen to encourage economic growth, despite the direct linkage being unclear, and successive governments around the world have been keen to craft public policies that encourage both. But can and should governments intervene, or should they just leave things to the invisible hand of the market? Casson et al. (2008) observe that entrepreneurship flourishes in liberal market economies that exhibit some or all of the following characteristics:

- Ownership rights for private property;
- Freedom of movement and association;
- Confidentiality specifically of business information;
- Protection of intellectual property rights;
- Access to impartial and competent courts to enforce these rights;
- A stable currency based on prudent control of the money supply;
- Democratic, stable government;
- Openness to immigration by entrepreneurs and skilled workers.

Given the existence of a liberal market economy, economists would generally say that 'market failure' is a necessary but not a sufficient condition for further government intervention and is therefore only justified when its societal benefits outweigh its costs. Market failure results in resources not being allocated efficiently or in a socially just way. Examples of market failure might include the inability of individuals to accurately assess the private benefit to them of starting their own business; the inability of financial institutions to offer finance to SMEs, for example because of their inability to accurately assess the risk of lending (see Chapter 19); the over dominance of large firms in some markets to the extent that competition is suboptimal (monopoly or oligopoly power). Policies would then be developed to address the identified market failure(s) and assessed to find those that provide the greatest net societal benefit. Nevertheless, it is also true that policies can be the result of political lobbying rather than economic analysis.

Notwithstanding this, government economic policy in most countries tries to encourage the start-up, survival and growth of SMEs. They do this because of start-ups' ability to generate jobs (particularly when large firms might be shedding them) and the ability of entrepreneurs to increase innovation and improve productivity and growth (Van Praag and Versloot, 2007). It might also have something to do with owner-managers being a powerful political constituency. These policies generally fall into six categories:

- The regulatory framework – All forms of taxation and social security; health and safety regulations; product/service and labour market regulation; bankruptcy regulation; as well as administrative burdens associated with market entry or growth (often referred to as 'red-tape').
- Entrepreneurial capabilities – Business education and skills training; entrepreneurial training; advice and mentoring; and the general entrepreneurial infrastructure.
- Enterprise culture – A wide range of influences on attitudes towards entrepreneurship and risk-taking. Policy initiatives might be targeted at the unemployed, young or the general public, ethnic minorities etc. and are often linked to initiatives to improve entrepreneurial capabilities.
- Access to finance – Grants; access to debt finance (through banks and crowdsourcing), including issues of collateral such as loan guarantee schemes and credit unions; micro-finance; equity finance (crowdsourcing, business angels and venture capital); as well as stock markets (see Chapter 19).
- R&D and technology – R&D investment grants and incentives such as tax credits; university/industry interaction, including business incubators and accelerators; technology diffusion; technology cooperation between firms; broadband access; intellectual property recognition.
- Market conditions – Competition policy and anti-trust laws including issues about access to domestic and foreign markets; government procurement policies; government subsidies and nationalisation of business.

In times of recession, encouraging start-ups is often seen as a way of reducing unemployment. Using the framework above, governments may wish to influence this by improving entrepreneurial capabilities and access to finance. They may be offered grants, 'soft loans' and training and advice as inducements. However, the 'salary-substitute' wage these businesses generate will often still be below the salary it substitutes, and self-employment is inherently risky because many firms do not survive long and few grow to any size. As a result these entrepreneurs may drift back into employment as the economy improves. In times of economic growth, when unemployment is low, public policy might shift towards raising productivity and innovation. Using the framework above, the focus might shift to encouraging R&D and technology and improving market conditions through competition policy.

SME policies are often linked with regional policies, usually in disadvantaged, high unemployment areas (e.g. enterprise zones, tax breaks, training etc.). However, there is evidence that the effects of these policies can be temporary and result in displacement of business from one location to another rather than the creation of new businesses (Givord et al., 2018; Neumark and Kolko, 2010). At this point it is interesting to return to the work of Florida (2002) on how to encourage clusters of firms that are creative. The cities around which these are often based are at the heart of successful contemporary economies. The implication

of Florida's work is that countries need to attract creative people in order to attract creative, innovative companies and encourage that virtuous circle of economic growth. He claimed that this is achieved by fostering a culture of openness and tolerance and that he found a strong relationship between openness to different communities, such as gays, bohemians and immigrants, and the ability of cities and regions to innovate, generate high-technology industry and secure high value-added economic growth. It is not that these groups create the economic growth, rather that their existence is a proxy that indicates something about the culture of the larger community that encourages growth – one that is open to new people and new ideas. Florida's work is controversial not least because of the implications across a wide range of public policies, including immigration. The work also has implications for city planners as they try to mirror the sort of environment these people like – with space for interaction like parks, cafés and small shops and with streets that are safe for these activities to take place.

POLICY INTERVENTION

As you would expect, governments in different countries take different views about policy interventions, reflecting their view of the role of government generally. Dennis (2004) provides a useful framework for looking at this based on the degree of intervention – both assistance and impediments – that a government might be willing to make (Figure 2.4). This generates four policy options that he calls 'compensating', 'competing', 'nurturing' and 'limiting'. Highly interventionist governments like those in the EU are willing to put impediments in the way of SMEs by way of rules and regulations, but at the same time will 'compensate' them by offering direct assistance in many different forms. By way of contrast, non-interventionist (or free-market) governments like that in the USA may offer little direct assistance but at the same time have very low impediments (except with regard to minority rights and the promotion of technology businesses) – called 'competing'. 'Nurturing' countries, like Canada and New Zealand, offer few impediments but many direct publicly funded incentives and assistance for SMEs. 'Limiting' countries, like many African, East European and South American countries, create high impediments to SMEs but offer little assistance. One major impediment in developing countries is lack of property rights which impedes ownership of both physical and intellectual assets and, at the same time, restricts borrowing potential.

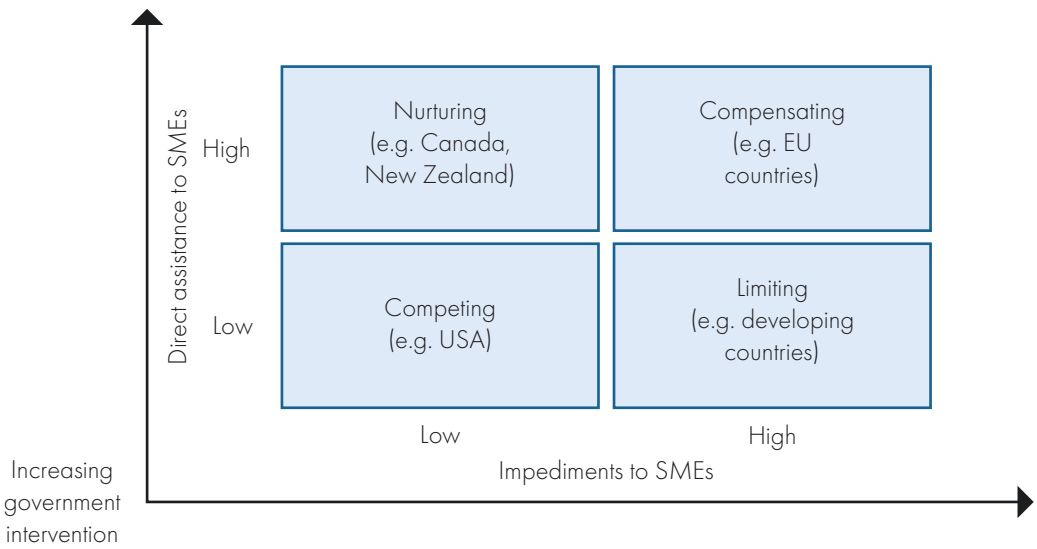


Figure 2.4 SME policy intervention framework

Source: Adapted from Dennis (2004).

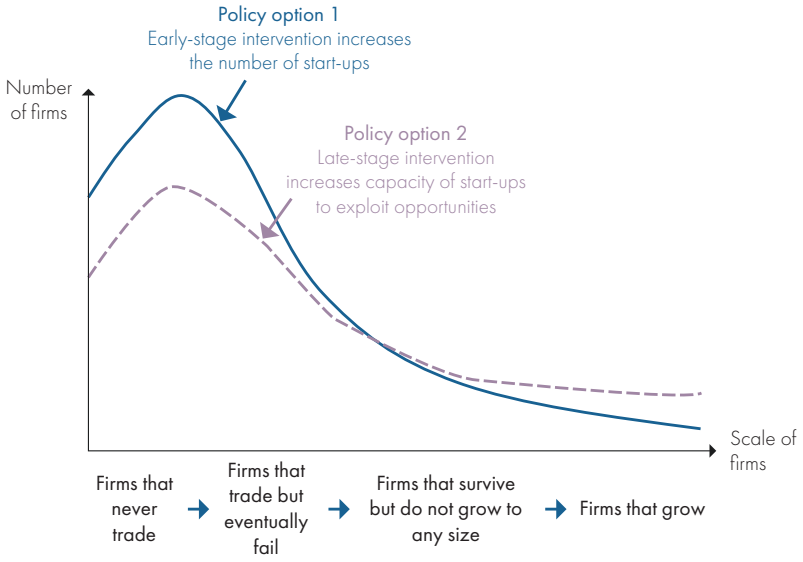


Figure 2.5 Policy options: Start-ups of growth firms

Source: Based on Figure 1 in Jovanovic (2001). With permission of Boyan Jovanovic and the American Economic Association.

Hölzl et al. (2006) provide a stylised typology (adapted and shown in Figure 2.5) for looking at the issue of whether governments should simply encourage more start-ups (Policy option 1) or increase the capabilities of existing SMEs (Policy option 2). The horizontal axis depicts the degree of success of the firm measured by their scale, and the vertical axis represents the number of firms achieving each stage. The strongly skewed shape of both curves reflects the decreasing number of firms that move from the idea stage to become growth businesses. There are many prospective entrepreneurs (latent or nascent), somewhat fewer actual start-ups, many of which fail, sometimes quickly. Even fewer firms will survive but not grow to any size and fewer still will go on to become growth businesses.

Policy option 1 (blue line) encourages more start-ups – converting more prospective entrepreneurs to actually 'take the plunge'. But this policy is likely to lead to many firms never actually trading and then more failing shortly after launch. In contrast, Policy option 2 (dashed line) diverts resources from encouraging start-ups to increasing the capabilities of surviving firms to exploit opportunities and grow. This is likely to lead to fewer start-ups but, more importantly, more firms that survive and grow. Which policy a government selects depends on their objectives and the shape of the two curves. There is also the issue of how you select surviving SMEs for Policy option 2, since most policy advisors would be sceptical about the ability of governments to 'pick winners'. However, as with so many things in the real world, it is usually not a question of 'either/or', but rather what balance is the right balance between the two policies.

THE EFFECTIVENESS OF POLICY INTERVENTION

This brings us to the issue of whether these sorts of policy interventions are effective or value for money to the taxpayer. Here we must distinguish between the micro-level interventions, like advice and assistance for SMEs, and the macro-level interventions, like taxation and regulation that affect the whole economy. We must also remember that policy effectiveness is determined, not only by the choice of policy, but also by how effectively that policy is delivered – a factor too often forgotten.

Most academics would seem unconvinced by the arguments for government micro-level intervention to encourage SMEs, observing that there is little evidence of success (Bill et al., 2009; Bridge and O'Neill, 2012; Davidsson, 2008; Storey and Greene, 2010). For them, governments cannot justify policy interventions related to provision of finance, training, advice and assistance etc. for particular groups or the general creation of an 'enterprise culture' – either in terms of effectiveness or value for money. The exception might be intervention to support technology businesses in terms of R&D and innovation because of information and knowledge imperfections. They might also agree

Case insight 2.6 Small Business Innovation Research initiative

SME R&D support

Launched in 2017, Ireland's Small Business Innovation Research (SBIR) initiative aims to encourage innovation in the Irish public sector by facilitating engagement with tech-based SMEs. It funds public bodies to purchase research to stimulate innovation, when goods or services are not available in the marketplace. It does this through a process that starts with public sector bodies identifying a number of 'challenges' where it is believed that there are technology-based solutions. The SBIR initiative brings these public sector bodies together with SMEs with relevant expertise. It then funds up to six companies to undertake a technical feasibility study to better understand the challenge and identify potential solutions. A smaller number of selected companies are then funded to prototype a specific solution to the challenge.

For example, one of the challenges set in 2018 was to address the problem of illegal dumping and fly-tipping by exploring a range of low-cost tech solutions. The cost of illegal dumping across the Dublin region was more than €1.5 million per annum, despite numerous campaigns from local authorities. The SBIR initiative brought together a number of companies, each offering different approaches to solving the problem. The public sector 'client' was Dublin City Council through Smart Dublin. Cobalt ID offered a data analytics approach that analysed data and predicted where dumping was most likely to take place so that preventative measures could be taken. Evercam provided intelligent, internet-linked, battery-powered cameras that are activated only when dumping is taking place. The algorithm used in this system was later sold to other cities based upon the success in Dublin. Sytango provided a platform that allowed drones to be deployed quickly by the local authority for tracking purposes or to explore the extent of the dumping problem.

Each year new challenges are presented. One 2020 challenge, with a budget of €240,000, was to develop a closed-loop reuse system for soft plastic waste, initially focused on reducing plastic waste from school lunches.

Not only does the SBIR initiative bring technological solutions to the public sector which may be more efficient and effective than existing practices, it also introduces SMEs to new markets in the public sector – funding their engagement – and encourages them to develop new products or services that can then be offered to a wider audience.

Access the *Digital Links* booklet to visit the SBIR website and watch a video explaining the initiative.

Questions:

1. What are the benefits of the SBIR initiative?
2. Why is it being funded?
3. How would you describe this sort of policy intervention?

with the case for a publicly funded loan guarantee scheme for SMEs for similar reasons. Both cases involve market imperfections caused by information asymmetry (Chapter 19). However, we must remember that we live in a political economy and SMEs can be an effective political constituency in arguing for special treatment.

By way of contrast, most academics would agree that broader macro-economic policies that encourage a stable but growing economy, such as taxation, regulation and competition policy, can have a powerful effect on SMEs and particularly high-growth businesses, simply because they affect the economic environment in which they and all other businesses operate, and particularly because of the degree of uncertainty faced by SMEs (Storey and Greene, 2010). This is particularly the case in developing countries.

Low tax rates (particularly capital gains tax)

These are often assumed to encourage SMEs, and would seem to be associated with a high proportion of 'super entrepreneurs' (millionaire entrepreneurs) within an economy (Sanandaji and Sanandaji, 2014).

Regulation

This is often seen as particularly onerous for SMEs, imposing burdens, costs and constraints on SMEs (e.g. Fletcher, 2001; Kitching, 2006, 2007). Some academics agree that there is a special case for deregulation for SMEs. Sanandaji and Sanandaji (2014) see low regulation as also being associated

with a high proportion of 'super entrepreneurs' within an economy. However, it has also been claimed that regulation does not necessarily constrain SME activity and performance and that it could create opportunities and enabling activities that might improve performance, depending upon the indirect reaction of other stakeholders – customers, suppliers, competitors, infrastructure providers and regulatory authorities (Kitching et al., 2013).

Competition policy

One example of regulation that might assist SMEs is in the area of competition policy. This is seen as a way of addressing 'market failure'. Market entry and exit barriers can lead to monopolies or oligopolies developing and other information or knowledge imperfections. Although the prime beneficiary of competition policy is consumers, SMEs can also benefit if they are affected by 'unfair' competition. This can be particularly the case in the provision of finance but also may apply to government procurement.

There is often a heated debate about immigration into particular countries. However, policies around this controversial area do affect entrepreneurial capabilities because, as we shall see in the next chapter, immigrants are often more entrepreneurial than the indigenous population. The problem is that, while high levels of immigration would seem to have a positive influence on entrepreneurship, they also have many other social and economic effects.



Bonus Case



UK mergers and acquisitions policy

Visit the companion website at www.bloombury.pub/burns-esb-5e to access this bonus case.

SOCIAL ENTERPRISE POLICY

Governments have many motivations for encouraging social enterprise. These include tackling social and environmental challenges, increasing levels of enterprise (particularly in developing economies), developing ethical markets and public sector reform. Among other things, the UK government sees social enterprise as part of its strategy for tackling long-term levels of deprivation and high rates of social exclusion. In 2001 it launched the Social Enterprise Unit within the Department of Trade and Industry. This evolved over the years to become the Office for Civil Society (OCS), part of the Department for Digital, Culture, Media and Sport). It is responsible for policy relating to young people, volunteers, charities, social enterprises and public service mutuals (used to spin out government services) and is responsible for maintaining the regulatory environment through the Charity Commission. The priorities for the OCS have changed with different governments, although its enduring policy has been to encourage a culture of social enterprise, providing advice and information and improving access to finance for social enterprises. In 2018 it published a civil society strategy (Department for Digital, Culture, Media and Sport, 2018).

The issue with social enterprises is that the diverse nature of the motivations for encouraging them can sometimes appear altruistic, indeed naive, while sometimes they appear highly political. For example, many people see the attitude towards social enterprise by the UK government as a means of reducing the size of the public sector – a way of reducing public sector expenditure, rather than increasing public good. The spinning out of government services has also been accompanied by reductions in government support. As a result, sometimes services have deteriorated and some of the organisations taking over these services have struggled to survive. Some charities have withdrawn from offering these spun-out services and some organisations have even closed. For social enterprise to work there does need to be a mutuality of interest and motivation to increase public good. And where government is the major funder of the service this can create a very real tension.

At the root of this tension is the fact that social enterprises of any sort cannot be relied upon to deliver social objectives as a matter of policy because they rely too much on the philanthropic motives

Case insight 2.7 Seven Stories

Social enterprise

The Seven Stories, otherwise known as the National Centre for Children's Books, is based in Newcastle upon Tyne and is the first museum in the UK wholly dedicated to British children's books. It was founded by Elizabeth Hammill and Mary Briggs with the help of many authors, illustrators, publishers, teachers and librarians. They wanted to inspire local children to love books. The aim of the centre is to collect, champion and celebrate children's literature and, in doing this, make a real difference to the children and families living nearby by improving childhood development and raising aspirations. It houses the archives of some famous children's authors. What spurred them to action in the 1990s was the sale of original manuscripts and illustrations of some of Britain's most influential authors to overseas collectors and institutions. There was nowhere in Britain that saw its role as protector of this literary heritage for children. In 2002 the charity purchased a semi-derelict seven-storey Victorian warehouse in the Ouseburn Valley, about half a mile from Newcastle city centre, and set about repairing and redeveloping it. The project cost £6.5 million and was financed by grants from Newcastle City Council and Arts Council England, as well as donations from many other trusts and individuals. It opened in 2005. Since then it has won many awards for its work around children's literature

The centre is a not-for-profit charitable trust governed by a board of trustees. It is run by 44 paid staff – paid for through grants, donations and self-generated income – and some 50 volunteers. It provides some 40 work placements annually. The centre has exhibitions of books, drop-in family activities, storytelling, author and illustrator events – all intended to bring children's books alive – open to families and school



Source: © Damien Wooten

parties. The museum charges for entry and has over 70,000 visitors annually. It works with over 50% of the schools in the north east of England and 85% of schools in Newcastle. It has over 10,000 school visitors annually and reaches another 12,000 children, young people and adults each year through its outreach work in schools and communities. It works with vulnerable children and families through partners such as Action for Children, St Oswald's Hospice and local children's centres.

Access the *Digital Links* booklet to visit Seven Stories' website and watch a video introducing you to the charity and taking you on a tour of the building.

Questions:

1. What might trigger innovative social initiatives?
2. What are the barriers to social innovation and how might they be overcome?

of individuals and/or governments. It has also been pointed out that, unlike its commercial counterpart, no economic case in terms of efficiency can be made to support a shift to social entrepreneurship and the market is not a legitimate benchmark to justify changes from a rights-based welfare system (Cook et al., 2003).

Eikenberry and Kluver (2004) were particularly concerned about the problems of what they call 'the methods and values of the market' being applied in both the public and the not-for-profit sector and the detrimental impact upon democracy and citizenship in the USA. They put their point strongly:

> For the public sector, an emphasis on entrepreneurialism is incompatible with democratic citizenship and its emphasis on accountability and collective action for the public interest (Box, 1999; Box et al., 2001; deLeon and Denhardt, 2000; Denhardt and Denhardt, 2000; King and Strivers, 1998). Furthermore, the market model places little or no value on democratic ideals such as fairness and justice (Terry, 1998). For the non-profit sector, marketisation trends such as commercial revenue generation, contract competition, the influence of new and emerging donors, and social entrepreneurship compromise the non-profit sector's civil society roles as value guardians, service providers and advocates, and the builders of social capital.

The problem then is the mixing of social and economic objectives. There is no accepted framework to measure the two together and, in particular, the trade-off between them. What is efficient economically may be ineffective socially and vice versa, but where does the acceptable trade-off lie, and who decides? Social enterprises can therefore all too easily avoid rigorous monitoring both because of the lack of an accounting framework and because of the complexity of the interests of their diverse stakeholder base. In the commercial world it is simple. Owners generally look to get the maximum financial return on their investment and if a sole owner has different, perhaps lifestyle, objectives, they have no other owners who can object to their decision. Traditionally economists have told us that in a free and efficient market these entrepreneurial motivations maximise the financial returns for society. However, some economists believe that these motivations need to be modified for the good of society and the environment and have provided a framework for doing so (e.g. Raworth, 2017). Whether this is ever implemented is another matter, but the threatening environmental and climate crisis may change this.

SUMMARY

- Many politicians would claim that the growth of small firms is a manifestation of the success of free-market capitalism, 'despite the fact that' Marxist theory does seem to be able to accommodate it. But while industrial economists would have little to say to explain the phenomenon, labour economists and psychologists have been more successful by looking at the influences on self-employment.
- It was Schumpeter who first linked entrepreneurs with economic growth through innovation and 'creative destruction'. Historically there have been cycles of innovation that disrupted economies, causing rapid growth. These are usually technology-led and facilitated by entrepreneurial activity.
- Theories of 'industrial evolution' link entrepreneurship and economic growth through the tendency of entrepreneurial companies to increase competition, make the most of knowledge spill-overs and create increased diversity.
- Innovation can take three forms: product/service, process and/or market innovation. To be successful it must be linked to customer demand.
- Innovation is difficult to define. It is about doing things differently. Although scale of innovation is important, competitive advantage can equally be gained by frequent, incremental innovations – a strategy that is less risky and from which the majority of commercially significant innovations have come. It is scale and frequency of innovation that combine to produce competitive advantage (innovation intensity).
- Basic research is often the source of innovation and this is mostly undertaken or paid for by government. Entrepreneurs mainly take these innovations to market, spotting or creating market opportunities.
- Social enterprises often use social innovation to achieve their objectives.
- Finding evidence of a relationship between innovation and business growth is problematic. Indeed, relationships between innovation and other factors would seem to be complex. The rate of innovation (however measured) seems to vary between firms of different size, across industries and sectors depending on industry age and stability, and even location.
- Small firms produce more than their fair share of innovations and seem to do it more efficiently than large firms. However, they tend to do this in sectors where resources, in particular capital, are less important. Innovation is not entirely related to firm size. It also relates to business activity, industry, nature of innovation and the type of company. Small and large firms have advantages in producing different types of innovation.
- Geographical proximity facilitates the process of knowledge transfer, and hence clusters of small firms can be observed, sharing 'collective learning' either through conscious or unconscious mechanisms. This underlines the importance of networks.
- Government economic policy in most countries tries to encourage the start-up, survival and growth of SMEs. However, most academics would conclude that there is little evidence of the effectiveness or value for money of micro-economic policy interventions. By way of contrast, most would agree that the broader macro-economic policies of taxation, regulation and competition policy can have a powerful effect.
- Governments have encouraged the development of social enterprises through legal and taxation changes and the provision of advice and finance, although the motivations for this can be diverse.

» A major issue with social enterprises is that they cannot be relied upon to deliver social objectives as a matter of policy because they rely too much on the philanthropic motives of individuals or governments. There is also the issue that, while commercial entrepreneurs operating in a free and efficient market might maximise the financial returns for society and generate economic growth, there is no such theoretical framework for social entrepreneurs that guarantees maximisation of social returns.

GROUP DISCUSSION TOPICS

1. What is innovation?
2. What are the differences between creativity, invention and innovation, and what are the links with entrepreneurship?
3. Assess the case for frequent incremental innovation rather than infrequent radical innovation. Are the two mutually exclusive? How can these be measured on Figure 2.1?
4. Assess the advantages and disadvantages small firms have over large firms in innovation, and vice versa.
5. Discuss the effect the internet might have in changing the nature of the geographic 'clusters' of high-tech SMEs.
6. Should the government obtain a 'return' from its funding of basic research? If so, how can this be achieved?
7. Discuss the ways entrepreneurship can help stimulate economic growth.
8. Assess the case for encouraging entrepreneurship. List the ways this might be achieved.
9. Discuss whether government policy should encourage start-ups and the growth of SMEs. If you believe it should, suggest specific policy interventions. If you do not, outline the role government intervention should take (if any).
10. Assess the case for all undergraduates undertaking enterprise courses at university.
11. Make the case for and against supporting female and/or minority entrepreneurship.
12. Discuss the arguments for and against business regulation.
13. Discuss the arguments for and against lower taxation for SMEs.
14. Discuss the reasons why a social enterprise needs to be socially innovative. Provide examples of what this means and how it might be achieved.
15. How do you undertake social and environment innovation if there is no commercial benefit?
16. Are social and environment objectives compatible with commercial objectives?
17. Discuss whether government policy should encourage the start-up and the growth of social enterprises.
18. Discuss whether or not social enterprises should undertake activities that the state normally has responsibility to deliver.

STUDENT ACTIVITIES

1. Research the government's current policies to encourage start-ups and the growth of SMEs, distinguishing between micro- and macro-economic policies. Compare these to the policies you advocated in Discussion question 9.
2. Research the government's current policies to encourage the start-up and growth of social enterprises.

3

THE ENTREPRENEURIAL MINDSET



Source: Getty Images/iStockphoto/Halfpoint

Contents

- Mindset, character traits and cognitive theory
- Character traits of entrepreneurs
- Evidence on the character traits of entrepreneurs
- Measuring entrepreneurial tendency
- Cognitive theory and behaviour
- Cognitive theory and entrepreneurial behaviour
- Influences on cognitive behaviour
- The influence of national culture
- Cultural influences on creativity
- Measuring cultural influences
- Summary
- Group discussion topics
- Student activities

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand the entrepreneurial mindset and how it is formed;
- Understand how character traits are developed and critically assess trait theory;
- Understand how cognitive theory explains some entrepreneurial behaviours and tendencies;
- Critically assess your character and whether you have entrepreneurial traits.

Case insights

3. 1 Julian Thomas and Figaro Brands (1)

3. 2 Adam Schwab and Lux Group

3. 3 Issam Al Harthy and United Events

3. 4 Jack Cator and Hide My Ass!

Explore further links

3.1 The Five-Factor personality test

3.2 General Enterprise Tendency (GET) test

3.3 Bias in decision-making

3.4 Entrepreneurs – born or made?

3.5 Meyer's culture assessment tool

MINDSET, CHARACTER TRAITS AND COGNITIVE THEORY

This chapter is about the cognitive and behavioural theories that underpin entrepreneurship. Mindset represents the cognitive processes activated by a person when undertaking a given task (French, 2016). Elements of our personality (qualities we exhibit externally – who we seem to be) and character (the inner beliefs that define how we act – who we really are) predispose us towards mindsets which lead us to certain ways of thinking, behaving and decision-making. Our personality traits are 'stable qualities that a person shows in most situations' (Coon, 2004). They reflect who we are (or appear to be) and how we act. Personality and character traits might in part be both inherited and shaped by the environments that we grew up in through our learned behaviour. Whereas personality traits might change over time, character traits are more enduring and difficult to change. Character traits distinguish our mental and moral characteristics – how we respond to a given situation.

There is strong empirical support for the view that competitive advantage and above-average financial performance stem from high levels of entrepreneurship in business (e.g. Fuentes and Gomez-Gras, 2011; Lee and Chu, 2011). Little wonder, therefore, that entrepreneurship is now encouraged and an 'entrepreneurial mindset' prized. The term 'entrepreneurial mindset' refers to the cognitive processes that are reflected in the conscious behaviour, decisions and approaches to management of an entrepreneur. For an entrepreneur, these are grounded in their character and often reflected in their personality. While you can nurture and develop an entrepreneurial mindset, the character of an entrepreneur is something altogether different and was developed as a child. Therefore to understand how we might develop an entrepreneurial mindset we need to understand the entrepreneurial personality and character traits. This in turn requires us to understand a little about cognitive theory.

The theory of cognitive development gives us an insight into how character traits develop. Jean Piaget (1896–1980) is usually credited with the origins of the theory. He saw children's cognitive development as being influenced both by biology and early environmental experience. Children construct mental models of how the world around them operates and these models change as they experience discrepancies between the real world and their mental models. They may start with certain 'models' but these are influenced and shaped over time by how the environment around them reacts and how it functions. Mental models influence our behaviour.

Cognitive theory therefore shifts the emphasis from the individual and their inherent traits towards the situations that have led to their development. It provides us with an insight into how the psychological factors that form part of our character and push, pull or restrain us from going into entrepreneurship might have developed through our life experiences. It also seeks to understand how mental models influence behaviour and how these models influence decision-making by creating mental 'short-cuts' – a process called 'cognitive heuristics', which is something that entrepreneurs make extensive use of (Delmar, 2000).

CHARACTER TRAITS OF ENTREPRENEURS

Numerous studies have consistently found robust links between entrepreneurship and psychological models of personality and character traits. The possession of certain personality or character traits predisposes an individual towards entrepreneurial behaviour such as starting a business (Westhead et al., 2011). Research into the character traits of entrepreneurs is substantial and goes back over 40 years and includes univariate studies (looking at a single trait) and multivariate studies (looking at multiple traits). While facing some methodological issues (which we shall return to later), these early studies highlighted a number of overlapping personality traits that distinguished an entrepreneurial character. These are summarised in Figure 3.1. Each trait is a necessary but not a sufficient condition for being predisposed towards entrepreneurial behaviour. What is needed is the combination of all of them to be present. The resulting entrepreneurial character is more than a simple sum of the individual traits. Subsequent, more general psychological models of personality, such as the Five-Factor model (which we shall also consider later), broadly confirmed these traits.

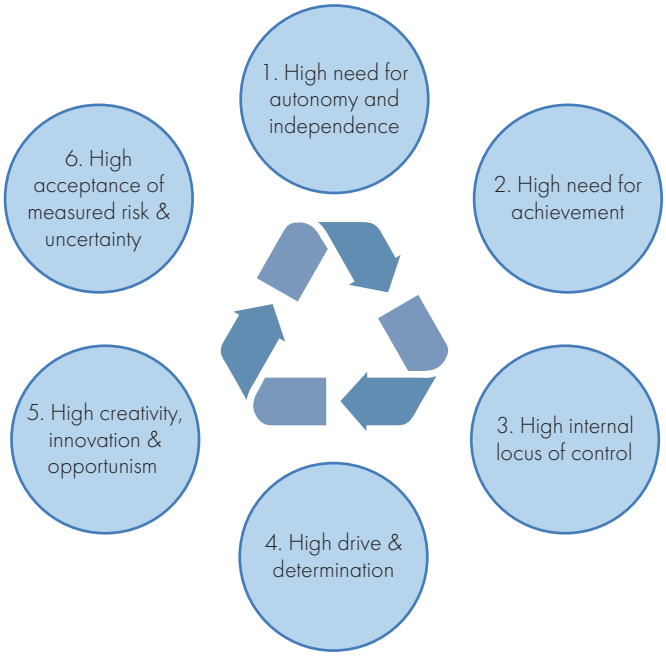


Figure 3.1 Character traits of entrepreneurs

> *I was not a job type of guy. I think it's my personality. I've always liked to make my own decisions.*
>
> Henri Nyakarundi, founder of African Renewable Energy Distributor, CNN African Start-up, 9 August 2016

High need for autonomy and independence

Entrepreneurs have a high need for autonomy and independence. This is most often seen as the need to 'be your own boss'. It has been said that, once you run your own firm, you will not want to work for anybody else. This is the most often-cited entrepreneurial trait and supported by researchers and advisors alike. However, independence means different things to different people: doing things differently, being in a situation where you can fulfil your potential or controlling your own destiny. Autonomy of action can be a strong motivator for staff undertaking cognitive tasks (Pink, 2011) and many have emphasised the need for autonomy in promoting creative and entrepreneurial behaviour within organisations more generally (e.g. Amabile, 1997; Isaksen and Ekvall, 2010) while others have found links between job autonomy and innovative behaviour (e.g. Burcharth et al., 2017; De Spiegelaere et al., 2014).

> *As a child I never felt that I was noticed. I never felt that I achieved anything or that there was any expectation of me achieving anything. So proving myself is something that is important to me and so is establishing respect for what I have achieved.*
>
> Chey Garland, founder of Garlands Call Centres, *The Sunday Times*, 27 June 2004

High need for achievement

Entrepreneurs have a high *need* for achievement – which is not the same as their actual achievement. However, people measure their achievement in different ways, depending on the type of person they are: for example, the satisfaction of producing a beautiful work of art, winning a race or making the magic one million dollars. For many entrepreneurs, money is just a badge of success, recognising and validating their achievement. It is not an end in itself. What they are satisfying is their underlying need for achievement. This 'need' creates their inner drive and determination that shows itself in the setting of ambitious goals. However, while entrepreneurs may have a high 'need' for achievement, that does not necessarily translate into them being high achievers. And if their ambitious goals are not achieved that can turn into stress and profound unhappiness. Studies suggest that entrepreneurs with higher levels of need for achievement are more likely to grow a more competitive and proactive organisational culture (Zhang and Bruning, 2011).

High internal locus of control

Entrepreneurs have a high internal locus of control – a belief that they control their own destiny. They may believe in luck, but not fate. They believe that they can create their own destiny. This is the opposite of a low internal locus of control – a belief in fate and destiny – and is associated with passivity in

individuals. A high internal locus of control is underpinned by a high level of self-efficacy. This shows itself in self-confidence, possibly unfounded, in the ability to complete a task successfully and can lead to over optimism in decision-making. In extremis, a high internal locus of control can also manifest itself in an unwillingness to take orders (a 'difficult' employee) or a desire to control everything and everyone around you. This can lead to a preoccupation with detail, overwork and stress, particularly if the person feels they cannot trust those around them to complete delegated tasks. This in turn can lead to a mistrust of subordinates, an unwillingness to delegate to them and their eventual infantilisation as they lose confidence in themselves (Kets de Vries, 1985). In this situation, good staff do not stay long.

> *I actually don't believe in luck ... I don't know anyone who got anywhere without hard work.*
>
> Lyn Lee, founder of Awfully Chocolate, *BBC News Business*, 8 November 2010

High drive and determination

Entrepreneurs have enormous drive and determination motivated by their need for achievement and underpinned by an internal locus of control which gives them self-confidence in their ability to achieve their goal successfully. Because of their drive, entrepreneurs are proactive rather than reactive and act quickly, thus appearing more decisive. However, this trait can also have its downsides. Entrepreneurs are often seen as restless and easily bored with their focus easily shifted, for example by a new market opportunity. They may also seem to do things at twice the pace of others, and are unwilling or unable to wait for others to complete tasks set for them. Patience is certainly not a virtue many entrepreneurs possess. As a result, they can be difficult to work for and can be intolerant of those who do not share their enthusiasm. They seem to work 24 hours a day and their work becomes their life, with little separating the two. It is little wonder that this places family and personal relationships under strain.

> *I'm often asked what sets successful entrepreneurs apart ... a couple of key attributes are determination and common sense ... anyone can make £100 million if they have the commitment and staying power. The beauty of being an entrepreneur is that, if the first idea doesn't work, you can come up with a second, and a third until you hit on a workable concept.*
>
> Duncan Bannatyne, serial entrepreneur, *Daily Telegraph*, 5 March 2009

High creativity, innovation and opportunism

The ability to be creative and innovative is an important attribute of entrepreneurs. Creativity can mean different things in different contexts and for entrepreneurs creativity is focused on commercial opportunities. They can spot an opportunity and then use their creativity and innovation to exploit it in a novel way. They create products/services that are different in ways that customers appreciate and this helps them grow their business. It is this trait that distinguishes innovative entrepreneurs from the larger population of self-employed (Wennekers and Thurik, 1999). Without it the entrepreneur might be left struggling, working hard with a copycat product/service. So, for a start-up it is important to find an innovative business idea, not a copycat idea, and then the entrepreneur can bring their drive and determination to bear on the task of launching it to market. One important aspect of this is timing – being in the right place at the right time. Timing is everything. Innovation that is before its time can lead to failure. Innovation that is late results in copycat products/services that are unlikely to be outstanding successes. A question constantly asked about successful entrepreneurs is whether their success was due to good luck or good judgement. The honest answer in most cases is probably a bit of both. But, as we shall see, real entrepreneurs can help to make their own luck.

> *I think as entrepreneurs we are driven by ideas ... when I have my free time, I like to go onto the internet and really explore the different things that people are doing: what are the different ideas popping up all over the world.*
>
> Elim Chew, founder of 77th Street, *BBC News*, 20 December 2010

Acceptance of measured risk and uncertainty

Entrepreneurs are willing to take risks and live with uncertainty – things that can be very stressful for most people. They are willing to risk their money, reputation and personal standing if the business fails. However, that does not mean they are reckless gamblers, and they will try to avoid or minimise the risks they face and insure against them. Unsurprisingly perhaps risk-taking does seem to be affected by other factors such as age, education, motivation, business experience and the numbers of years in business (Westhead et al., 2011). As we shall see later in this chapter, entrepreneurs have a distinctive approach to risk mitigation involving gaining knowledge and information from a wide range of sources and compartmentalising the potential impact of risks. They often believe they have knowledge or information that others do not and that reduces the uncertainty in their minds (this can be real or imagined). Because of their internal locus of control and high self-efficacy they really do believe that they can succeed where others might have failed. The challenge is to ensure the information on which this belief is based is real and verifiable.

> *You have to be prepared to lose everything and remember that the biggest risk is not taking any risk at all.*
>
> Jonathan Elvidge, founder of Gadget Shop, *The Sunday Times*, 17 March 2002

These character traits are likely to show themselves in the behaviours summarised in Table 3.1. Studies suggest that these traits are, to a greater or lesser extent, also linked to the performance of a venture (e.g. Baum and Locke, 2004; De Zoysa and Herath, 2007; Dickers et al., 2010; Gupta and Muita, 2013; Wijewardena et al., 2008). However, there are so many other situational factors (firm- and economy-wide) affecting performance that the founder's character traits can only be one element, likely to be a necessary but not a sufficient condition for success. There is one further quality that founders of growth businesses seem to have, although not necessarily at the launch of their business. They have or quickly develop a vision for their business – what they want it to become (Baum and Locke, 2004). It is part of the fabric of the entrepreneur's self-motivation – a strong driver. They are able to see what the business might become, despite the odds. It is an essential leadership quality and helps them to bring other stakeholders along with them.

Table 3.1 Behaviours associated with entrepreneurial character traits

NEED FOR INDEPENDENCE	NEED FOR ACHIEVEMENT	INTERNAL LOCUS OF CONTROL
You are likely to be a person who: * Dislikes taking orders * Prefers to work alone and 'do their own thing' * Likes to make up their own mind and not bow to pressure * Can be seen as stubborn and determined * Prefers to do 'unconventional' things	You are likely to be a person who: * Is restless and energetic * Is task and results-orientated * Is persistent and determined * Is self-sufficient * Is optimistic rather than pessimistic	You are likely to be a person who: * Believes they control their own destiny * Believes they create their own luck by hard work and effort * Is self-confident and shows considerable determination * Is willing to take advantage of opportunities that present themselves
DRIVE AND DETERMINATION	**CREATIVITY AND INNOVATIVENESS**	**ACCEPTANCE OF RISK AND UNCERTAINTY**
You are likely to be a person who: * Is proactive rather than reactive * Acts decisively and quickly * Sets goals and then works hard to achieve them * Is persistent and determined * Continues in a task despite setbacks * Is 'on the go' all the time * Is restless and easily bored	You are likely to be a person who: * Is curious and inquisitive * Is intuitive and imaginative * Is innovative with an abundance of ideas * Is sometimes a bit of a daydreamer * Enjoys change and the challenges it poses	You are likely to be a person who: * Makes decisions quickly * Can act on incomplete information, evaluating likely costs against benefits * Accurately assesses their capabilities and then sets challenging but attainable goals * Is neither over nor under ambitious

EVIDENCE ON THE CHARACTER TRAITS OF ENTREPRENEURS

One of the problems with many of the studies into entrepreneurial character traits is that entrepreneurship itself is not consistently defined. Some studies have focused on nascent entrepreneurs – people who intend to go into self-employment (e.g. Korunka et al., 2003); some have focused on those who actually enter self-employment (e.g. Frank et al., 2007); and some on those entrepreneurs who run successful businesses (e.g. Baum and Locke, 2004). Another criticism of the early studies is that they use a variety of inconsistent methods to measure personality traits (Delmar, 2000). What is more, some studies attempt to link only a single trait to entrepreneurship, while others attempt to link a number (multivariate studies). Multivariate studies have failed to identify a strong causal link between a single trait and entrepreneurship (Shook et al., 2003). This is, perhaps, not unexpected given that, as we noted in Chapter 1, the impetus towards entrepreneurship is influenced by an individual's personal situation ('push' and 'pull' factors as well as barriers).

Chell (2008) undertook an extensive review of the early studies into entrepreneurial character traits and concluded that they showed 'mixed results' – supporting the 'need for achievement' trait,

showing mixed results for 'locus of control' and concluding that 'risk-taking' needed greater definition (as it included 'uncertainty'). Westhead et al. (2011) concluded that personality theories did not offer sufficient explanation on why some individuals engage in entrepreneurial behaviour while others do not – they were too influenced by situational factors. In an earlier study Deakins (1996) highlighted a range of methodological problems that led him to the same conclusion. He observed that measuring personality traits requires subjective judgements and that these studies tend to overlook a range of influences such as culture, environment and situation as well as issues such as age, sex, race, social class, education, training and learning more generally. He also observed that, because of these influences, character traits are not stable and can change over time.



Source: Alamy Stock Photo/imageBROKER

Possibly because of these criticisms, more recent studies have focused on established psychological models to see whether entrepreneurs have certain distinguishing characteristics. For example, numerous meta-analyses of psychological studies using the widely accepted Five-Factor model of personality have consistently found robust linkages between personality traits and entrepreneurship – both the intention to start up a business and often its performance (e.g. Brandstätter, 2011; Collins et al., 2004; Larson et al., 2002; Obschonka et al., 2013; Rauch and Frese, 2007; Schmitt-Rodermund, 2004; Stewart and Roth, 2001, 2007; Zhao and Seibert, 2006; Zhao et al., 2010). The five factors in the model are openness, conscientiousness, extraversion, agreeableness and neuroticism. High scores in these five traits indicate:

- **Openness** – An openness to experience and outside influences indicating a more curious, creative and inventive personality, compared to a more cautious, reserved approach (linked to the trait of creativity and innovation in Table 3.1);
- **Conscientiousness** – An organised, self-disciplined and driven approach to undertaking tasks with a strong aim for achievement compared to a more easy-going approach (linked to drive, determination and a need for achievement in Table 3.1);
- **Extraversion** – An energetic, assertive, outgoing personality with a 'can-do' view of life compared to a more solitary and introverted approach (linked to drive, determination and internal locus of control in Table 3.1);
- **Agreeableness** – A friendly, cooperative and compassionate personality compared to a more detached and analytic approach;
- **Neuroticism** – A sensitive, nervous and anxious personality compared to a more self-assured and confident approach (linked to internal locus of control in Table 3.1).

Zhao et al.'s study (2010) concluded that four of these traits were associated with both the inclination to start up a business and performance – a high degree of openness, conscientiousness, extraversion and a low degree of agreeableness and neuroticism. The study added that risk propensity, included as a separate dimension of personality, was positively associated with entrepreneurial intentions but was not related to entrepreneurial performance. Openness is the trait that shows the strongest positive effect on creativity and innovation (Ma, 2009), but low agreeableness is also important (Ekehhammar et al., 2004). This is because people with low agreeableness are those most likely to avoid the 'groupthink' or the 'dominant logic' of a group or an organisation (a topic we shall return to in Chapter 4) and therefore more likely to generate radical new ideas (Kerr and Tindale, 2004). Brandstätter's (2011) meta-analysis of five prior meta-analyses endorsed these relationships and also reported differences between the traits of managers and entrepreneurs, who had a low degree of agreeableness.

In the light of the research evidence, we can reasonably conclude that personality and character are important influences on entrepreneurial behaviour. More generally, our personality and character

set the context for how we approach many issues in life. They are shaped by our core values and beliefs, which in turn are influenced by many factors over time. And, importantly, they are significant predictors of our behaviours and attitudes.

Explore further 3.1

The Five-Factor personality test

Access the *Digital Links* booklet to visit the website. Take the Five-Factor personality test to find out what it says about your personality.

MEASURING ENTREPRENEURIAL TENDENCY

The General Enterprise Tendency (GET) test measures an individual's entrepreneurial tendency – how much they are inclined towards entrepreneurial activity – based on five established entrepreneurial character traits:

- Need for independence;
- Need for achievement;
- Internal locus of control;
- Acceptance of measured risk and uncertainty;
- Creativity and innovation.

The test was developed by Caird and Johnson over a number of years. Caird (1991a, 1991b) established the construct validity and reliability of the test by testing it on entrepreneurs and comparing it to occupational groups including teachers, nurses, civil servants, clerical workers, and lecturers and trainers. Overall, entrepreneurs were found to be significantly more enterprising than the other groups; however, they were not the only group to score highly on *individual* measures. Stormer et al. (1999) applied the test to 128 owners of new (75) and successful (53) small firms. They concluded that the test was acceptable for research purposes, particularly for identifying owner-managers, but it was poor at predicting business success. Either the test scales needed to be refined for this purpose or the test did not include sufficient indicators of success such as antecedent influences on the individual or other factors related to the business rather than the individual setting it up.

The test comprises 54 questions and takes only five minutes. Results are analysed and a personal report produced upon completion of the test. The report is based on scores for each dimension (shown as a 5D plot) and an overall evaluation based upon the combined scores.

Explore further 3.2

General Enterprise Tendency (GET) test

Access the *Digital Links* booklet to visit the website and take the GET2 test. The results provide you with the opportunity to reflect on whether you have the character to become an entrepreneur.

Case insight 3.1 Julian Thomas and Figaro Brands (1)

Entrepreneurial personality

After graduating from Edinburgh University with a degree in History, Julian Thomas went into marketing. For 18 years, Thomas led the life of a busy marketing executive, working in Asia for the Swire Group and Cathay Pacific, with postings to Melbourne, Taipei, Singapore and Hong Kong, before landing a job with the global brand consultancy, Interbrand, which took him to the UK and Australia.

However, the banking crisis of 2008 created shockwaves through the creative services industry, as clients reappraised their strategy and slashed their marketing budgets. Thomas suddenly found himself redundant. This shock caused him to fundamentally reappraise his work–life balance. He reflected on key questions like: Do I want to work for a large corporation again? Do I want to spend more time with my young family? Do I want to have a greater control of my own destiny? Thomas decided to start his own business trying to work as much as possible from home. In 2010 he founded Figaro Brands, working out of a shed adjacent to his house in the UK. He had one client, a small cancer charity called BRIGHT. Project work was scarce and often quickly taken up by freelancers, moonlighting from other marketing agencies. By 2020, however, Figaro Brands had grown to a core team of eight people, with some 50 clients worldwide such as Swire Group, Bertarelli, Harvard Medical School, Northill Capital and TrueNord Regional Aircraft Leasing.

Figaro Brands is a brand design consultancy that targets companies selling to non-consumer markets that do not have their own marketing departments. Thomas realised that there was a gap in the market. While business-to-consumer (B2C) companies are well served by brand agencies (e.g. ten companies control almost every large food and beverage brand in the world, and are supported by hundreds of agencies), by contrast, business-to-business (B2B) companies are not well served by marketing agencies. To some, B2B marketing might be less glamorous but these companies were his target market.

The services offered by Figaro include brand naming, brand identity, brand architecture, brand positioning and messaging. This covers printed literature and all forms of online communications. However, what made Figaro almost unique was that this was a virtual organisation – the team all work from their home offices and studios, whether in the UK, France or Switzerland, and are linked by computer, phones and tele-conferencing. As well as Thomas and fellow director Matt Hopkins, the core team comprises another six self-employed professionals – designers, programmers and animators. This



Source: Julian Thomas

virtual structure gives the team much more creative and personal freedom, cuts overhead costs and, since they do not have to travel into an office every day, increases productivity. The low level of fixed overheads gives the company a pricing edge. With the exception of the directors, Thomas and Hopkins, each member of the team is paid according to the number of hours of work undertaken for specific clients.

Thomas has an open and outgoing personality. He strongly believes in the value of personal networks and that one of the keys to his success has been his interpersonal skills, often building trust with people he meets through his social networks who subsequently turn out to be potential clients. He believes in being positive-minded and sharing success. Thomas was asked to speak to an MBA class and, as part of this, was asked to take the GET2 test and share the results with the class. He was sceptical before he took the test, but the results stunned him with their accuracy. The report summarised his results, which are shown in Figure 3.2:

'The overall GET2 test score of 83% suggests that your enterprising tendency is high. This means that you have a tendency to start up and manage innovative projects. This could be your own business venture, within your employing organization or your community. You may recognize the following qualities in yourself:

- You have a strong need for achievement;
- You like to be in charge;
- You will seek opportunities and use resources to achieve your plans;
- You believe that you possess or can gain the qualities to be successful;
- You are innovative and willing to take a calculated risk to achieve your goals successfully.

The most enterprising people set up projects more frequently, set up more innovative projects and are more growth-orientated, which means that they are opportunistic and good at utilising resources, including human, technological, physical and organisational resources.'

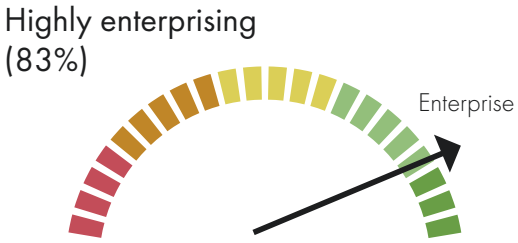


Figure 3.2a Overall GET2 result

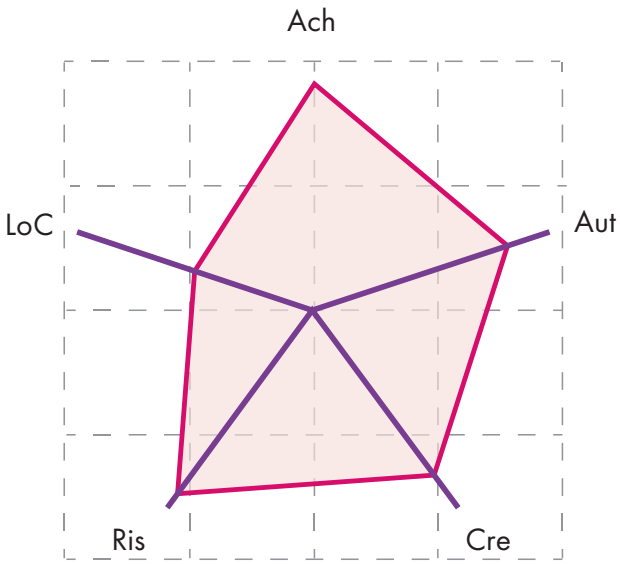


Figure 3.2b GET2 plot

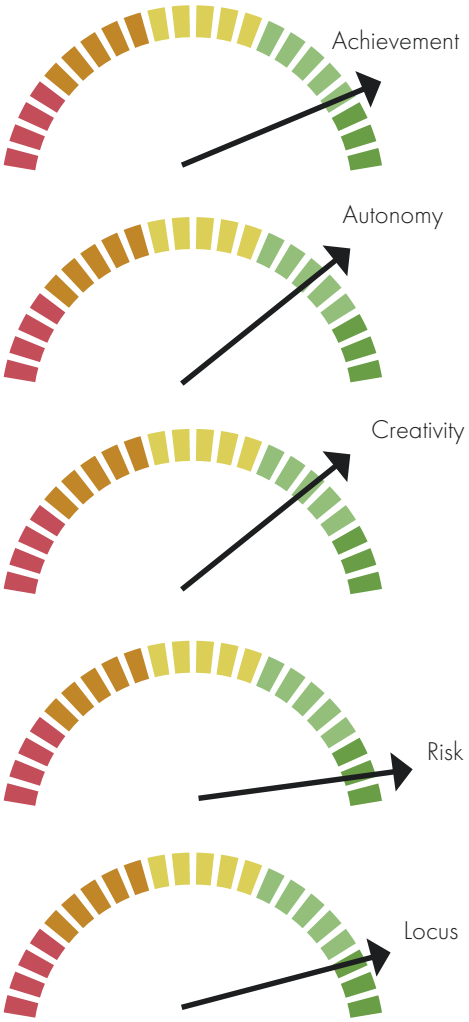


Figure 3.2c Detail GET2 results



Get into the entrepreneurial mindset. Access the *Digital Links* booklet to visit the website and watch an interview with Julian Thomas exploring his mindset and his reactions to the GET2 results. There is also a website showcasing some of Figaro's creative video work.

Questions:

1. What do you think of the GET2 test results?
2. What are the keys to Figaro's success?
3. Are there any weaknesses in this virtual organisation structure?

COGNITIVE THEORY AND BEHAVIOUR

To understand how cognitive theory might explain our behaviour – and therefore how it might explain the behaviour of entrepreneurs – we need to understand a little more about how the brain works. The brain has two different systems or ways of working that are interlinked and complementary but function in different ways. Different authors have used various names for these two systems, but largely agree on how they interact.

System 1 (often referred to as 'right-brain' and often intuitively referred to as 'the heart')

This system is more intuitive and emotional. It is non-verbal, linking images together to get a holistic perspective (also called creative or lateral thinking). The right-brain[1] (System 1) is most likely to engage first. It is automatic and involuntary. Dominant right-brain thinkers are more intuitive, emotional, value-based and non-linear in their approach. They are more creative, characterised by Kirton (1976, 2003) as 'innovators' – divergent thinkers who discover problems by approaching tasks from unusual angles, and are less concerned with 'doing things better' and prefer 'doing things differently'. They are imaginative and often come up with more than one solution to a problem because they explore different approaches. They can take discontinuous leaps and often restructure the original problem. The right-brain is often the source of the 'hunch' or 'gut feeling' that people refer to in coming to some decision or conclusion about a situation. It often relies on past experience for this and is probably the source of the cognitive heuristics used by entrepreneurs. It is therefore a source for quick decision-making, but can prove to be inaccurate once the left-brain is engaged and rational analysis is undertaken. Dominant right-brain thinkers tend to prefer working in groups, experiencing things (for example, learning-by-doing) and generating lots of options in preference to focusing on making a speedy decision which might be based on incomplete data.

System 2 (often referred to as 'left-brain' and often intuitively referred to as 'the head')

This system performs rational, logical functions. It tends to be verbal and analytic, operating in a linked, linear sequence (also called logical or vertical thinking). The left-brain (System 2) takes effort and concentration to engage. Dominant left-brain thinkers tend to be rational, logical, analytical and sequential in their approach to problem-solving. Kirton characterised them as 'adaptors' – convergent thinkers who solve problems with a disciplined, rational approach, and are best at refining current practices and 'doing things better'. They always look for direct answers to problems and often converge on a solution, usually without questioning the premise upon which it is based. They use existing structures and problem-solving approaches, concentrating on those approaches that they see as 'relevant'. Although this is the analytical side of the brain, it can be distracted or disrupted when attention is drawn elsewhere. Because it takes effort and energy, the mind does not always use this system, relying instead initially on the right-brain to respond to a situation. Dominant left-brain thinkers tend to prefer working alone, learning about things rather than experiencing them and having the ability or preference to focus on making quick, logical decisions.

We use both systems of brain, shifting naturally from one to the other in different situations. Mostly they work together, although sometimes they can be in conflict. However, both sides are liable to bias and are not always rational. The right-brain reacts quickly and relies heavily on instinct. Instinct can be deep seated. For example, the reaction of many animals to a change in the environment (e.g. a loud noise or a different smell) is often alarm and fear. It signifies risk and danger and puts the animal on its guard. This is a deep-seated instinct that helps all animals survive. It explains why so many people do not welcome change. The right-brain is therefore inherently risk-averse for most people. This has

1 The terms 'right- and left-brain' have no neurological foundation. The brain comprises numerous different parts and is made up from innumerable neurons and axons.

helped us survive over many generations. Once the left-brain is engaged it provides the logical analysis that tells us whether the change presents us with a real risk. However, the left-brain takes more effort and time to engage. It requires willpower. And this means that right-brain judgments and decisions come easily, quickly and confidently, but are often not questioned by the left-brain because it takes more effort to engage. What is more, without adequate time to think the left-brain often endorses ideas or feelings that are generated by the right-brain. The truth is that we rarely understand how these judgments and decisions are arrived at Figure 3.3 show some of the differences in the two systems.



Source: ElisaRiva from Pixabay

System 2: Left-brain	System 1: Right-brain
Logical	Intuitive
Analytical	Emotional
Rational	Value-based
Convergent	Imaginative
Linear	Divergent
Disciplined	Creative
Seeks answers	Innovative
Thinks in numbers or words	Seeks questions
Uses existing structure	Thinks in pictures
Relies on past experiences	Welcomes discontinuous leaps
Concentrates on what is 'relevant'	Prefers to do things differently

Figure 3.3 Systems of the brain

Kahneman (2012) described the workings of the mind as 'an uneasy interaction between two fictitious characters: the automatic System 1 and the effortful System 2' that interact in making decisions and exercising judgment. He pointed to the growing evidence that right-brain function is associated with moods, intuition, creativity and gullibility and left-brain function with vigilance, suspicion, analysis, increased effort and sadness. A happy mood (positive emotions) loosens the control of the left-brain over performance: 'when in a good mood, people become more intuitive and more creative but also less vigilant and more prone to logical errors'. Kahneman talked about a range of moods between 'cognitive ease', which encourages right-brain creativity (no threats, no need to redirect attention and mobilise effort), and 'cognitive strain', which encourages left-brain activity and discourages creativity (an urgent problem exists which requires attention), noting that cognitive ease is both a cause and a consequence of a pleasant feeling. In other words, the physical environment you operate in can affect how you behave. What is more, cognitive ease can facilitate the development of the creativity skills that we shall explore in the next chapter.

COGNITIVE THEORY AND ENTREPRENEURIAL BEHAVIOUR

As we have already observed, two important character traits of entrepreneurs are their creativity/innovation and their approach to uncertainty and risk-taking. To deal with uncertainty they approach decision-making in a different way, often being seen as intuitive or 'illogical' and certainly in a more incremental way. There is another characteristic – a heavy reliance on interpersonal relationships and networks. The informality and lack of hierarchy within many SMEs mean the entrepreneur has to rely on their personal authority to control the firm. Their ability to network provides information that allows them to capitalise on commercial opportunities and mitigate the risks they face. We shall look at each of these characteristics to see how cognitive theory might explain the behaviour of entrepreneurs, alerting us to both the strengths and weaknesses.

Creativity and innovation

Creativity and innovation is a distinctive character trait of entrepreneurs. However, while right-brain thinkers are typically seen as more creative, both approaches can be creative, albeit in different ways, and can complement each other. The right-brain 'innovator' is typically better at radical or disruptive innovation. The left-brain 'adaptor' is typically better at incremental innovation. These thinking styles can be influenced by situational and environmental factors. Good mood, elation and simply laughing seems to encourage right-brain activity like creativity and problem-solving. In contrast, education generally encourages logic and conformity – left-brain functions – not only in terms of its values and encouraged behaviours but particularly in learning many of the basic life-skills such as reading, writing and arithmetic. Kirby (2003) argued that entrepreneurs are right-brain dominant, speculating that this may explain why so many successful entrepreneurs appear not to have succeeded in the formal education system (e.g. Steve Jobs and Richard Branson). They do not conform and tend to misbehave. He went further by speculating that there may be a link between this and dyslexia, observing that many entrepreneurs (e.g. Branson) are dyslexic and that language skill is a left-brain activity. This is an interesting but unproven hypothesis.

Cognitive theory tells us that oscillating between left- and right-brain appears to improve *practical* creativity (Fox Cabane and Pollack, 2017). This is why alternating between challenging cognitive tasks (such as writing a report) and activities with low cognitive loads (such as exercising) enhances creativity. Fox Cabane and Pollack said that the best activity for encouraging practical creativity is physical activity such as walking, when both left- and right-brain can be engaged. As we have observed, normally the two functions of the brain complement each other and people can (and do) switch between them for different tasks and in different contexts, although people may have a preference for one or other style of thinking. In the next chapter we shall look at how entrepreneurial creativity and innovation require connectivity with different ideas (Johnson, 2010) and 'cognitive diversity' – an ability to create different insights and find solutions to problems from different contexts (Syed, 2019). And here is the key – entrepreneurial creativity and innovation are *practical* and require right-brain creativity to provide insight linked to left-brain analysis to find the profitable ways to market. Both are important in the entrepreneurial context.

Management and leadership

If entrepreneurs are indeed right-brain dominant as Kirby (2003) asserts, they are likely to be more intuitive, emotional and less rational and formal in their approach to management and leadership. However, Mintzberg (1976) observed that while effective leadership appeals to people's emotions and requires emotional intelligence – a right-brain activity, effective management is concerned with logic, detailed analysis and planning – a left-brain activity. However, he also observed that most managers split their attention between a number of different tasks. They prefer to talk directly to staff rather than writing or emailing them, and this allows them to take a holistic view of the situation and 'read' non-verbal as well as verbal aspects of the interaction – interpersonal skills that echo right-brain characteristics. Entrepreneurs need to be both effective leaders *and* managers – and this therefore requires oscillating between left- and right-brain.

Delmar (2000) outlined two cognitive concepts that are relevant to the effectiveness of different start-up motivations. 'Intrinsic motivation' suggests people who undertake tasks for their own sake perform better than those motivated by external factors. This implies that start-up entrepreneurs are likely to be more highly motivated by the 'pull' factors outlined in the previous chapter, rather than the 'push' factors. This strong inner drive – called type 'A' behaviour – amounts to almost compulsive behaviour. 'A' types tend to be goal focused and exhibit high levels of drive, wanting to get the job done quickly. Delmar's second cognitive concept, 'intentionality', suggests that people who intend to do things are more likely to do them than people who do not. In other words those start-up entrepreneurs motivated by 'pull' factors are more likely to actually do it, compared to those motivated by 'push' factors. Both concepts therefore suggest that 'pull' factors are more likely to lead to start-ups seeing the light of day, compared to 'push' factors.

Entrepreneurs exhibiting type 'A' behaviour are also likely to show particular characteristics in their approach to management and leadership. Because they are so goal focused, they also tend to try to proactively affect events (internal locus of control), focusing on the future when they are often not in control of the present. This can make people exhibiting this behaviour difficult to work for. They can seem 'pushy', to the point of bullying, and often 'meddle' because they believe they are best placed to understand what needs to be done. These are typical entrepreneurial behaviours.

> *I thrive on adversity. I like it when the chips are down. When nobody believes that something can be done, I think, 'We are going to do this!'*
>
> Dale Vince, founder of Ecotricity, *The Daily Telegraph*, 27 May 2011

Strategy and decision-making

Entrepreneurs often describe making decisions based on 'gut feeling' – a process that has been described as 'muddling through' (Lindblom, 1959). Sarasvathy (2001) observed that they do not like formal research and planning (left-brain). While strategy can be developed in a systematic, almost mechanistic, manner many entrepreneurs develop it instinctively and intuitively and without a formal structure (right-brain). For them strategies evolve on a step-by-step basis as one 'roadblock' after another is dismantled and more information is gained. They do not wait for perfect knowledge. If one step works then the second is taken – a process of experiential learning or learning-by-doing. In this way, decision-making is often seen as incremental and short term (Burns and Whitehouse, 1995a, 1995b).

Learning-by-doing helps develop a library of mental models which are the basis for the cognitive heuristics used so extensively by entrepreneurs in decision-making (Delmar, 2000). Cognitive heuristics originate from the intuitive right-brain. It is the entrepreneur using their mental models and past situational experiences as a basis for decision-making. It helps them make decisions quickly. It also might explain the belief that 'success breeds success, and failure breeds failure'. However, entrepreneurs do this even if their mental models are based upon relatively few experiences and therefore might be unreliable. Because of this characteristic, entrepreneurs believe they are objective and analytical and tend to attribute any failure to outside factors such as insufficient effort or poor knowledge. This can be dangerous. However, entrepreneurs also receive information through their network of relationships, and incorporating this into their cognitive heuristics can improve decision-making.

Chen et al. (1998) argued that it is the entrepreneur's belief in their own capabilities (called 'self-efficacy') that drives and motivates them and gives them the dogged determination to persist in the face of adversity, when others just give in – the type 'A' behaviour noted earlier. Because of this, successful entrepreneurs can often be seen as 'overconfident' (Forbes, 2005), particularly with regard to predicting a future outcome, to the point of escalating their commitment to it when it appears illogical to do so (Baron, 1998). Many studies observe that people who report overconfidence and high levels of self-efficacy therefore are more likely to become entrepreneurs (e.g. Chen et al., 1998; Koellinger et al., 2007; Krueger and Dickson, 1994). Generalised self-efficacy is effectively the same as the internal locus of control trait observed in entrepreneurs.

> *Being an entrepreneur is like being a juvenile delinquent ... The more you tell us we can't do it; the more we want to prove you wrong.*
>
> Elim Chew, founder of 77th Street, *BBC News*, 20 December 2010

Risk-taking

As we have observed, people use both systems of the brain, shifting naturally from one to the other in different situations, but our right-brain is the system that reacts instinctively and quickly to signs of danger. It is the side that is inherently risk-averse. Again, cognitive theory helps us to better understand

this. Kahneman (2012) demonstrated that the interaction of the two sides of the brain can be more complex, particularly in the context of decision-making. He asked readers to make two concurrent or joint decisions by making two choices with four options (AC, AD, BC or BD):

Decision 1		Decision 2
A: A sure gain of $240 or B: 25% chance to gain $1,000 and 75% chance to gain nothing	AND	C: A sure loss of $750 or D: 75% chance to lose $1,000 and 25% chance to lose nothing

He observed that most (but not all) people select options AD – an instinctive right-brain reaction based on the certainty of A being a sure gain and D an uncertain (as opposed to certain) loss.

Conclusion 1: Most people are risk-averse to gains – they prefer the certainty of a small gain (A). However, they are also risk-seeking for losses – they prefer to gamble and avoid the certainty of loss (D).

Kahneman also then pointed out that most people did not calculate all the combinations of options open to them: AD; as selected, AC, BC and BD. This involves a calculation and effort, which the left-brain (unless forced) is too 'lazy' to make.

Decision 1: A: A sure gain of $240

= 100% x $240 = +$240

B: 25% chance to gain $1000 and 75% chance to gain nothing

= [25% x $1000] + [75% x 0] = +$250

Decision 2: C: A sure loss of $750

= 100% x $750 = -$750

D: 75% chance to lose $1000 and 25% chance to lose nothing

= [75% x $1000] x [25% x 0] = -$750

If they had made the calculation they would have found that options BC and BD – not AD – offer the lowest loss:

Option AD:+$240 – $750 = –$510

Option AC:+$240 – $750 = –$510

Option BC:+$250 – $750 = –$500

Option BD:+$250 – $750 = –$500

Conclusion 2: Most people do not approach complex decision-making logically by analysing all the options.

Kahneman demonstrates that humans do not make mathematically perfect decisions about probability, instead relying on rough rules of thumb that are less than perfect and open to bias. As he observed:

> Every simple choice formulated in terms of gains and losses can be decomposed in innumerable ways into a combination of choices, yielding preferences that are likely to be inconsistent … it is costly to be risk averse for gains and risk seeking for losses. These attitudes make you pay a premium to obtain a sure gain rather than a gamble, and also willing to pay a premium (in expected value) to avoid a sure loss.

Since the entrepreneurial character makes them generally more ready to accept risk and uncertainty, it is likely that an entrepreneur might select option BD, rather than AD, taking a risk for both the gain

and the loss (which is actually a better overall outcome than AD). However, Kahneman's results are likely to mean that, while entrepreneurs may be willing to take greater risks than most people for gains (commercial opportunities), they are also likely to take even greater risks to avoid losses (commercial risks). This willingness to gamble when it comes to dealing with downside risks is particularly dangerous. What is more, because of their 'self-efficacy' and reliance on cognitive heuristics (retrieved from the right-brain in an automatic way that the left-brain is unaware of) they are even less likely than the ordinary person to engage the left-brain and undertake the more detailed analysis required for a 'correct' answer. There is a further danger here because of the tendency of most people to treat known risks or dangers that have not materialised, even if there were 'near-misses', optimistically. If a known risk does not materialise most people are strengthened in their belief that it is unlikely to do so again. For example, a Norwegian study found that drivers who had near accidents were subsequently more willing to take risks while driving.

However, this tendency to rely on cognitive heuristics can be an advantage to them if the knowledge and experiences they rely on for their mental models are as broad and as positive as possible – in other words their rough rules of thumb may be correct. Networks of relationships can provide that knowledge and experience and generate strategic options that can reduce risk or come up with new ideas. Nevertheless, the best decisions are made taking the time and effort to use both left- and right-brain systems. The old saying to 'sleep on the decision' proves very true.

> *You have to have nerves of steel and be prepared to take risks. You have to be able to put it all on the line knowing you could lose everything.*
>
> Anne Notley, co-founder of The Iron Bed Company, *The Sunday Times*, 28 January 2001

A survey by the Boston Consulting Group found that many larger companies were risk-averse and this was a major barrier to innovation (BCG, 2018). Kahneman's conclusions help explain why this might happen. The natural tendency of managers is to select those projects that are low risk for gains – at the expense of projects that might be riskier (more innovative) and offer higher returns. With a portfolio of projects, however, risk can be spread (a topic explored in Chapter 18). A business therefore needs some higher risk projects to balance off against lower risk projects: it wins a few, it loses a few (to fully spread risk, the projects need to be independent).

Kahneman also showed how easy it is to influence decision-making, regardless of risk. He asked readers to make the following decision choice:

Decision AD	OR	Decision BC
25% chance to win $240 *and* 75% chance to lose $760		25% chance to win $250 *and* 75% chance to lose $750

This time he observed that most people select [BC], which is, of course, the better (least worse) option:

AD: (25% x $240) – (75% x $760) = –$510

BC: (25% x $250) – (75% x $750) = –$500

The issue here, however, is that [BC] is just the combination of the rejected options in the previous decision problem.

Conclusion 3: Not only do people have risk-averse biases, their decision-making can be influenced by how the decision is presented or framed.

As Kahneman showed in his book, many other factors can affect our judgement and decisions. Factors such as our mood, norms, 'anchor numbers' which set expectations, associative thinking, triggers such as food and mood music, an exaggerated faith in small numbers or in personal experience, confirmation bias (the reliance on evidence that confirms what you already believe), even the font size on a report. All these factors can affect the cognitive heuristics individuals might use in making decisions involving risk. They should sound warning bells for entrepreneurs. We return to risk management in Chapter 13.

Explore further 3.3

Bias in decision-making

Access the *Digital Links* booklet to watch the following videos:

- A Harvard Business Review animation on bias in decision-making.
- A one-hour TED talk by Daniel Kahneman, recipient of the Nobel Prize in Economic Sciences for his seminal work on the psychology of decision-making.

INFLUENCES ON COGNITIVE BEHAVIOUR

While we may have some inherent character traits, cognitive theory tells us that our character is the product of the many other influences that have shaped and developed us over our life: from our parents and family to our nationality and religion, from our education to our work careers. It is influenced by the culture of these different groups – their basic values, beliefs and norms of behaviour. We 'learn' how to behave in these groups and we can adapt to behave differently in each, if required. Cognitive theory emphasises the influence of situational factors. Figure 3.4 shows these influences on our character.

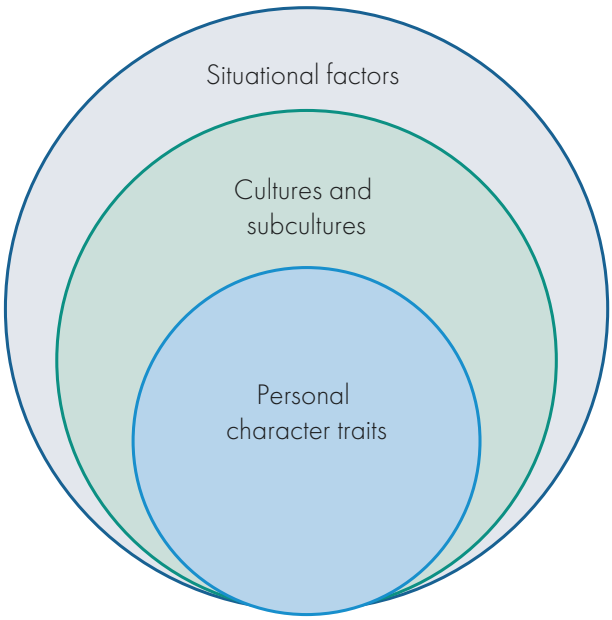


Figure 3.4 Influences on character

The demographics of entrepreneurship (discussed in Chapter 1) are influenced by these factors; for example, the link between immigration and entrepreneurship. We 'learn' from our individual experiences of life. We might speculate that because of the hardships likely to have been endured by immigrants they are likely to have drive and determination (need for achievement), a belief that they can affect their own destiny (internal locus of control), and be more comfortable with uncertainty and risk-taking. Similarly the link between education and entrepreneurship may be due to exposure to a wider variety of ideas and business opportunities (creativity) and an increase in confidence in how to make well-informed decisions (internal locus of control).

This patchwork of cultural influences can explain a number of other things. For example, studies have shown that a family business background, such as having a parent who was an entrepreneur or having worked in a family business, increases the probability of starting up in business (e.g. Athayde,

Case insight 3.2 Adam Schwab and Lux Group

Entrepreneurial personality

Lux Group is one of the largest e-commerce group of companies in Australia with a turnover of some AUD $300 million. In 2017 it was named Australia's fastest-growing company under five years old by *The Australian Financial Review* Fast Starters list. One of its companies, Luxury Escapes, is the most popular travel website in Australia. Lux Group was co-founded by Adam Schwab in July 2010 and has gone through many changes, coming a long way from its humble beginnings as the flash sales e-commerce website DEALS.com. Schwab intended to sell the business and step down as CEO in 2020 but his plan was thwarted by the coronavirus pandemic, which affected the travel business particularly badly.

Schwab's first experience with the business world came as an 11-year-old, when he realised there was a captive market selling lollipops to other kids on his school bus. He went to Caulfield Grammar School, where he met Jeremy Same (co-founder of Lux). The pair started a number of successful small ventures together. One was of dubious legality. DigiCat sold CDs containing copies of high-scoring assignments to students across Australia: 'this wasn't a huge business but relatively speaking, it was a nice little earner for a couple of 18-year-olds'. Schwab went on to study Commerce/Law at Monash University and during this time he set up a business called DigiLaw selling law notes to law students. Schwab managed to convince the campus bookstore to sell the product, leading students to believe that it was somewhat more official than it actually was. Despite being successful, the business closed when the dean of the Law School banned students from using it.

After leaving university, Schwab started work as a corporate lawyer specialising in mergers and acquisitions. In 2004, he and his friend, Same, started renting and furnishing inner-city apartments in Melbourne, which they would then let as a serviced apartment to small groups of 'high-end' backpackers and travellers for shorter periods. This business model required little capital and later morphed into offering apartments to corporate clients under the Living Corporate brand. The Melbourne property market was booming and the pair bought six properties which they subsequently sold for a profit of more than AUD $1 million only two years later.

However, Schwab and Same wanted to start a business that was scalable on an international basis and the idea of an internet-based business was attractive. They noticed the success of the TopTable restaurant booking business in the UK (now a part of global travel giant, Priceline) and they started working on a similar concept called MyTable. Then they noticed the success of Groupon in the USA (the online experiences marketplace covering local businesses such as restaurants, events and travel). This was the basis for Zoupon, which later became DEALS.com, offering daily deals on experiences in cities throughout Australia. MyTable was subsequently developed into a takeaway food ordering website and was sold off, eventually to become part of the UK-based Just Eat (Case insight 7.6). These websites formed the basis for what is now Lux Group.

Lux expanded both organically and through acquisitions, developing or buying websites offering new products/services to new markets so as to create a dominant market position. It has been able to set up new websites quickly when expanding into new countries. Businesses are acquired as cheaply as possible and then rigorous cost controls applied before looking at ways sales can be grown through synergies with other group websites. Schwab has said that his imperatives for Lux websites were early profitability and good cash flow and that the group has been focused on profit rather than revenue growth. Another characteristic is its lack of reliance on outside capital. Almost all the earnings are ploughed back into the business, often paying for acquisitions. It remains a private company and this lack of outside interference means it can make quick decisions.

Schwab has said that the business was on track to achieve a turnover of AUD $500 million in 2020. But in March and April revenue dropped by 97% (compared to January) – and that was before refunds and credits (SmartCompany, 20 July 2020). The focus switched from growth to survival. Will Schwab turn the business round and succeed in selling? Time will tell.

Access the *Digital Links* booklet to visit the company website and to watch a video with Adam Schwab talking about Luxury Escapes.

Questions:

1. What lessons do you learn about the entrepreneurial character from Adam Schwab?
2. What lessons about e-commerce start-ups do you learn from this case?
3. What social and human capital does Adam Schwab possess?

2009; Levie, 2010). They can also help to explain the differing importance of personal drivers and fears about entrepreneurship – the importance an individual places on 'pull' factors and how they react to 'push' factors (Chapter 1). It might also be the source of many of the barriers placed in the way of being an entrepreneur. However, while it might be possible to identify character traits at a point in time and understand how they might have developed, these traits can change over time either through changing circumstances or through determination.

Explore further 3.4

Entrepreneurs – born or made?

Access the *Digital Links* booklet to watch the following videos:

- A talk by Professor Paul Burns about whether entrepreneurs are born with certain character traits or whether these traits result from their various cultural influences.
- An animation explaining the difference between a 'growth' and a 'fixed' mindset and how a mindset can be changed.

THE INFLUENCE OF NATIONAL CULTURE

National culture is seen as a major influence on individual behaviour (Morris et al., 1994). However, defining and measuring the impact of culture in any meaningful way can be extremely difficult. Several cultural models have been developed in order to better understand and measure culture. These include the Hofstede model (Hofstede 1981, updated 2001; Hofstede and Hofstede, 2005; Hofstede, 2007), studies by Schwartz and Bilsky (1987), Trompenaars (1993), and the GLOBE model (House et al., 2004). Of these, it is the Hofstede model that has been applied most often (Mooij and Hofstede, 2010). Hofstede undertook an extensive cross-cultural study, using questionnaire data from some 80,000 IBM employees in 66 countries across seven occupations. Drawing on his research he established the four dimensions shown in Figure 3.5. This figure also shows the dominant culture he found in employees in particular countries.

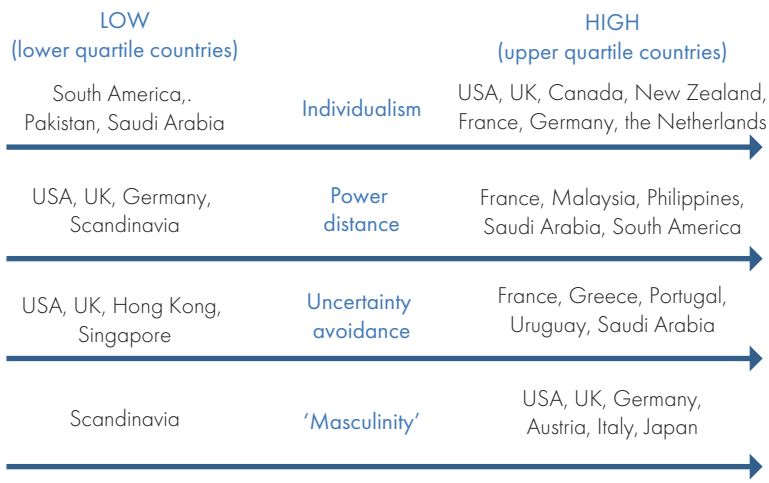


Figure 3.5 Hofstede's dimensions of national culture

Source: Based on the text of Hofstede (1981).

Individualism (versus collectivism)

This is the degree to which people prefer to act as individuals rather than groups. Individualistic cultures are loosely knit social frameworks in which people primarily operate as individuals or in immediate families or groups. By contrast, collectivist cultures are composed of tight networks in which people operate as members of 'in-groups' and 'out-groups', expecting to look after, and be looked after by other members of their 'in-group'. In the individualist culture, the task prevails over personal relationships and the atmosphere is competitive. In collectivist cultures it is cooperative within the 'in-group'; however, it may well be uncharacteristically competitive with 'out-groups' – a feature associated with the 'competitive aggressiveness' dimension of an organisation with an entrepreneurial orientation. Hofstede found that the 'Anglo' countries (USA, UK, Australia, Canada and New Zealand) were the highest scoring individualist cultures, together with the Netherlands, France and Germany which just made it into the upper quartile of individualist cultures. At the other end of the spectrum, South American countries were the most collectivist cultures, together with Pakistan.

Power distance

This is the degree of inequality among people that the community is willing to accept. Low power distance cultures endorse egalitarianism, with open and informal relations, functional and unrestricted information flows and organisations that tend to have flat structures. On the other hand, high power distance cultures endorse hierarchies, with more formal relations, restricted information flows and organisations that tend to be rigid and hierarchical. Individuals in high power distance cultures have difficulty working in unsupervised groups whereas those in low power distance cultures might be thought to exhibit a lack of 'respect' for authority. In Hofstede's classification the low power distance countries were identified as Austria, Ireland, Israel, New Zealand and the four Scandinavian countries. The USA, UK and Germany also made it into the lower quartile. Among the high power distance countries were Malaysia, the Philippines and four South American countries, with France also making it into the upper quartile in this respect.

Uncertainty avoidance

This is the degree to which people prefer to avoid ambiguity, resolve uncertainty and prefer structured rather than unstructured situations. Low uncertainty avoidance cultures tolerate greater ambiguity, prefer flexibility, stress personal choice and decision-making, reward initiative, experimentation, risk-taking and team-play and stress the development of analytical skills. High uncertainty avoidance cultures prefer rules and procedures, stress compliance, punish error and reward compliance, loyalty and attention to detail. The lowest uncertainty avoidance countries were Hong Kong, Ireland, Jamaica, Singapore and two Scandinavian countries, with the USA and UK also in the lowest quartile. The highest uncertainty avoidance countries were Greece, Portugal, Guatemala and Uruguay, with France also in the highest quartile group. Germany was about halfway.

'Masculinity' (versus 'femininity')

This defines quality of life issues. Hofstede defined 'masculine' virtues as those of achievement, assertiveness, competition and success. 'Masculine' cultures reward financial and material achievement with social prestige and status. 'Feminine' virtues include modesty, compromise and cooperation. 'Feminine cultures' value relationships. Issues such as quality of life, warmth in personal relationships, service and so on are important, and in some societies having a high standard of living is thought to be a matter of birth, luck or destiny, rather than personal achievement (an external locus of control – the opposite of internal locus of control). Hofstede found the most 'masculine' countries to be Japan, Austria, Venezuela, Italy and Switzerland, with the USA, UK and Germany all falling into the highest quartile. Four North European countries were the highest scoring feminine countries. France was about halfway.

At a later date Hofstede and Bond (1991) added a fifth dimension – short-/long-term orientation. A short-term orientation focuses on past and present and therefore values respect for the status quo.

For example, it includes an unqualified respect for tradition and for social and status obligations. A long-term orientation focuses on the future and therefore the values associated with this are more dynamic. For example, it includes the adaptation of traditions to contemporary conditions and only qualified respect for social and status obligations.

Hofstede's work is particularly interesting because it allows us to describe national cultures. In particular it allows us to describe what many people would see as the most entrepreneurial culture of all – that of the USA. Welsch (1998) described entrepreneurship as 'ingrained' in North American culture. The USA emerges as a highly individualistic, 'masculine' culture, with low power distance and uncertainty avoidance – one that is said to be conducive to entrepreneurship (Licht and Siegel, 2008). And indeed we recognise this. It is a culture that tolerates risk and ambiguity, has a preference for flexibility and is an empowered culture that rewards personal initiative. It is highly individualistic and egalitarian, a culture that is fiercely competitive and the home of the 'free-market economy'. Assertiveness and competition are central to the 'American dream'. If there is a key virtue in the USA it is achievement, and achievement receives its monetary reward. It is an informal culture. According to the Declaration of Independence, 'all men are created equal', but they also have the freedom to accumulate sufficient wealth to become very unequal. The USA is the original 'frontier culture'. It seems to like change and uncertainty and certainly rewards initiative and risk-taking.

Interestingly, Saudi Arabia is at the opposite extreme to the USA on three of these dimensions. It has a collectivist culture, with high power distance (a respect for authority) and high uncertainty avoidance – a description that, by and large, still rings true. The Muslim religion and local tribal ties are important influences on the culture of most Gulf States. Notice one more thing from Figure 3.5. The UK sits alongside the USA – our benchmark for a national culture that encourages individual entrepreneurship. However, in the 1970s when these studies were conducted, the UK had a stagnant economy and could hardly have been held up to be the epitome of an enterprising nation. The explanation of the findings may lie in the timing of the study. Attitudes to enterprise were changing rapidly. In the UK and USA, political interest was focused on enterprise as a means of rescuing stagnant economies (O'Connor, 1973) and it was argued that structural change was needed to achieve an 'enterprise culture' (Morris, 1991; Carr, 2000). This happened in the UK with the arrival of the Thatcher government. The UK may not have been an enterprising nation at the time but cultural attitudes towards entrepreneurship were indeed changing rapidly, as subsequent economic performance indicated.

Hofstede's cultural framework is widely used and well respected and it remains important because of the scale of the sample. The GLOBE study (House et al., 2004), by contrast, is more recent and covered more than one company. Designed to replicate Hofstede's work, it covered 17,000 middle managers from 951 organisations in three industries, across 62 societies. Although there is considerable academic debate about the subject, Hofstede (2010) believed the GLOBE researchers essentially adopted and verified his five dimensions of national culture, although they expanded them to nine: power distance; uncertainty avoidance; future orientation (all used by Hofstede); institutional collectivism; in-group collectivism (Hofstede used individualism-collectivism); assertiveness; gender egalitarianism; performance orientation; and humane orientation (similar to Hofstede's 'masculine-feminine').

Many academics and politicians believe that the impact of national culture upon aggregate levels of individual entrepreneurial activity could have significance for public policy. In a review covering 33 countries using Hofstede's dimensions, Shane (1992, 1993) concluded that national rates of innovation were positively correlated with individualism and power distance and negatively with uncertainty avoidance. Rinee et al. (2012) came to similar conclusions for individualism and power distance using the Global Innovation Index across 66 countries. However, these studies have been questioned on a number of grounds (e.g. Hofstede's dimensions can change over time; Shane, 1992, 1993). What is more, the dimensions were correlated against innovation, not entrepreneurial propensity or start-up rates. However, in a review of the literature Hayton and Cacciotti (2014) concluded that national cultural values did indeed 'influence, or at least correlate with individual motives, motive dispositions, traits and cognitions that are associated with being an entrepreneur'. What they could not find was any evidence of a causal link and this leads them to conclude that 'evidence for the mediating process linking culture and behavior remains sparse and inconsistent, often dogged by methodological challenges'.

Case insight 3.3 Issam Al Harthy and United Events

Entrepreneurial personality

The idea of starting a business came to Issam Al Harthy while studying for his bachelor's degree in Muscat, Oman. He had previously worked for United Media, a Muscat-based media-services company, where he developed his media and PR experience. However, having taken an entrepreneurship course, he wanted to make his own mark in the world by starting his own business. During this course he took the GET2 Enterprise Tendency test. The results were not expected or encouraging (see Figure 3.6). The report summarised his results:

> *'The overall GET2 test score of 69% suggests that you are likely to have strengths in some of the enterprising characteristics and may be enterprising in some contexts. At this time in your life you may find that you are content to work on a limited number of projects and may be happy to be enterprising either within employment as an intrapreneur, or in your leisure time through voluntary community projects. However, if you have ambitions to have an innovative growth business, there is much you can do ... If you have never set up an enterprise before you might consider starting a small project in your community that represents a minimal risk to your time and money, to build up your experience and expertise.'*

Nevertheless, Al Harthy pressed ahead and in his search for a business idea he discovered that there was a growing trend in Oman of hiring event management companies for both social and professional gatherings. What was more, existing event management companies, just like United Media, targeted only large companies. He believed there was a gap in the market for a company targeting a wider demographic.

Occasionally enterprising (69%)

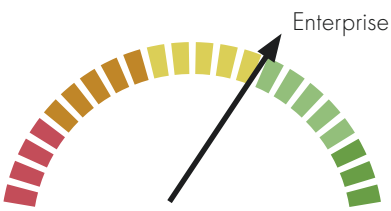


Figure 3.6a Overall GET2 result

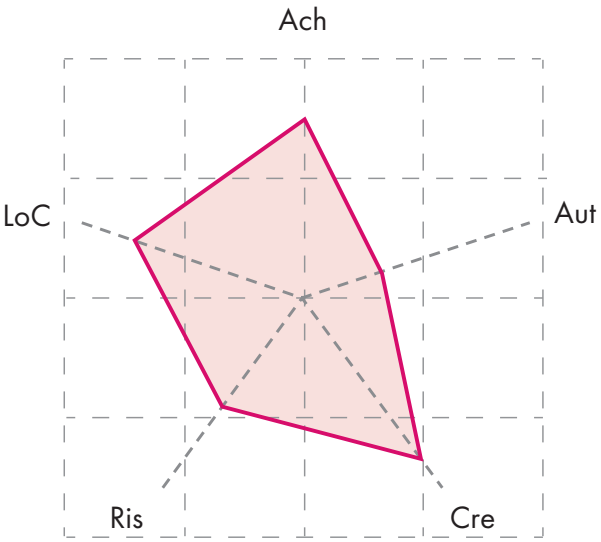


Figure 3.6b GET2 plot

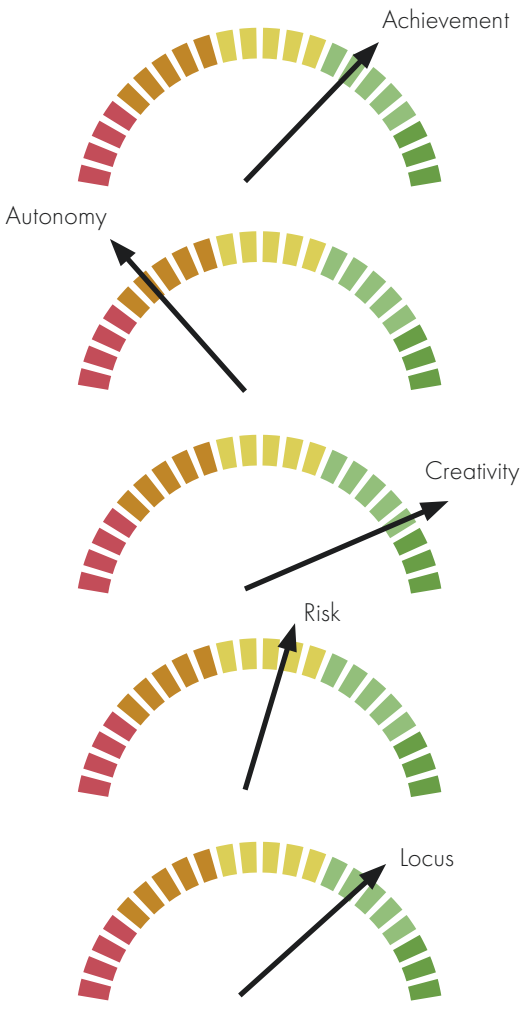


Figure 3.6c Detail GET2 results

Al Harthy started this venture with three friends while at college (this inspired the company logo). However, starting up was not easy. In Oman, firms must obtain a 'business licence' to operate and this was not straightforward as he and his friends were still students. Even once the business got started it was slow to secure its first client and his friends eventually decided to leave the firm for well-paid government jobs. Over this period Al Harthy began to wonder whether he should do the same; however, he was undaunted and persevered, maintaining his self-confidence.

His first client was Daleel Petroleum where he organised a family day out for their employees. With a budget of OMR 10,000 (about £20,000), this was an up-market event. In order to keep his overheads to a minimum, many facilities were hired-in (e.g. stage and sound system) and many aspects of the event subcontracted out (e.g. catering and photography). Nevertheless, this event generated a handsome profit of OMR 2,000 (about £4,000). The event was a success and as a result of word-of-mouth recommendations he was able to secure similar work with other companies in the industry. Indeed, he secured contracts for six similar events from the sister companies of Daleel Petroleum.

During this first year Al Harthy never disclosed to his clients that he hired-in equipment or subcontracted many activities and many believed that he owned these facilities. However, he never compromised on quality and controlled his subcontractors closely, trying to maintain an up-market image for his firm. Although as a start-up he accepted every event he was offered whatever its scale or budget, he gave personal attention to all events. He took as a deposit only the amount he needed to hire-in equipment. By the end of the second year, he had been able to save enough money to buy some event equipment and had four full-time employees, allowing Al Harthy to spend most of his time in networking, relationship building and securing new business leads.

When he was not busy following up leads or managing events, Al Harthy focused on building the firm's brand. Personal recommendation is important in Oman and, as well as face-to-face networking, he used various social media platforms such as Instagram, Snapchat and Facebook and posted videos from his events on YouTube to spread awareness of his company. In 2019 he opened an outlet renting out his event equipment to other smaller companies. This yielded about OMR 4,500 (£9,000) per annum and improved cash flow for the business. Al Harthy now wants to buy more event equipment. By 2019, United Events had organised some 30 events per year, yielding a net profit of OMR 24,000 (£48,000).

Questions:

1. Compare and contrast the GET2 results for Issam Al Harthy with those of Julian Thomas (Case insight 3.1). What conclusions do you draw?
2. What is the logic behind running the rental business alongside the events business?
3. Why might net profits in 2019 have been OMR 800 per event on average, compared to OMR 2,000 for his first event? What does this tell you?

This case was contributed by Dr Veena Tewari and Dr Kishan Kanchralapalli, Majan College, Muscat, Oman.

CULTURAL INFLUENCES ON CREATIVITY

As we have seen, one of the important character traits of entrepreneurs is creativity – an aspect of culture that Hofstede is silent on. But there are important influences here. Cognitive diversity is the ability to create different insights and find solutions to problems from different contexts. It typically stems from an exposure to different ideas and a willingness to explore them – to question the status quo or 'dominant logic' of a particular group. And cultures that encourage this tend to be more creative and innovative. Henrich (2015) said that the innovativeness of different societies was, in part, down to: 'the willingness and ability of large numbers of individuals to freely interact, exchange views, disagree, learn from each other, build collaborations, trust strangers, and be wrong'. He added: 'Innovation does not take a genius or a village; it takes a big network of freely interacting minds.' Syed (2019) talked about cognitive diversity being the real driver of innovation today both at an organisational and societal level. It can give different perspectives on a problem that facilitates the recombination of ideas from different walks of life – particularly important for today's tech companies:

> [Organisation and societal] cultures that encourage new ideas, foster dissent and have strong networks through rebel ideas can flow, innovate faster than those held back by cultures of intellectual conformity.

As we saw in the previous chapter, Florida (2002) and Florida and Tinagli (2004) argued that this sort of diversity might be found more in major cities such as London or Barcelona with their open and tolerant cultures that attract, what he called, 'the new creative class'. Individuals exposed to this

culture are more likely to become more creative, innovative or entrepreneurial, influenced more by the city than their national culture. The point remains that the cultures we encounter and grow up in influence our personal character for good or ill. We are what we are (or at least inclined to be), however, we can determine our future behaviours. By understanding the character and entrepreneurial mindset we can start to understand our own cultural influences and construct behaviours to mirror those of entrepreneurs. So, for example, in the next chapter we look at how cognitive diversity can be encouraged through 'connectivity' – and help in the search for a good business idea.

MEASURING CULTURAL INFLUENCES

One widely used tool for measuring a person's culture was developed by Erin Meyer (2014). Based on research data from over 30 countries, it identified eight dimensions that she claims capture most of the differences among cultures that affect the ways we communicate and understand each other:

- Communicating – This scale measures the degree to which a culture prefers low- or high-context communication. Low-context cultures (e.g. USA, Germany, the Netherlands), favour simple, clear and precise communication, often with written confirmation. High-context cultures (e.g. China, India and France) employ nuanced, layered communication with less put in writing and more left to interpretation.
- Evaluating – This scale measures the relative preference for direct versus indirect criticism. There is no direct link between this and the communication scale. While France favours high-context communication, it also favours being much more direct with negative feedback, compared to the USA (low-context). Similarly, Spain and Mexico may both favour high-context, but Spain favours more direct criticism than Mexico.
- Persuading – This scale measures preference for principles-first (theory) vs applications-first arguments (practice). Germans and southern Europeans favour setting out generally accepted principles before presenting an opinion while Americans and the British typically start with opinions or practical observations, adding theory and principles later.
- Leading – This scale gauges the degree of respect and deference shown to authority figures (power distance). High power distance favours hierarchy (e.g. China, Russia, Nigeria and Japan). Low power distance favours egalitarianism (e.g. Scandinavia and Israel).
- Deciding – This scale measures how group decision-making is consensual compared to reliant on one person (the boss). There is no direct link between this and power distance (e.g. the Japanese and Germans are hierarchical but are also consensual).
- Trusting – This scale balances task-based trust (from the head) with relationship-based trust (from the heart). In task-based cultures (e.g. USA, UK, Germany) trust is built through work. In relationship-based societies (e.g. Brazil, China, India) trust is built by personal networks.
- Disagreeing – This scale measures how confrontation is viewed – whether it improves or harms relationships. Some countries are comfortable airing differences (e.g. Germany, France, the Netherlands), others are not (e.g. Indonesia, Japan, Thailand).
- Scheduling – This scale measures whether time and time-keeping is seen as flexible (e.g. in Switzerland, Germany and the USA, time-keeping is expected, whereas in India, Brazil and Italy it is viewed more flexibly).

Explore further 3.5

Meyer's culture assessment tool

Access the *Digital Links* booklet to take Meyer's culture assessment tool which is free to use by individuals. It provides a comparison with the typical result from your country.

Case insight 3.4 Jack Cator and Hide My Ass!

Entrepreneurial personality



Source: Dan Nelson on Unsplash

Hide My Ass! (HMA!) began as a free proxy service created by Jack Cator. He originally created it as a way around school rules about using the internet. He wanted to unblock popular sites at the time like MySpace and other online games sites. The original HMA! masked the users' IP addresses by using proxy sites. By replacing their online identities it allowed users to access sites that might be restricted from their home IP address, although it only worked on a site-by-site basis. It soon developed into a way people could get around censorship and access otherwise forbidden internet sites by appearing to be based in another country.

Cator enjoyed working with computers from an early age. He left school in 2005, aged 16, to enrol on a two-year technology course at college, where he developed HMA! He worked from his bedroom at home and used income from advertisers to set up the service, using freelancers in eight countries. HMA! went online in the same year and, because it was a free service, rapidly gained users. In 2008, still running the business from his parents' house, Cator added a low-cost subscription-based virtual private network (VPN) to the otherwise free service. This protects the user's entire internet connection – including browser, online games and Skype – rather than simply their activity on individual sites. Because the free proxy service was so popular, the business did not have to convert many of these visitors into paying customers to start generating substantial profits. What is more, regular, professional users became more frequent. Because it offers users anonymity, the service is now used by professional security firms tracking down hackers and virus writers. In 2011, he opened the company offices in London.

By 2014 Cator had built HMA! into an expert VPN service with the widest international server network of any other VPN company in the world. The parent company, Privax – of which Cator was CEO – provided VPN services to over 10 million users and 250,000 paying subscribers worldwide using over 700 servers in some 130 countries. It generated profits of £2.3 million on turnover of £11.5 million and employed over 80 people based in London. That year it also launched an app, Hide My Phone! which allowed users to rent mobile phone numbers temporarily, masking their country of origin.

In 2014 Cator was a guest speaker at the *Wired* Next Generation Conference. He gave these ten 'top tips' based on his success in launching and growing the business:

1. Exploit your age
2. Go out and get the experience
3. Understand your audience
4. Branding is everything
5. Get it out there
6. Make use of free marketing
7. Engage with users
8. Don't delegate too early
9. Outsource your staff
10. You don't need financing

In 2015 Cator sold HMA! for £40 million ($60 million) to AVG Technologies, a New York-listed Dutch company specialising in online privacy and internet security. One-third of the price was performance-dependent. Not bad for a 26-year-old, one-time rebellious school boy!

Access the *Digital Links* booklet to visit the HMA! website and to watch a video of Jack Cator's talk at the Full *Wired* conference in 2014.

Questions:

1. What lessons do you learn about the entrepreneurial character from Jack Cator?
2. Explain the meaning of Cator's 'top tips'. Do they apply only to technology-based start-ups or can they be applied to any start-up?
3. Was Cator wise to sell his company at this stage? Explain.

SUMMARY

- To develop an entrepreneurial mindset involves understanding the entrepreneurial personality and character traits. This in turn requires us to understand a little about cognitive theory.
- The entrepreneurial character has six traits: high need for autonomy; high need for achievement; high internal locus of control; high drive and determination; high creativity and innovation; and a willingness to take measured risks and live with uncertainty.
- Cognitive development theory emphasises how these traits are influenced by background and upbringing, underpinned by the cultures of the different groups individuals associate with such as nationality, family, religion, education, work etc.
- The brain has two different systems or ways of working that are interlinked and complementary but function in different ways. System 1 (right-brain) is more intuitive, emotional, creative and engages automatically. System 2 (left-brain) is more logical, analytical and takes more effort to engage. We use both systems, shifting naturally from one to the other in different situations. Mostly they work together.
- The right-brain 'innovator' is typically better at radical or disruptive innovation. The left-brain 'adaptor' is typically better at incremental innovation. Entrepreneurial (practical) creativity requires the ability to oscillate between left- and right-brain activity.
- Effective leadership and management also require both left- and right-brain activity and the ability to oscillate between them is therefore important.
- Entrepreneurs make extensive use of cognitive heuristics in decision-making (right-brain), using knowledge gained from their network of contacts and past experience to make incremental decisions in risky situations. Strategy is emergent and in these circumstances generating as many strategic options as possible is important.
- Entrepreneurs' high internal locus of control (generalised self-efficacy) motivates them and gives them the dogged determination and self-belief to persist in the face of adversity, when others just give in.
- Most people are risk-averse to gains – they prefer the certainty of a small gain. They are also risk-seeking for losses – they prefer to gamble and avoid the certainty of loss. However, they do not approach complex decision-making logically. Entrepreneurs are likely to be less risk-averse for gains and more likely to gamble to avoid a loss. Their reliance on cognitive heuristics together with a high internal locus of control can be dangerous if it is not based upon a wide range of experiences and network of contacts.

GROUP DISCUSSION TOPICS

1. Are entrepreneurs born or made?
2. Can character traits really predict who might start up a business?
3. Which entrepreneurial character traits might have negative implications? What are they and how might they be countered?
4. What does self-efficacy mean? Is it a good or a bad thing for entrepreneurs?
5. Are entrepreneurs delusional?
6. Are entrepreneurs gamblers?
7. In the context of entrepreneurship, what does creativity mean?
8. Are entrepreneurs control freaks?
9. How has your education affected the development of your left- and right-brain?
10. Are you a dominant right- or left-brain person?
11. Compare and contrast left- and right-brain thinking. How can you get them to work together?
12. Give some examples of how you might influence the decision someone is making.
13. How might you improve entrepreneurial decision-making?
14. Are entrepreneurs really different to other people?
15. Does your country have an entrepreneurial culture?
16. How can an entrepreneurial culture be encouraged?
17. What do you have to do to develop an entrepreneurial mindset?

STUDENT ACTIVITIES

1. Take the GET2 test (page 58) and discuss the results with friends who know you well. Do they recognise these characteristics and the associated behaviours in you? Reflect on the influences that might have contributed to your character.
2. Take the Five-Factor personality test (page 58). Does this broadly support the results from GET2? If not, can you explain the differences?
3. Take Meyer's cultural influences test (page 74). Consider whether this explains any of the characteristics shown in the GET2 test. Discuss the results with the rest of the class, trying to understand the reasons for similarities and differences.
4. Reflect on the implications of these results for you. Based on the GET2 test results, write a report on whether you have an entrepreneurial character and the implications of this, making certain to cite the evidence to support your conclusions.
5. Get an entrepreneur to complete the GET2 test and have them reflect on the results. Compare their results with yours. Reflect on the similarities and differences.

4

RECOGNISING BUSINESS OPPORTUNITIES

Contents

- New venture typologies
- Creative cognition, diversity and connectivity
- Opportunity perception using discovery skills
- Measuring creativity
- Creating opportunity
- Spotting commercial opportunities
- Spotting opportunities in the value chain
- Techniques for exploring changing needs
- Techniques for exploring product/service inadequacies
- Systematic Inventive Thinking
- Finding an idea for a social enterprise
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: iStock.com/Rostislav_Sedlacek

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand and explain how practical creativity is important in finding new business opportunities and how it might be enhanced;
- Understand and explain how new business ideas come from creating opportunities by changing products/services or market paradigms and by spotting opportunities resulting from unmet demand or product/service inadequacies;
- Develop a range of discovery skills that enhance creativity, innovation and opportunity perception;
- Use a range of techniques to scan the environment for changes that might highlight business opportunities and to explore product/service inadequacies.

Case insights

4.1	TransferWise	4.7	Julian Thomas and Figaro Brands (2)
4.2	Azuri Technologies and M-Kopa	4.8	Apple and iTunes
4.3	Hackathons	4.9	Duplays Sports Services
4.4	Fetchr	4.10	Digikala
4.5	Great Ormond Street Hospital	4.11	Starship Technologies
4.6	Henry Ford	4.12	Maggie's

Explore further links

4.1	The art of innovation
4.2	Connectivity
4.3	Discovery skills
4.4	Creativity tests
4.5	Radical innovation
4.6	Market paradigm shift
4.7	Systematic Inventive Thinking

NEW VENTURE TYPOLOGIES

Good business ideas are usually based around finding a solution to a problem that somebody is willing to pay for. Finding one depends on the 'type' of new venture you want to start. Figure 4.1 shows six generalised types of new venture, depending upon how innovative the product/service and how new (and therefore less familiar) the market. Each has implications for how you go about finding the idea and each requires a very different approach to launching and growing the business because the complexity and risks increase with the degree of product/service innovation and the newness of the market. Those typologies shown in dark-blue are higher risk than those in light-blue. They are also likely to require greater investment. However, hand in hand with the high risks goes the prospect of high profits.

1. Copycat – If you introduce an existing product/service into an existing market you are copying competitors. Of course there is always room for competition in free markets but, unless you are significantly better than the competition in some way, you will probably be left to compete on price. This can be problematic if your competitors are large, well established and able to capitalise on economies of scale because low price implies low costs. Most copycat start-ups do compete primarily on price and therefore struggle to survive. They have low profitability and will probably stagnate with low growth potential. They are salary-substitute or lifestyle firms and comprise the majority of small, owner-managed businesses in any country. However, each new venture must be considered on its own merits. For example, a convenience/grocery store would be entering a highly competitive environment where large supermarkets have enormous economies of scale and will be able to compete more effectively on price. However, if this is the only store on a new housing development, with the nearest supermarket 10 miles away, then there is a good chance of making a healthy profit … that is until another copycat store starts up because there are no barriers to entry in this market.
2. Incremental product/service innovation – To avoid competing primarily on price, the thing to do is to try to modify the product/service in some way. Of course technological innovation (incremental or radical) is likely to require a deep understanding of the technology. It can involve providing the product/service with greater or improved functionality and/or applying the technology to other applications. Another approach is to spot opportunities or gaps in the market (unmet needs), perhaps by altering elements of the product/service in some significant way that adds value to customers. Changing the product/service in some way avoids competing head-on with established businesses and should allow a higher price to be charged, at least until competitors appear. If you are able to safeguard this innovation in some way – for example through branding (Chapter 8) or through intellectual property (IP) rights (Chapter 11) – then you might sustain this strategy for longer and it could even provide a platform for further growth. Staying in an already established market means that there is proven demand, but the danger here is that you are, by definition, competing against established suppliers with recognised brands, distribution channels and loyal customers. Competition could be fierce and competitors may be able to copy any incremental innovation quickly.

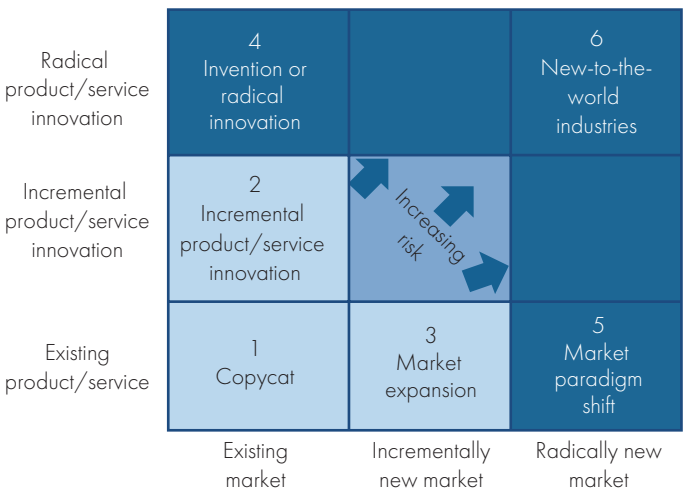


Figure 4.1 New venture typologies

> *Reinventing the wheel is risky and usually money and time-consuming – both of which would-be entrepreneurs normally lack. However, improving something that is already on the market means there is a demand for the product and you can just do it better with some lateral, creative thinking.*
>
> Adam Schwab, founder of Lux Group, *Business Review Australia*, https://issuu.com/businessreviewaustralia, July 2014

3. Market expansion – Another option is to expand the market by finding new customers not currently served by existing suppliers, for example in different geographical markets (both national and international). This offers considerable opportunities for new ventures because new products/services that originate in more developed markets often take time to find their way into developing markets. Timing and local knowledge can be crucial when a new product/service is introduced into any market. However, the danger here is always that the established supplier in the original market eventually moves into this new market and has sufficient resources and market presence to out-compete you. The challenge is therefore to move with sufficient speed that you dominate this new market before the established suppliers try to enter it.
4. Radical innovation or invention – Introducing a radically new product/service into an existing market will certainly confound the competition, possibly causing considerable disruption. If successful, competitors will certainly try to copy the invention, so it is important that IP is safeguarded (Chapter 11). However, while most companies are continually making improvements and incremental innovations to their product/services, invention is not something that all of us are able to do and can be risky and takes both time and money. Unlike James Dyson and his now ubiquitous cyclone vacuum cleaner, many inventors fail to make their invention commercially viable, failing to make the connection between an invention and the market opportunity. Steve Jobs never invented anything but he revolutionised three industries – personal computers, music and film animations – because he was able to find commercial applications for the innovations of others.
5. Market paradigm shift – This is when you create radically new markets by challenging the paradigms or conventions upon which an industry bases its whole marketing strategy – creating a new market where none existed before by recognising unmet (future) customer needs. So, for example, the development of the low-cost airline industry involved no inventions or innovations, only different ways of doing things that involved minimising the costs, and therefore the price, of air travel. In doing this, companies such as Southwest Airlines in the USA and easyJet and Ryanair in Europe created whole new markets for air travel that never existed before. Tony Fernandes later copied this business model very successfully in different markets with AirAsia – an example of market expansion (3).
6. New-to-the-world industries – Just sometimes radical new inventions create radically new markets – with entrepreneurs capitalising on the opportunities this brings. Tim Berners-Lee made nothing out of the invention of the World Wide Web in 1990, which in turn created new internet-based markets for information and changed the way we shop for many products/services. However, the founders of numerous internet firms, such as Larry Page and Sergey Brin of Google and Jeff Bezos of Amazon, created businesses based on Berners-Lee's invention and made their fortune out of it. Again, it was an entrepreneur who saw the commercial application for the invention. New-to-the-world industries have been created for centuries; water power, textiles and iron in the eighteenth century; steam, steel and rail in the nineteenth century; electricity, chemicals and the internal combustion engine in the early twentieth century. These innovations are disruptive and difficult to predict, but cause enormous economic booms that eventually peter out as the technologies mature and the market opportunities are fully exploited. They may offer the greatest commercial opportunity, but they are also the most difficult to achieve.

A review of these six new venture typologies will lead you to realise that there are two approaches to finding a commercial business opportunity:

- Spotting an opportunity or gap in the market where current (or future) customer needs are not being met. This probably involves incremental changes to a product/service or market expansion. Since there is some basis for estimating market demand, this is a relatively low-risk approach that can shield you from competition (at least in the short run) and be highly profitable.
- Creating an opportunity by developing a new market through radical product/service innovation and/or market paradigm shift. Since this would be an unproven market it is the riskier approach, but could offer greater profits. What is more, radical innovation requires a deep understanding of the technologies involved and probably a large investment over an extended period. On the other hand, a market paradigm shift may require an understanding of existing technologies, but requires a greater understanding of customer needs and market potential.

Case insight 4.1 TransferWise

Disruptive innovation start-up



Source: Getty Images/Maria Toutoudaki

Taavet Hinrrikus and Kristo Käärmann are both from Estonia. Both lived in London. Hinrrikus was employed by Skype and was paid in euros (€), so he needed pounds (£) to pay his bills. Käärmann worked for financial consultants and was paid in pounds but needed to pay a mortgage in euros back in Estonia. Moving money between euros and pounds meant that they lost about 5% in transfer and currency conversion charges – which they resented. So each month Hinrrikus would put his euros into Käärmann's Estonian mortgage account and Käärmann placed his pounds into Hinrrikus's UK bank account, using the exchange rate quoted at the time on Reuters. Both got the currency they needed without paying extra charges or suffering poor exchange rates. Then they realised that they could scale-up this operation by using internet-based technology to match currency transfers by people transferring money in one direction with people transferring it in the other – a form of peer-to-peer currency exchange bypassing banks and their commission charges, allowing customers to wire money to one another more cheaply. In 2008 they both decided to leave their jobs to build the money transfer system and in 2011 TransferWise went live.

> *'Faith in the banking system dropped significantly after the financial crisis ... customer expectations changed and the time was right for financial technology.' (Taavet Hinrrikus,* The Sunday Times, *16 November 2014)*

The service is cheaper than traditional fund transfer mechanisms, charging a fee of 0.5% (compared to 5–8%) or a flat fee of £1 if the amount is less than £200. Today TransferWise has revenues of £179 million with 8 million customers and transfers more than £4 billion each month. The head office is in London and technical staff are based in Estonia, but they have a total of 14 offices around the world with over 2,200 employees. The company now offers multi-currency accounts which allow customers to receive money with international bank details and track transactions on a smartphone as well as having its own TransferWise debit Mastercard. By 2017 it had raised about $400 million in venture finance from a number of investors including Richard Branson's Virgin Group and Peter Thiel's Valar Ventures.

In 2021 the company, now valued by private investors at $5 billion, re branded by shortening its name to Wise ahead of an expected IPO. Wise is part of the emerging fintech industry that we shall look at more closely in Case insight 5.4

Access the *Digital Links* booklet to visit the company website and to watch a video telling the story of TransferWise and an interview with founder Taavet Hinrikus.

Questions:

1. Why is TransferWise such a success?
2. Are there any advantages to being headquartered in London and what are the implications of the UK leaving the EU?

For most people spotting an opportunity is easier than creating one. However, creating opportunity is not always as difficult as it may seem, even for tech businesses, because incremental innovations can be cumulative. Most successful tech businesses are really based on incremental improvements to existing technologies rather than ground-breaking inventions:

» Apple's success is based upon good design and improving product ease of use rather than invention. Apple 1 was a big improvement on other computers with its graphic user interface and 'mouse', the iPod was a big improvement on MP3 players which had been available for years and the iPhone improved on mobile phones from Nokia and Blackberry.

- Google entered a crowded search engine market then dominated by AltaVista and simply created a better product by using an improved search algorithm. It became commercially successful after it introduced its AdWords bidding system – invented by Idealab.
- Facebook entered the market well after social networking sites such as Friendster and MySpace – it just established its dominance in a market where having people connected to one network was important and offered real customer benefits (called 'network effects').

Explore further 4.1

The art of innovation

Access the *Digital Links* booklet to watch a TED talk by Guy Kawasaki, author and advisor to Google, where he sets the scene on innovation.

CREATIVE COGNITION, DIVERSITY AND CONNECTIVITY

Both spotting and creating commercial opportunity require an entrepreneur to find solutions to problems that sufficient people are willing to pay for but that nobody (or very few) has solved so far. This practical, entrepreneurial approach to creativity is sometimes called 'creative cognition'. Successful entrepreneurs are able to match opportunities in the marketplace with innovative ways of meeting those opportunities. They link opportunity with creativity and innovation. But which comes first: seeing the commercial opportunity or the innovation? That 'eureka moment', when a good business idea is born, rarely happens by chance. Successful entrepreneurial firms such as Google or Samsung go about searching for and developing new business ideas in a systematic way. They actively stimulate employee creativity while integrating commercial information and knowledge into organisational learning. Their success is not just down to good luck. Entrepreneurs can do the same.

> *That's how we learned: by travelling, meeting people, setting up appointments, it's a continuous process.*
>
> Manish Agarwal, CEO of Reliance Games, *The Guardian*, 22 April 2015

Generating a good idea is a numbers game: the more ideas generated, the more likely it is that some will see the light of day. And, while there is an element of randomness about this, being exposed to different environments and opening your mind to how solutions in one context might be used in another increases the chance of this happening. A prerequisite to all creative processes is the generation of information, knowledge and the curiosity needed to be open to different ideas (Simmie, 2001). All too often we are blind to the knowledge and information that is being generated around us. However, we are often also constrained in our thinking not only by our prior knowledge and experiences but also the 'dominant logic' (ways of doing things) of the groups we operate in. We need to be more actively aware of what we are seeing – using our left- and right-brains together to link problems and practical solutions unhindered by conventional thinking. We then need time to mull over that knowledge and information as we apply it to finding a business idea. This subconscious 'incubation period' happens when we are engaged in other activities and can let our mind work on the problem.

> *You're constantly reading business books and constantly meeting people, [taking] advice from all sorts of people. I would recommend that.*
>
> Mark Constantine, founder of Lush, *RealBusiness*, 26 May 2009

Johnson (2010) did a good job of dispelling the myth that good ideas are a result of a single moment of serendipity – a 'eureka moment' for a lone genius. His central thesis was that new ideas rarely happen by chance. They take time to germinate and mature. Often the big idea comes from the 'collision' of smaller ideas or hunches and the chance of these 'accidental collisions' is increased with the exposure to more people and different ideas. So, while creativity underpins the generation of ideas, a prerequisite of this is connectivity – a connection with and an awareness of what is going on in the world in general and an ability to transfer ideas from one context to another. It generates new ideas, knowledge and information.

Connectivity is aided by reading, travel, even web browsing, but essentially it is a social process that involves meeting and talking with diverse people with different views of the world so as to see how different people do things and understanding why. It involves engaging both left- and right-brain. A number of studies have found that knowledge about markets, customer problems and ways to serve them help improve creative cognition (e.g. Shane, 2000; Shepherd and DeTienne, 2005). Networks

Case insight 4.2 Azuri Technologies and M-Kopa

Finding solutions to problems

Africa faces many problems associated with its poor infrastructure. Two of these are the lack of a reliable electricity system and the lack of money to pay for any investment in electricity generation. The World Bank estimates that some 600 million people in sub-Saharan Africa still do not have access to electricity, relying instead on hazardous kerosene lamps. And the World Health Organization found that fuels such as wood, dung, coal and other solid fuels cause 1.5 million deaths annually. Two companies, Azuri Technologies and M-Kopa (*kopa* is Swahili for borrow), aim to solve both problems with one product – solar panels with a simple pay-as-you-go business model. Both companies provide the solar panels connected to a battery which powers a range of appliances, including low-energy LED lights, a USB port for charging a mobile phone and a flat screen digital TV. Weekly payments can be made via the mobile phone that can be charged from the system. For example the financial model used by M-Kopa involves a deposit of approximately $35 followed by 365 daily payments of about $0.50 made through the widely used mobile money system M-Pesa using the mobile-phone that is being charged on the solar panel. Once paid for (usually in a year) the solar panel belongs to the buyer outright. Both companies sell through direct sales representatives, many of whom are women, who visit local villages.

Azuri was launched in 2012 in Kenya by Simon Branfield-Garth and headquartered in Cambridge, UK. Azuri now sells its systems in 12 African countries. In 2018 it sold over 150,000 solar panel systems and generated sales of £8.8 million.

M-Kopa was also launched in 2012 by Nick Hughes, Chad Larson and Jesse Moore and has its headquarters in Nairobi, Kenya. It has some 2,000 sales representatives and is now connected to about 750,000 homes across East Africa. Hughes previously set up and ran the M-Pesa payment system at Vodaphone, where Moore was working while completing his MBA. Larson met Moore on their MBA course in the UK.

Access the *Digital Links* booklet to visit the Azuri and M-Kopa websites and to watch videos showing how both Azuri and M-Kopa operate.

Questions:

1. What does this case tell you about how business ideas are formed?
2. How does this involve creativity or innovation?
3. Do you see any threats to this business model?
4. These two companies are direct competitors. What factors will determine which company is more successful than the other?

can be important structures that can provide information about markets as well as professional advice and opinion – often without charge. This might involve attending meetings, clubs, seminars and conferences. It is likely to involve travel. Formal networks such as chambers of commerce and trade associations can be invaluable. Universities often provide opportunities for novel insights. Networks can also provide opportunities to form formal or informal partnerships with different individuals or organisations so as to better exploit an opportunity.

However, connectivity extends beyond any industry or market context. It is not just about being aware of different approaches or perspectives on a problem, but also about getting the brain to accept that there are different ways of doing things – developing an open and enquiring mind. It is about being able to see the use of a novel idea in a different context, reusing or 'remixing' existing knowledge. Koestler (1964) talked about the creative act bringing new, previously unassociated frames of reference to bear on a topic with an existing frame of reference (patterns and rules that define boundaries of thought). Psychologists call it developing 'conceptual distance' – not becoming a prisoner to accepted paradigms or the dominant logic of a particular group – and seeing things from a different perspective. It is not so much about seeing something new as about seeing something familiar in a new way – like the way the paintings of Picasso represented familiar objects in a very different way. There are many examples of how solutions to commercial problems or opportunities can come from unrelated disciplines. Famously, Steve Jobs' interest in calligraphy is claimed to be the source of Apple's early development of a wide range of fonts on its computers. The ubiquitous Velcro

fastening was conceived in 1941 by Swiss engineer, Georges de Mestral. He got his inspiration from nature. After a walk, he observed that there were burrs of the burdock plant sticking to his clothes and dog's fur. He looked at them under a microscope and observed they had hundreds of tiny 'hooks' that caught onto 'loops' on clothing or fur. From this he conceived the possibility of two materials being bound together.

Explore further 4.2

Connectivity

Access the *Digital Links* booklet to watch:

- An animation from the RSA Animate series which explains the concept of connectivity, narrated by Stephen Johnson.
- A short clip which shows how 3M go about stimulating design innovation through collaborative working and connectivity.

Connectivity, then, is about creating different perspectives, insights and being open to different thinking styles. Syed (2019) believes this can be encouraged and facilitated through meeting and mixing with people from different backgrounds who might think about problems in different ways. He believes that working as a group with this 'cognitive diversity' stimulates creativity. This is consistent with how innovation is encouraged in certain locations through network effects (Chapter 2) and how cognitive processes and decision-making can be influenced by apparently unrelated factors (Chapter 3). He observed how the number of academic papers written by individuals has declined year on year and almost all the most challenging work is now undertaken in groups – 90 per cent of science and engineering papers are now authored by teams. He attributes the reason to the increasing complexity of the modern world. One way of addressing this is crowdsourcing – using the internet to get people to contribute ideas. Lego has used crowdsourcing very effectively to leverage up creative inputs. But this does depend upon who in the 'crowd' is willing or able to contribute ideas. Selected crowdsourcing is called 'open innovation'. The best-known examples of this are Wikipedia and Linux, where people and organisations have contributed their time and ideas without expecting remuneration. Apple have taken a different route to encourage outsiders to develop apps for its App Store. It sells a Software Development Kit for a nominal fee and allows them to sell the app for a price of their choosing, with Apple taking 30 per cent. The charges did not discourage app development.

> *You don't have to be a genius, or a visionary, or even a college graduate to think unconventionally. You just need a framework ... Seeing and seizing opportunities are skills that can be applied universally, if you have the curiosity and commitment.*
>
> Michael Dell, founder of Dell Corporation, (1999), *Direct from Dell: Strategies that Revolutionized an Industry*, New York: Harper Business

Many authors have observed that most innovations do not emerge in isolation but are at least in part recombinations of previously existing ideas or technologies (Flath et al., 2017; Ridley, 2020) – an assertion that can be traced back to Schumpeter (1942). In a quantitative review of patents, Strumsky and Lobo (2015) showed that most radical innovations come from the remixing and recombination of existing diverse knowledge – a conclusion supported by other research (Kaplan and Vakili, 2015; Nakamura et al., 2015). It is a case of many incremental innovations being combined to create a radical one. This reuse or remixing of existing knowledge – sometimes called 'bricolage' in the context of entrepreneurship – is an indispensable part of the creation of novel ideas. Gruber et al. (2013) called it 'the holy grail of innovation research'. That is not to say that expertise and depth of knowledge is unimportant. It just means that most innovation requires connectivity and having a more questioning and open perspective is vital.

Burt (2004) showed that in many business contexts, good commercial ideas have social origins. He looked at a range of business sectors and measured the number of business ideas that staff came up with. He found that the staff coming up with these ideas spanned 'structural holes' – they looked outwards for their ideas: 'This is not creativity born of genius; it is creativity born out of the import-export business.' Similarly, Lakhani (2006) found that it was 'outsiders – those with expertise at the periphery of a problem's field – who were most likely to find answers and do so quickly'. In other words,

Case insight 4.3 Hackathons

Finding solutions to problems

A hackathon is a time-limited (e.g. one-day), project-centred innovation event originally for computer programmers and others involved in software development (e.g. app development) but now used more generally to find solutions to problems. It has a very specific focus – to solve a specific problem. It can be for individuals but often involves cross-functional teams (e.g. programmer, graphic designer, project manager etc.). It can be an 'open' event (often the source of more radical innovations) or a closed-company event focusing on specific products/markets. It might involve competing teams. Programming hackathons' aim is to create a functioning piece of software or hardware at the end of the event such as an app. Usually this involves demonstrations.

An early example was in 1999 when Sun Microsystems challenged attendees at the JavaOne conference to write a program in Java script for the new Palm V using the infrared port to communicate with other Palm users. The GroupMe company was born out of an open hackathon at the TechCrunch Disrupt conference in 2010. Yahoo! holds an annual open hackathon that focuses on apps for its websites. Google has run similar events. A closed-company hackathon was credited with coming up with the ubiquitous 'like' button, originally developed for Facebook.

Access the *Digital Links* booklet to watch a video of a hackathon at Massachusetts Institute of Technology (MIT) in the USA.

Questions:

1. Why do hackathons work so well?
2. What lessons about innovation more generally do you take from the success of hackathons?

ideas that are commonplace for one group can spark insight for another. It is all about being open to ideas from all and every source and not being inward-looking. For example, Cadbury, the chocolate-maker, was founded in 1924 based on Quaker values with the aim of persuading people to drink chocolate rather than alcohol.

Case insight 4.4 Fetchr

Finding solutions to problems

Joy Ajlouny was raised in the USA by Palestinian parents. She previously ran an e-commerce business called Bonfire that specialised in luxury footwear and she became frustrated by the number of packages returned from customers in the Middle East marked 'address not found'. In many emerging markets delivery of goods can be a problem because of the absence of a physical address. She discovered that delivery companies were literally sending the driver out with a piece of paper containing telephone numbers to call the customers one at a time to find out where to deliver the package.

Ajlouny met Idriss Al Rifai at a Tech conference in San Francisco in 2014. Al Rifai was born in Iraq and raised in France, and had experienced similar problems as head of operations of the Dubai-based e-commerce company Markavip. They started discussing the problem and identified a technology-based solution – a patented app that allowed pick-up or delivery of merchandise to an exact GPS location based on the customer's smartphone signal. It means that there is no need for delivery directions.

The founders needed their own savings and some $1.2 million of seed equity (see Chapter 19) to develop the app and launch Fetchr in Dubai, UAE in 2015. They quickly rolled it out to Saudi Arabia and Bahrain. Their plan had been to be an aggregator between couriers and customers, but, to prove the concept and save time and money, the company has been using its own fleet of vans in Dubai to make deliveries and this has proved successful. Fetchr then raised $11 million in venture funding in 2015, making it the first early-stage investment in an Arab start-up by a top US venture capital firm.

Access the *Digital Links* booklet to visit the company website and watch a video of the two founders of Fetchr explaining how their app works.

Questions:

1. What problems might you foresee in scaling-up this business idea?
2. Are there any recurrent 'problems' that you face in your everyday life? Could solutions to these 'problems' form the basis of a business idea?

> *There is always something to learn from meeting someone new and a lot to learn from meeting someone old. The right contacts can become an invaluable source of learning as well as an inspiration and support.*
>
> Jonathan Elvidge, founder of Gadget Shop, *The Times*, 6 July 2002

There is also a link here to the high entrepreneurial tendency of immigrants (see Chapter 1) who experience different cultures and have the potential to bring ideas together. The perspective they have, being outsiders to a new culture, probably stimulates their awareness of differences and confers on them an ability to question the status quo. It gives them a diversity of experience that helps them recombine solutions to problems and provide different answers. Supporting this idea, Vandor and Franke (2016) reported on a study in which 243 US undergraduates were tested on their ability to identify profitable business opportunities – 128 before and after a semester of living and studying abroad and 115 who continued their studies in their home university – using four venture capitalists and other industry experts to assess their ideas. Those who studied abroad were rated 17 per cent higher than those remaining in the USA – in fact those remaining at their home university actually experienced a decline (–3 per cent) in the quality of their ideas over the course of the study. They concluded that 'cross-cultural experiences may increase individuals' capabilities to identify promising business ideas. By living in different cultures, they encounter new products, services, customer preferences, and communication strategies, and this exposure may allow the transfer of knowledge about customer problems or solutions from one country to another.'

Case insight 4.5 Great Ormond Street Hospital

Connectivity

Ideas for innovations can come from unusual sources. The Great Ormond Street Hospital for children took its inspiration from watching the McLaren and Ferrari Formula 1 racing teams take only six seconds to turn a car around at a pit stop. Doctors at the hospital were concerned by the time they took to move patients from the operating theatre to the intensive care unit where they recovered. Delays in emergency handover could cost lives, so they contacted Ferrari to see how the process might be improved. Ferrari explained that their pit-stop procedure was kept simple, with minimal movements all planned in advance. In fact, it was so simple that it could be drawn on a single diagram. From that plan, every member of the Ferrari team knew exactly what they had to do and when to do it in a coordinated fashion. Ferrari filmed the hospital's handovers. When the doctors watched it they were shocked at the lack of structure. Ferrari concluded that, with an ever-changing team and unpredictable demand, the hospital's handover teams needed a simple formula they could understand and work to – just like a pit stop. And Ferrari helped the hospital to design it.

The hospital team *observed* the speed of the Formula 1 pit stop. They *associated* this activity with the process that they undertook to move patients into intensive care. They *questioned* whether they could use similar processes. And finally they *experimented* to see if it would work.

Access the *Digital Links* booklet and watch a talk by Professor Martin Elliot about the involvement of the F1 team with the hospital. The first 20 minutes of the video relates to this case.

Question:

1. What are the barriers to developing discovery skills?

OPPORTUNITY PERCEPTION USING DISCOVERY SKILLS

There are a set of skills that can be used to help find business opportunities, building on the knowledge and information coming from connectivity. In a six-year study of more than 3,000 US CEOs, contrasting 25 well-known entrepreneurs (such as Steve Jobs of Apple, Jeff Bezos of Amazon, Pierre Omidyar of eBay, Peter Thiel of PayPal, Niklas Zennström of Skype and Michael Dell) with other CEOs who had no

track record for innovation, Dyer et al. (2009) found five 'discovery skills' that made these entrepreneurs particularly adept at linking market opportunity and innovation:

1. Networking – Echoing ideas of connectivity, these innovative entrepreneurs spent time finding and testing ideas with a network of diverse individuals in different countries. They started with a problem they wanted to solve and spent time talking to a network of different people – different ages, backgrounds, skills, countries etc. – so as to get new insights and different approaches to finding a solution. They did not just network with like-minded people, or just people involved in a particular industry. They were open to new ideas and different ways of doing things. Networking is a prerequisite for the other discovery skills.
2. Observing – These entrepreneurs observed common phenomena and people's behaviours, particularly that of potential customers. They scrutinised these phenomena, noticing fine detail and gaining insight into new ways of doing things. Ratan Tata, founder of Tata Motors, observed a family of four perched on a moped and asked why they could not afford a car. In 2009, after years of product development which involved new modular production methods, he launched the lowest priced car in the world – the Nano. Effective observing requires the ability to handle complexity and shift one's perspective.
3. Questioning – These entrepreneurs have the curiosity to challenge conventional wisdom, asking 'why?', 'why not?' and 'what if?' Why is something the way it is; why can it not be done a different way; what if I tried doing it this way instead? The iconic Apple iPod was developed at a time when MP3 players were well established. Staff developing Apple's iTunes software for use with MP3 players formed such a low opinion of the ease of use of MP3s that they decided to do better. Most of the entrepreneurs were able to remember the specific question that inspired them to set up their business. They were also able to imagine opposites – apparent paradoxes – including some different future state (e.g. new inventions) and to embrace real-world constraints so that they became opportunities if the constraints could be overcome.
4. Associating – These entrepreneurs connected seemingly unrelated questions, problems or ideas from many different fields. They were able to recognise relationships among objects, processes, cause and effect, people and so on that others did not see, searching for different, unorthodox relationships that could be replicated in a different context. They linked solutions to problems from one context to another, often from their mixing with people from diverse backgrounds and disciplines. These relationships might have led to completely new business ideas, products/services that nobody else had thought about. For example, James Dyson was able to see that a cyclone system for separating paint particles could be used to develop a better vacuum cleaner. Larry Page's idea for PageRank, which underpins Google's search engine, stemmed from an unrelated project he was working on called Stanford Digital Libraries. Dyer et al. (2009) also found that this ability to associate seemed to be something that could be encouraged through stimulation: 'The more frequent people in our study attempted to understand, categorise, and store new knowledge, the more easily their brains could naturally and consistently make, store and recombine associations.'
5. Experimenting – These entrepreneurs actively tried out new ideas, creating prototypes and launching pilots. Where these did not work, they learned from any mistakes and tried to use the learning in different projects. The Apple iPod started life as prototypes made out of foam-core boards, using fishing weights to give them the right feel. Not all products work to start with, and not all ideas are commercially viable to start with. Howard Head, the inventor of today's steel ski, made some 40 different metal skis before he found one that worked consistently. All the entrepreneurs engaged in some form of active experimenting, ranging from 'intellectual exploration' to 'physical tinkering' – taking things apart, or building prototypes. One of their most powerful experiments was visiting, living and/or working in overseas countries and being exposed to new ideas and mixing with people from diverse backgrounds.

> *Network. Meet people. Show a genuine interest in others. Don't talk too much. Listen more.*
>
> Raoul Shah, founder of Exposure, *The Observer*, 29 September 2013

> *That's how we learned: by travelling, meeting people, setting up appointments, it's a continuous process.*
>
> Manish Agarwal, CEO, Reliance Games, *The Guardian*, 22 April 2015

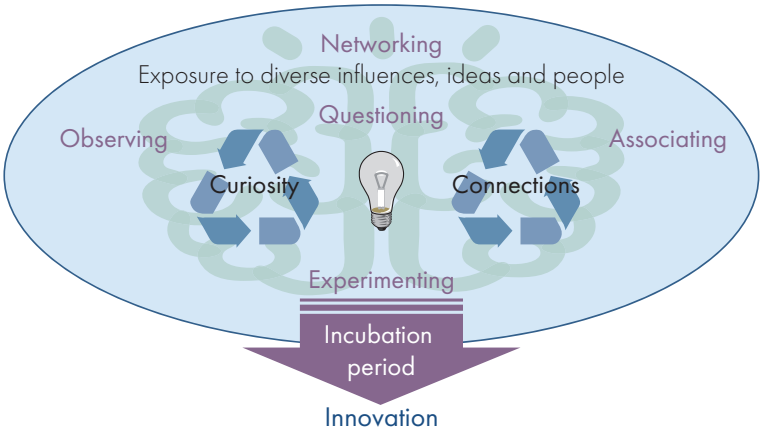


Figure 4.2 Discovery skills



Source: Shunya Koide on Unsplash

If there is a 'eureka moment' this is when it happens – the realisation that there is a solution to a problem you have been facing – and it often comes from the most unexpected of sources. But this only happens if your mind has a 'library' of knowledge and experiences to draw from – to come together to spark a new thought or idea. However, most people walk through life as if on auto-pilot (right-brain), unobservant and unquestioning as to why things are happening around them. To practise these discovery skills requires the active engagement of both left- and right-brain systems – an open mind that questions, makes connections and is willing to experiment. It is also worth remembering that physical activity encourages practical creativity, which is part of what is required in the process of networking. There is also the curious relationship between elation – simply laughing – and broader, more associative thinking which is particularly effective when it comes to solving a problem that demands a creative solution (Goleman, 1996). However, making these connections and associations can take time – time to incubate ideas. And taking time to think things through might well alleviate some of the cognitive biases that Kahneman (2012) outlined by allowing the left- and right-brains to better interact. There is an element of serendipity here. But the longer the time and the more the potential connections, the more likely an idea is to germinate. These linkages are shown in Figure 4.2.

Explore further 4.3

Discovery skills

Access the *Digital Links* booklet and watch:

- A short Harvard Business Review interview with Professor Jeff Dyer explaining how the discovery skills were developed.
- An INSEAD interview with Professor Hal Gregson about discovery skills and how they might be enhanced.
- Five short videos with Hal Gregson explaining in detail how each of the five discovery skills can be enhanced.

Case insight 4.6 Henry Ford

Market paradigm shift using discovery skills

Henry Ford revolutionised the way cars were produced and sold in the 1900s, moving from craft-based to production-line methods and from wealthy customers – a strategy all other firms were pursuing at the time – to supplying an affordable car for every person – a vision he had to turn into a reality. He created a new commercial market for motor cars – a market paradigm shift that changed the rules of the game. And yet this involved only incremental changes – albeit on an extensive scale – to products and processes, component and factory design and in the way labour was organised in his factories. This disruptive innovation created the mass market for cars that we know today. But where did Ford get his vision of the future from? How was he able to break away from the established thinking of how a car should be made and who it should be sold to?

Henry Ford was an 'active discoverer'. Firstly, he *questioned* why it was that only the wealthy could travel by car and came up with an alternative reality or vision. This all revolved around finding ways of producing cars cheaply – a low-cost business model with business strategies that reflected the need to mass produce and sell cars in high volumes. He *connected* this vision with a number of other situations he had *observed* through his *networks*.

Ford's key idea was to get workers to undertake repetitive tasks on a moving assembly line, rather than craftsmen being responsible for much of the assembly within a static garage. This idea came from observing how a slaughterhouse worked and connecting this to his vision. He implemented a system of profit sharing with front line workers in order to motivate them to do this quickly (time was money) – a concept that had been used by a French printing company decades earlier. His strategy of making one standard product in one colour (the black Model T Ford) was designed to make the assembly line operate as fast as possible – and he knew through *experimentation* that the black paint dried faster than any other colour. Finally, to get



Source: Hulton Archive/Stringer/Getty Images

the volumes of cars coming off this production line sold quickly he started a novel network of car dealerships, partly paid on a commission basis – just like Isaac Singer had done to sell his sewing machines nearly half a century earlier.

Ford started with a problem – how to make an affordable motor vehicle – made new connections that led to novel solutions, and wrapped a successful strategy around the big idea – the moving assembly line. As Henry Ford said: 'I invented nothing new. I simply assembled the discoveries of others.'

Access the *Digital Links* booklet and watch a short video showing the original Ford assembly line.

Questions:

1. From the examples given, which discovery skills did Henry Ford exhibit and how were they used to make his vision a reality?
2. What do you have to do to develop these discovery skills?

MEASURING CREATIVITY

Creativity means different things to different people. The GET2 test highlighted in the previous chapter provides only a limited insight into an individual's creative character. There are other tests that measure specifically creativity.

Kirton Adapter-Innovator (KAI) test

This is a test that distinguishes between the two cognitive thinking styles described in the previous chapter: right-brain innovators (System 1) and left-brain adaptors (System 2). It assesses the different dimensions of creativity including originality, attention to detail and following rules by way of 32 questions. With a score ranging from 32 to 160, one in the 60–90 range indicates an adaptive

cognitive style and a score in the 110–140 range indicates an innovative style. Neither style is seen as 'better' than the other, only different and complementary in the context of problem-solving and team working.

AULIVE test

This test provides a measure of general creativity. It is a 40-question instrument that assesses the respondent on eight dimensions against answers from others with similar backgrounds. The dimensions are:

- Curiosity – the desire to change or improve things that others see as normal.
- Connection – the ability to make connections between things that do not appear to be connected (connectivity).
- Perspective – the ability to shift one's perspective on a situation in terms of space, time and other people – an essential part of 'cognitive diversity' (thus allowing connections to be made).
- Abstraction – the ability to apply abstract concepts/ideas (thus facilitating making connections).
- Boldness – the confidence to push boundaries beyond accepted conventions. Also the ability to eliminate the fear of what others might think of you (not being constrained by 'dominant logic').
- Paradox – the ability to simultaneously accept and work with statements that are, or appear to be, contradictory.

Case insight 4.7 Julian Thomas and Figaro Brands (2)

Creativity and the entrepreneurial personality

Julian Thomas was just as sceptical about the AULIVE test as he was about GET2. His results are shown below in Figure 4.3. He was surprised, particularly with his high 'boldness' score which he felt mainly reflected how well his business was doing at any particular time. However, he did note that his above-average overall score was consistent with the GET2 result for creativity (Figure 3.2).

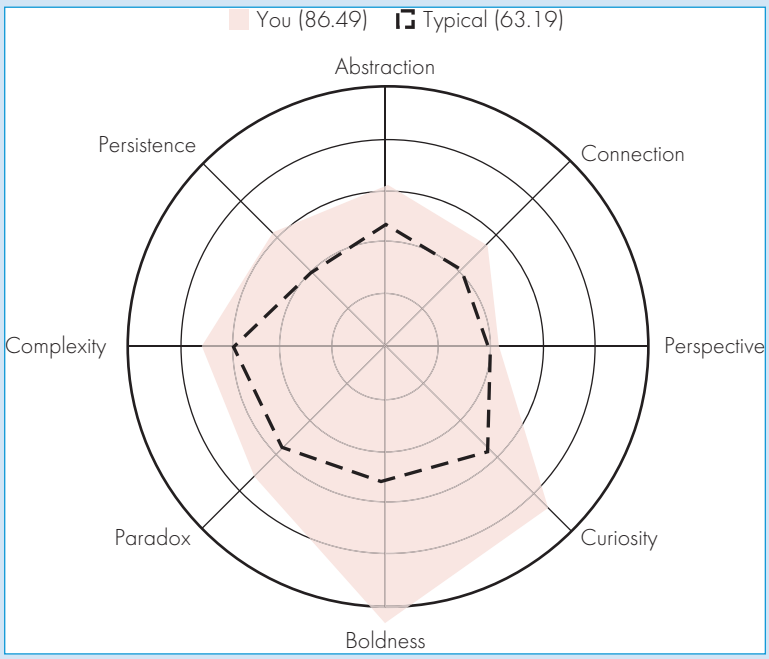


Figure 4.3 AULIVE creativity test results for Julian Thomas

Questions:

1. What conclusions do you draw from Julian's test results?
2. How do the dimensions of the AULIVE test relate to those in the GET2 test?

Explore further 4.4

Creativity tests

Access the *Digital Links* booklet and take these creativity tests online:

- The Kirton Adapter-Innovator (KAI) test.
- The AULIVE test.
- The Herrmann Brain Dominance Instrument (HBDI) test.

» Complexity – the ability to carry large quantities of information, and to manipulate and manage the relationships between such information.

» Persistence – the ability to force oneself to keep trying to find more and stronger solutions even when good ones have already been generated.

All the AULIVE creativity test dimensions map onto the characteristics of the discovery skills outlined in the previous section other than networking. Observing requires 'curiosity', the ability to handle 'complexity' and shift 'perspective'. Questioning involves 'curiosity', 'boldness' and the ability to perceive 'paradox'. Associating links the attributes of 'connection', 'abstraction' and 'perspective'. Experimenting is one aspect of 'curiosity', but also requires 'persistence'.

Herrmann Brain Dominance Instrument (HBDI)

This is a test that measures and describes thinking preferences in four dimensions, based on a 120-question online test:

» A: Analytical thinkers – rational, logical, analytical and critical thinkers who prefer collecting and analysing data, understanding how things work and judging ideas based on facts.

» B: Sequential thinkers – organised, structured, conservative thinkers who can handle complexity but prefer following detailed directions and step-by-step problem-solving and are good at organising work and implementing ideas.

» C: Interpersonal thinkers – emotional, intuitive thinkers who prefer listening to and expressing ideas, group interaction and looking for personal meaning.

» D: Imaginative thinkers – imaginative, intuitive, conceptual and holistic thinkers who can synthesise different ideas. They prefer looking at the big picture rather than dealing with detail, challenging assumptions, and are good at creative problem-solving and long-term thinking.

Generally dimensions A and B are more left-brain (System 2) thinkers – more 'rational'. C and D are more right-brain thinkers (System 1) – more 'intuitive'. Type D thinkers are the most creative, but a person may have more than one thinking preference and A and D are more 'intellectual' and B and C are more 'instinctive'. Each thinking preference brings advantages and, because of this, a new venture team comprising different thinking preferences can bring distinct advantages, which we explore in Chapter 14.

CREATING OPPORTUNITY

Creating a business opportunity can come through radical product/service innovation or market paradigm shift. It can be highly disruptive and may lead to the development of new-to-the-world industries. While it may hold the prospect of spectacular profits in the future, it is risky and is likely to take time and resources. For the entrepreneur it requires vision and self-belief aplenty. It requires a leap in creative imagination, from mere possibility to commercial reality that can be difficult for many people. It involves a step change in the technology of the product/service, processes or the framing of

markets. Phadke and Vyakarnam (2017) call this 'creative synthesis' – a blending of an understanding of technology with an understanding of the market that can create a whole new market space. As we saw in Case insight 4.6, Henry Ford was able to link his knowledge of car building to radical ideas about how cars might be assembled and then marketed. But it also probably needs a team of people to launch the business, ample funding and careful planning.

Explore further 4.5

Radical innovation

Access the *Digital Links* booklet and watch:

- A brief Harvard Business Review animation explaining how radical innovation can disrupt an industry.
- A Harvard Business Review interview with Scott Anthony on how to spot disruptive innovation opportunities.

> *We learned the importance of ignoring conventional wisdom ... It's fun to do things that people don't think are possible or likely. It's also exciting to achieve the unexpected.*
>
> Michael Dell, founder of Dell Corporation, (1999), *Direct from Dell: Strategies that Revolutionized an Industry*, New York: Harper Business

Market paradigm shift happens when entrepreneurs challenge the conventional ways of marketing a product/service. In most sectors there are factors that managers believe are critical to the success of their business. These paradigms become part of the dominant logic of an industry. But circumstances and the environment can change and the managers running the industry may not adapt their way of thinking. Kim and Mauborgne (2005) coined the term 'blue ocean strategy' for a strategy that seeks to identify and meet currently unrecognised and unmet market needs. Based on a sample of 108 companies, they estimated that, whereas only 14 per cent of innovations created new markets, these innovations delivered 38 per cent of new revenues and 61 per cent of increased profits. They observed that companies creating blue ocean strategies never benchmark against competitors, instead they make this irrelevant by 'creating a leap in value for both the buyers and the company itself'. They create uncontested market space, creating new demand and making competition irrelevant. They contrasted this to 'red ocean strategy' which involves gaining competitive advantage in existing, often mature markets. They acknowledge that 'red oceans' cannot be ignored, but criticise conventional marketing strategy as being too focused on building advantage over competition in this way.

This was new. Based upon a study of firms that had challenged established big companies in a range of industries, Hamel and Prahalad (1994) claimed that these firms had succeeded in creating entirely new forms of competitive advantage by asking three key questions:

» What new types of customer benefits should you seek to provide in 5, 10 or 15 years?

» What new competencies will you need to build or acquire in order to offer these benefits?

» How will you need to reconfigure our customer interface over the next few years?

Chaston (2000, 2015) argued that firms have to systematically challenge established market conventions – the dominant logic in an industry – and develop new solutions. His approach was simple: understand how conventional competitors operate and then challenge their approach by asking whether a different one would add customer value or create new customers. Sometimes doing things differently can add value for the customer without involving extra costs – indeed sometimes doing things differently can reduce costs – while still providing the opportunity to charge a high price. An entrepreneur might dissect and challenge every element of an existing business model or those used in an industry: '*why* is the product assembled, priced, promoted, distributed etc. in this way?' '*Why not* do it differently?' This is one of the fundamental discovery skills. Chaston suggested three broad categories of conventions that can be challenged:

1. Sectoral conventions – These are the strategic rules that guide the marketing operations of the majority of firms in a sector, such as efficiency of plants, economies of scale, methods of distribution and so

on. Kim and Mauborgne (2005) talked about re-orientating analysis from *competitors* to *alternatives*. So, for example, in the UK insurance used to be sold through high-street insurance brokers until Direct Line challenged the conventional wisdom and began to sell direct over the telephone, then on the internet. Now this is the norm.

2. Performance conventions – These are set by other firms in the sector and include profit, cost of production, quality and so on. Kim and Mauborgne argued that both value enhancement and cost reduction can be achieved by redefining industry problems and looking outside industry boundaries, rather than simply trying to offer better solutions to existing problems as defined by the industry. In the 1960s, Japanese firms ignored Western performance conventions en masse and managed to enter and succeed in these markets.
3. Customer conventions – These conventions make certain assumptions about what customers want from their purchases, for example price, size, design and so on. Kim and Mauborgne talked about re-orientating analysis from *customers* to *noncustomers*. The Body Shop redefined the cosmetic industry's 'feel-good factor' to include environmental issues.

Creating opportunity through market paradigm shift is probably easier and less risky than radical product/service innovation – and can be just as profitable. Both approaches require creativity – an ability to 'think outside the box', to be open to new ideas and challenge conventions, using wide-ranging knowledge and information as powerful stimuli. They require an ability to deal with rapidly changing and disparate information perhaps in a wide range of new technologies and in diverse, fragmented and often geographically widespread markets – linking a vision of the future with market opportunities. To do this entrepreneurs may need to assemble a team with the key skills and capabilities to deliver their vision. They need to be able to chart a way through what might be an uncertain market and regulatory environment – leading and motivating the team they have assembled. But remember, creating these sorts of opportunities can be risky. There is no guarantee that the market will agree with this vision of the future.

Explore further 4.6

Market paradigm shift

Access the *Digital Links* booklet and watch a Harvard Business Review animation explaining blue ocean strategy, using Cirque du Soleil as an example.

SPOTTING COMMERCIAL OPPORTUNITIES

Creating opportunity is hard. Spotting opportunity in a systematic way is easier and there are tools and techniques that can help. The main source of opportunity is change – changes in technology, law and regulation, market and industry structures, demographics, culture, moods and fashions all create market opportunities that entrepreneurs can exploit. Change creates unexpected events and incongruities. It provides clues to the existence of commercial opportunities – unmet needs now or in the future – and can destabilise existing market structures. Trying to analyse existing products/services and markets is probably easier than trying to invent new ones. And if exploiting the opportunity involves incremental product/service innovation and market expansion, it is certainly less risky. There may well already be existing commercial opportunities arising from:

» Unmet needs or the unsolved problems consumers face now (and in the future). This can arise through laziness, ignorance or just because it takes time for the market information to be acted on.
» Inadequate products/services where the product/service itself or the process undertaken to produce it can be improved. Deficiencies in products/services can go undealt with for months or years, to the

Case insight 4.8 Apple and iTunes

Industry dominant logic

In 2019 Apple announced that it would be terminating iTunes and splitting the software into three functional units dealing with music, podcasts and TV apps. It seemed logical as iTunes had grown bloated. However, only 13 years before this iTunes had burst onto the market and revolutionised the music industry by making it easy to buy and download music. But how did this revolution happen?

Music has been on the internet since CDs made music digital in the early 1980s. Despite being huge (700MB), CDs could be copied and, despite the slow network connections, shared. But it was not until the early 1990s when it was discovered how to shrink files that file sharing became practical. In 1994 the MP3 encoder was released, compressing three minutes of music into just 3MB of data. This opened the floodgates to music 'sharing'. But it was not until Napster came along in 1999 – a free-to-use, internet-based software system that enabled computer users to 'share' music – that the music industry was turned on its head. Files of music could be shared for free, albeit illegally. The dominant logic in the industry was selling CDs that were protected by copyright and Napster undermined completely that business model. When they eventually managed to close down Napster in 2001 it left some 60 million users looking for, but unable to find, an internet-based substitute product. The industry continued to try to sell the physical product called a CD.

It took Steve Jobs and Apple to recognise that there was a commercial opportunity for an internet-based music market. Based on SoundJam MP, a software program that Jobs acquired in 2000, in the following year Apple launched its own software that enabled music to be easily uploaded, organised and played. When in 2003 Apple finally added the iTunes store to it, enabling tracks to be purchased and downloaded easily and legally, the revolution was complete. Apple had reinvented the business model for a music industry that had been fixated on selling physical products. In doing so, it leap-frogged competitors and quickly established itself as a dominant player in the music industry. What is more, because music was such an important part of the internet evolution, this also increased the functionality of its physical products such as computers, iPods and iPhones and was integral to their success.

Questions:

1. Why was the music industry fixated on selling CDs at the time?
2. How difficult is it to transfer knowledge and learning (along with market opportunities) from one industry to another?

> *As Darwin well understood, it is the species most responsive to change that is the best equipped for survival.*
>
> Luck Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 21 May 2017

point where they are just taken for granted. Entrepreneurs are often closer to customers and listen to what they say, and they recognise and act on market opportunity more quickly than established firms.

» Products/services that can be reimagined and re-engineered to produce alternatives that also have value in the market.

This requires creativity and innovation. It was Drucker (1985) who said that innovation was 'capable of being presented as a discipline, capable of being learned and capable of being practiced', adding that 'entrepreneurs need to search purposefully for the sources of innovation, the changes and their symptoms that indicate opportunities for successful innovation'. He believed the search for innovative opportunities can be practised systematically through a creative analysis of change in the environment and the opportunities this generates. It is not the result of 'happenstance' or that rare 'eureka moment'. He listed seven symptoms of change that can be used to search systematically for entrepreneurial opportunities. These are 'basic symptoms' – highly reliable indicators of changes that have already happened or can be made to happen with little effort. They are:

1. Unexpected change – be it the unexpected success or failure or the unexpected event. Nobody can predict the future but an ability to react quickly to changes is a real commercial advantage, particularly in a rapidly changing environment. Information and knowledge are invaluable.
2. Incongruity – between the change that actually happens and what was supposed to happen. Plans go wrong and unexpected outcomes produce opportunities for firms that are able to spot them.
3. Inadequacy in underlying processes – that are taken for granted but can be improved or changed, often as a result of changes in technology. This often involves improving some elements of process

Case insight 4.9 Duplays Sports Services

Spotting an unmet need

In many countries in the Middle East locals prize jobs in the public sector rather than in private business. It is not surprising therefore that many start-ups originate from the large expatriate populations. And where better to find a business idea than from the unmet needs of the people you come from. While working as expatriates in Dubai in the United Arab Emirates, Canadian-Indian born Davinder Rao and Indian-born Ravi Bhusari wanted to make friends and play sport but found that most social activities revolved around going to bars or visiting shopping malls. They had already organised 20 expat friends to play frisbee on a regular basis and reasoned that if they wanted to do this, other expats might be interested as well and there might also be a business opportunity. So, in 2007 they launched Duplays Sport Services.

From this small beginning, the company has grown and now organises sports such as football (soccer), beach volleyball, basketball, touch rugby, netball, cricket, frisbee and golf, often with related social events. They offer nightly league matches and weekend tournaments organising facilities, equipment, staffing and scheduling:

> *'Most of the institutionalised activity seemed to revolve around shopping malls or going for drinks or brunches. We figured plenty of people like to play sport and so the secret was to meet that need and build a website and a business that helped people discover what was out there.'*

The notorious red tape in many countries of the Middle East can make it hard to start a new business. The founders discovered that the bureaucracy can be especially difficult for expats to negotiate without local connections. However, while many countries require expats starting a business to have a local partner, Dubai has a free-zone system that gets round this requirement, meaning founders can own 100% of the business. Nevertheless, they still found that raising finance was difficult.

Since its launch Duplays has grown to over 100,000 members playing over 29 recreational sports. It now has branches in cities in the UAE (Dubai, Abu Dhabi and Al Ain), Saudi Arabia (Riyadh and Jeddah), Qatar (Doha) and India (Delhi and Gurgaon) and claims to rank as one of the largest adult sport and social clubs in the world.

In fact, much of its income now comes from organising corporate events – sports leagues and complete wellness programmes for organisations to get employees healthy and active, using sport and activities to help with team-building. Being based in an international business hub has proved crucial to Duplays' success in this market, and Dubai's tax-free status has not hurt either. The company's clients now include a range of international organisations like Castrol, Gillette, Samsung and Volkswagen as well as local companies such as Al Hilal Bank, Dubai Airport, Emirates Aluminium and First Gulf Bank.

Ahead of the coronavirus outbreak in 2020, Duplays had planned to open its own indoor sports facility in Dubai in 2021, but the lockdown meant that all sports (and building) activity across the region was halted. The company is planning to open as soon as it is safe.

Access the *Digital Links* booklet to visit the company website and to watch a video promoting the company's corporate events service.

Questions:

1. What are the barriers and constraints to spotting this sort of opportunity?
2. What factors have influenced the success of the business?

engineering – especially important if the product/service is competing primarily on price. We explore product/service inadequacies and how they might be improved later in this chapter.

4. Changes in industry or market structure – that take everyone by surprise. Again, unexpected change, perhaps arising from technology, legislation or other outside events creates an opportunity to strategise about how the firm might cope and, as usual, first-mover advantage is usually worth striving for. We explore how the value chain of a product/service might be reviewed in the next section.

These changes produce sources of opportunity that need to be dissected and the underlying causes of change understood. The causes of the changes give clues about how innovation can be used to increase value added to the customer and economic return to the firm. The other three factors come from scanning for change in the outside world:

5. Demographic changes – population changes caused by changes in birth rates, wars, medical improvements and so on.
6. Changes in perception, mood and meaning – that can be brought about by the ups and downs of the economy, culture, fashion etc. In-depth interviews or focus groups can also often give an insight into these changes.
7. New knowledge – incremental or radical, scientific or non-scientific innovations that have not, as yet, been successfully exploited, possibly because markets have not been identified. Entrepreneurs are usually good at exploiting new technologies, sometimes creating disruption in established markets.

Drucker listed these seven factors in increasing order of difficulty, uncertainty and unreliability (i.e. risk), which means that he believes that new knowledge, including scientific invention, for all its visibility and glamour, is in fact the most difficult, least reliable and least predictable source of innovation. Paradoxically, this is the area to which government, academics and even entrepreneurial firms pay most attention. He argued that innovations arising from the systematic analysis of mundane and unglamorous unexpected successes or failures are far more likely to yield successful commercial innovations. They have the shortest lead times between start and yielding measurable results and carry fairly low risk and uncertainty.

> *Innovation has more to do with the pragmatic search for opportunity than the romantic ideas about serendipity or lonely pioneers pursuing their vision against all the odds.*
>
> Nicholas Valery, 'Innovation in Industry', *The Economist*, 5(28) 1999.

Case insight 4.10 Digikala

Importing an idea from another country

Commercial opportunities often emerge in one country before others and sometimes copying that idea can give a start-up first-mover advantage in a market. This is particularly the case in emerging, less-developed markets. Digikala (meaning 'digital products' in Parsee) is an online e-commerce site similar to Amazon but based in Tehran. It was launched from a small rented office in Tehran by twin brothers, Hamid and Saeed Mohammadi, in 2007. Originally they had been frustrated trying to find a shop that sold the digital camera they wanted and when they bought one it turned out to be a fake. So they started an online company that sold only two products – mobile phones and digital cameras – and posted authentic Amazon-style reviews of these goods. Digikala started with seven employees. By 2020 it had over 4,500 and was operating in more than 20 Iranian cities, selling everything from food to consumer goods. Digikala offers same or next day delivery in a country that has high internet usage (over 62% in 2017) but no Western internet competitors because of sanctions. Almost 90% of Iran's e-commerce now takes place on the site. Digikala has become Iran's third most popular website (it even ranks in the top 40 in the UK) and is now the biggest e-commerce platform in the Middle East with some 2 million visitors each day. Hamid Mohammadi does not see Amazon as a threat, as Digikala is too well established:

> *'I don't think Amazon is a threat to us. Even if they do see Iran as so big a market [that they enter it], they would have to establish a Persian-language Amazon. I think lifting sanctions would be more of an opportunity for people like us than a threat.' (The Sunday Times, 21 May 2017)*

Access the *Digital Links* booklet to visit the company website and to watch a video telling the story of Digikala.

Questions:

1. Why has Digikala been so successful?
2. If Amazon were to enter the market in Iran, how might they do so and how would Digikala react?

SPOTTING OPPORTUNITIES IN THE VALUE CHAIN

One way to discover inadequacies in underlying processes and even question market paradigms is by analysing the value chain of an industry. Behind this is the idea that real advantages in cost or product/service differentiation can be found in the chain of activities that a firm performs to deliver value to its customers. In recent years opportunities for smaller firms have been created as the internet allowed

value chains to be disaggregated, or broken down. The value chain comprises five primary activities (Porter, 1985):

1. Inbound logistics (receiving, storing and disseminating inputs)
2. Operations (transforming inputs into a final product/service)
3. Outbound logistics (collecting, storing and distributing products/services to customers)
4. Marketing and sales
5. After-sales service

and four secondary or supporting activities:

1. Procurement (purchasing consumable and capital items)
2. Human resource management
3. Technological development (R&D etc.)
4. Firm infrastructure (general management, accounting etc.).

Each generic category can be broken down into discrete activities unique to a particular firm or industry. By looking at the costs associated with each activity and trying to compare them to the value obtained by customers, mismatches can be identified. In reality it is difficult to undertake this analysis with any precision; however, it might be possible to reduce costs through new technologies, different sourcing or work efficiencies. For example, low-cost supply may be linked to proximity to a key supplier of raw materials or labour. The internet provides the opportunity to look at disintermediation – reducing the use of intermediaries – in order to reduce costs. In contrast, if customers value certain stages of the chain more highly than indicated by the resources allocated to them, it may be profitable to offer an improved product/service by increasing the resources allocated to these stages. For example, a high-quality product may be let down by low-quality after-sales service – the value to the customer not being matched by sufficient investment.

An analysis of the value chain may also highlight where changes in the linkages might create new opportunities. For example, real and virtual products can now be sold globally through virtual sales channels and shipping subcontracted. Entrepreneurial firms might also add value within the chain in a number of ways, not least by developing closer relationships with customers and/or suppliers. This might create the opportunity to offer complementary product/services.

TECHNIQUES FOR EXPLORING CHANGING NEEDS

There are a number of tools that can be used to identify and explore change.

Brainstorming

Brainstorming is one of the most widely used, basic techniques designed to generate a large volume of ideas around a topic. It is practised in a group, thus encouraging connectivity. In the session participants do not question or criticise ideas. They suspend disbelief and do not engage left-brain. The aim is to encourage the free flow of ideas – right-brain, divergent thinking – and to come up with as many ideas as possible. Everyone has thousands of good ideas within them just waiting to come out. But people inherently fear making mistakes or looking foolish in front of others. Here making 'mistakes' and putting forward ideas which do not work is not only acceptable, it is encouraged. The group leader might start with a problem to be solved or an opportunity to be exploited. They will encourage and write down ideas as they come – there are no 'bad' ideas. All ideas are, at the very least, springboards for other ideas.

PESTEL analysis

This is a widely used tool to aid thinking about changes in the wider environment. This in turn can be used to spot commercial opportunities arising from these developments. PESTEL is an acronym that stands for:

Political changes like local or central government elections, political initiatives, for example on price competitiveness, new or changed taxes, merger and takeover policy and so on.

Economic changes such as recession, growth, changes in interest rates, inflation, employment, currency fluctuations and so on.

Social changes such as an ageing population, increasing inequality, increasing work participation often from home, 24-hour shopping, increasing crime, increasing participation in higher education, changing employment patterns, increasing number of one-parent families and so on.

Technological developments such as increasing internet band width, the coming together of internet technologies, increasing use of computers and chip technology, increasing use of mobile phones, increasing use of surveillance cameras and so on.

Environmental developments such as climate change, waste and pollution reduction, species reduction and so on.

Legal changes such as health and safety, changes in employment laws, food hygiene regulations, patent laws and so on.

Having highlighted significant changes, the next question is 'what commercial opportunities do they generate?' The acronym is sometimes shortened to 'PEST' or 'SLEPT' by dropping the 'legal' and/or 'environmental' elements.

Futures thinking

Once PESTEL has identified the broad environmental trends, futures thinking can be used to help paint a more comprehensive picture of the future state of the competitive environment. It tries to take a holistic perspective, developing a vision about the future state after the change has taken place. This provides a further insight into the changes, ahead of defining the commercial opportunity using the technique of brainstorming. Current constraints to action might be ignored and in this way barriers to change can be identified. Some barriers may indeed prove to be permanent or insurmountable, but many might not. Objections are therefore outlawed and disbelief suspended at the initial ideas stage. Only later on might options be discarded, once the barriers are considered. The key to thinking about the future is not to assume it will necessarily be like the past. Change is now endemic and often discontinuous. For example, what will be the state of a particular form of retailing in five years' time, given the impact of the internet, smartphones and more recently the coronavirus pandemic? Will bricks-and-mortar retailing continue to exist? If so, how will it combine with these technological developments? What will it look like, where will it be located and what services will it need to offer? How will it attract customers? These and many more questions might help to 'flesh out' a picture of how it might look and what a company needs to do to survive and prosper in the future.

Mind maps

Mind maps are simple maps that link one idea to another. Previous techniques are designed to generate a volume of ideas and mind maps can be used in a similar way, generating related ideas that might not have been encapsulated in the original. This can help identify connections between apparently unconnected ideas. However, mind maps can also be used to develop and refine an idea. As you go further down any particular 'route' in the map you enter into more and more detail about that particular direction. Figure 4.4 shows a simple mind map for the activities involved in opening a shop. It shows how the technique can be used to break down quite complex activities.

The techniques outlined so far can be combined to form the systematic 4-stage process for spotting a commercial opportunity shown in Figure 4.5. Starting with PESTEL to identify changes; selecting one or more change to explore its implications through futures thinking; brainstorming the commercial opportunities arising; finally using mind maps to refine the idea and understand what actions need to be undertaken to make it a commercial reality.



Figure 4.4 Mind map for a shop opening

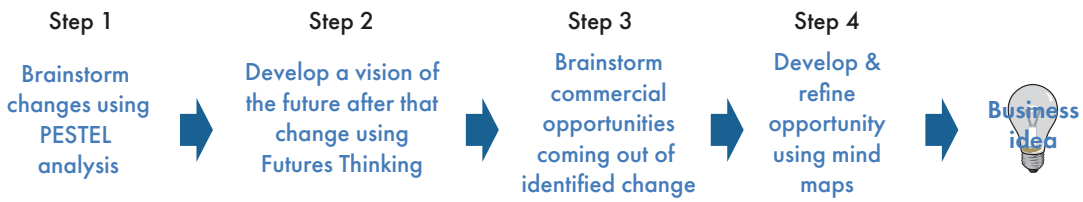


Figure 4.5 Spotting a commercial opportunity arising out of change

TECHNIQUES FOR EXPLORING PRODUCT/SERVICE INADEQUACIES

Often an existing product/service does not perform as promised presenting fairly obvious opportunities for improvement. However, sometimes the deficiencies can be more subtle. There are a number of techniques that can be used to explore product inadequacies.

Analogy

This is a product-centred technique that attempts to join together apparently unconnected or unrelated combinations of features of a product/service and benefits to the customer to come up with innovative solutions to problems. It is therefore designed to provide more focused ideas that create opportunity out of the unsolved problems facing customers. Analogies are proposed once the initial problem is stated. The analogies are then related to opportunities in the marketplace. It works in a similar way to brainstorming. Georges de Mestral's connection between the properties of burdock seed and the need to stick and unstick things is an example of analogy that led to the development of Velcro.

In building an analogy, basic questions might be asked such as:

» What does the situation or problem remind you of?

» What other areas of life or work face a similar situation/problem?

» Can the principles underlying the solution to the original situation/problem be adapted to the new situation/problem?



Source: Photo Mix from Pixabay

Often the analogy contains the words '… *is like* …', encouraging you to ask why something 'is like' another. For example, why is advertising like cooking? Answer – because there is so much preamble to eating – anticipation from presentation and smell, even the ambience of the restaurant you eat it in, are just as important as the taste and nutritional value of the food itself. They 'advertise' the food to be eaten.

Attribute analysis

Attribute analysis is another product-centred technique designed to evolve product/service improvements and line extensions, often used as the product/service reaches the end of its life cycle. It uses the basic marketing technique of looking at the features of a product/service which in turn perform a series of functions but, most importantly, deliver benefits to the customers (see Chapter 8). An existing product/service is stripped down to its component parts and then you explore how these features might be altered, using brainstorming. The focus needs to be on whether those changes might bring valuable benefits to the customer. Nothing must be taken for granted. These changes can then be developed and refined using mind mapping. For example, a domestic lock; this secures a door from being opened by an unwelcome intruder. The benefit is security and reduction/elimination of theft from the house. But keys can be lost or doors left unlocked, and some locks are difficult or inconvenient to open from the inside. A potential solution is to have doors that sense people approaching from the outside and lock themselves. There could be a reverse sensor on the inside – one that unlocks the door when someone approaches (which could be activated or deactivated centrally). The exterior sensor could recognise 'friendly' people approaching the door by means of sensors they carry in the form of 'credit cards' or the sensor could be over-ridden by a combination lock. The lock could be linked to a door that opens automatically.

Attribute analysis can be used alongside brainstorming and mind mapping to form the systematic 3-stage process for spotting a commercial opportunity shown in Figure 4.6. Starting with listing the product/service attributes; brainstorm how these might be improved; finally develop and refine the idea using mind maps, then decide on what actions need to be undertaken to make it a commercial reality.

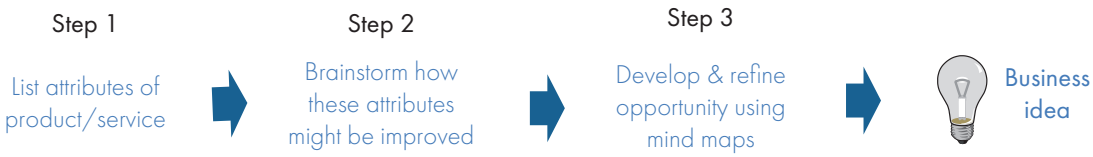


Figure 4.6 Spotting a commercial opportunity by analysing the attributes of an existing product/service

Gap analysis

This is a market-based approach that attempts to produce a 'map' of the attributes of the product/service based on dimensions that are perceived as important to customers; analysing where competing product/services might lie; and then spotting gaps where there is little or no competition. Because of potential complexity, attributes are normally shown in only two dimensions at a time. There are a number of approaches to this task:

» **Perceptual mapping** places the attributes of a product/service within specific categories. So for example, the dessert market might be characterised as hot vs cold and sophisticated vs unsophisticated. Various products would then be mapped onto these two dimensions and shown graphically (Figure 4.7). Whether the 'gap' identified is one that customers would value being filled depends on the value customers place on the two dimensions and that is a question for market research to answer.

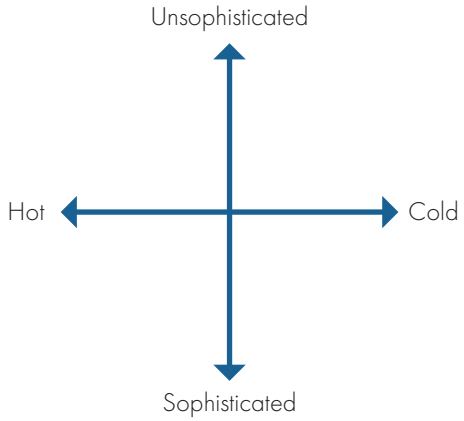


Figure 4.7 A perceptual map for desserts

- **Non-metric mapping** places product/services in generic groups that customers find similar and then tries to explain why these groupings exist. A classic example would be its application to the soft drinks market where products might be clustered and then described simply in terms of the widely used generic groups such as 'still' vs 'carbonated' and 'flavoured' vs 'non-flavoured'. The key here is also finding the appropriate dimensions that create opportunities for differentiating the product.
- **Repertory grid** is a more systematic extension of this technique using market research. Customers are asked to group similar and dissimilar products/services within a market, normally in pairs. They are then asked to explain the similarities and dissimilarities. The sequence is repeated for all groups of similar and dissimilar products/services. The explanations are then used to derive 'constructs' which describe the way in which people relate and evaluate the products/services. These constructs form a grid that can be used to map the products/services, using the words used by the customers themselves.

These techniques can be used alongside brainstorming and mind mapping to form the systematic 3-stage process for spotting a commercial opportunity shown in Figure 4.8. Starting by listing the product/service attributes; brainstorm the dimensions into which these attributes might be mapped; identify the gaps in the mapping (again using brainstorming); finally verify the dimensions and gaps using market research (Chapter 5), then decide on what actions need to be undertaken to make a product/service that fills this gap a commercial reality.

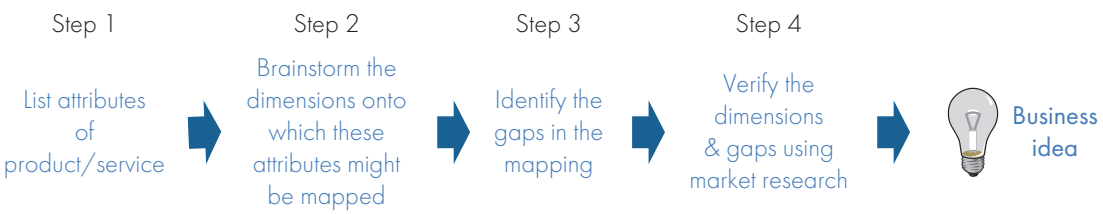


Figure 4.8 Spotting or creating a commercial opportunity using gap analysis

Delphi method

This is useful where expert opinion is needed on aspects of developments in the future. It is often used to try to identify new technologies that might trigger discontinuities or disruption. First, relevant experts need to be identified. These might include experts in non-technological fields so that the economic, social and environmental impacts of the changes are not overlooked. The experts are then asked to complete a questionnaire survey of their opinion on what the key future issues might be and their likelihood of occurrence. Having been analysed, the questionnaire is then refined into a

Case insight 4.11 Starship Technologies

Solutions looking for problems

Starship Technologies is a company behind the small, self-driving robotic delivery vehicles seen negotiating their way around some US university campuses and towns in Estonia, Germany and the UK. The electrically powered robots deliver groceries ordered online. Travelling on footpaths at 6 kilometres an hour and with a range of 6 kilometres, they are equipped with a sensor suite that includes cameras, a GPS inertial measurement unit, ultrasonic sensors and radar. They have speakers, so they can communicate with humans they meet, and inform customers by smartphone when they leave and then arrive at their destination, allowing them to unlock their cargo with a smartphone app. Delivery is free above a certain value.

Starship Technologies was founded by Skype co-founders Janus Friis and Ahti Heinla in 2014 with commercial services launched in 2017. The company is headquartered in San Francisco, California, with engineering operations in Tallinn, Estonia, and a satellite team in Helsinki, Finland. But where did the idea come from? Friis and Heinla had been looking for another commercial idea for a couple of years but at the time Heinla was heading a team of ten Estonian engineers participating in a 'hobby project' – the NASA Centennial Challenge, building an experimental sample retrieval robot (team 'Kuukulgur' or 'Moon Rover'). This led the pair to think whether there were any big problems on earth that could be solved by using autonomous robots – agriculture, house cleaning? Finally, they homed in on the 'last mile' problem. Goods can be delivered to a central hub or shop relatively cheaply, but it is in the 'last mile' where most of the delivery costs are incurred. These robots solve that problem in an environmentally friendly way.

Access the *Digital Links* booklet to visit the company website and to watch a video of a Starship in operation.

Questions:

1. What was the key to finding this business opportunity?
2. What are the operational limits to this technology?
3. Are there any other problems the Starship robot could solve?

second more focused version and the experts resurveyed. The process is repeated until there is some convergence of opinion on the future events, their probability and timescale. Delphi forecasts can be costly and time-consuming and depend upon the appropriateness of experts and the quality of questionnaires.

SYSTEMATIC INVENTIVE THINKING

Boyd and Goldenberg (2013) provided a 'short-cut' to spotting opportunities for new products/services derived from the attributes or features of existing ones. They called this 'Systematic Inventive Thinking' and asserted that the five techniques could be applied to most existing product/services:

1. Attribute dependency – Bringing together or correlating two or more apparently unrelated attributes of the product/service can add value for customers. Examples include smartphones that provide information that depends on geographic location, car windscreen wiper speeds or radio volume that varies with the speed of the car and headlights that dim automatically for oncoming cars.
2. Task unification – Similarly, bringing together multiple tasks into one product/service can add value for customers. For example, sunscreen products added to facial moisturisers and make-up (and vice versa) to unify a task. Samsonite used this principle to redesign the shape of straps on backpacks so as to press softly at 'shiatsu points' on the back and provide a soothing massage sensation rather than causing back and neck strain due to the weight of their contents. The heavier the contents, the deeper the sensation and the more stress-relieving for the wearer, thus using the heavy load carried as a comfort advantage.

3. Multiplication – By way of contrast, duplicating some product/service feature or characteristic may enhance customer value. For example, 'picture-within-picture' TVs allow people to watch more than one programme at a time. Pearson Education used this principle to create a new course designed specifically for students who failed algebra exams and needed a different approach to studying the subject.
4. Division – Alternatively, dividing out the functions of a product/service might add value for some customers. For example, the dividing out of the control features on many electronic products and placing them into a remote control provided more convenience and allowed the products to become smaller, cheaper and easier to use.
5. Subtraction – Finally, subtracting product/service features not valued by some market segments. This was the approach taken by low-cost airlines. This process of reducing product/service complexity by subtracting non-essential features has been called 'frugal innovation or engineering' (Radjou et al., 2012). It is often associated with cost and price reduction strategies that will make the product/service more attractive in low-income or developing economies. Of course, other changes to the product/service (e.g. improved durability) and business model (e.g. changes in distribution channels) will probably be needed alongside it.

Explore further 4.7

Systematic Inventive Thinking

Access the *Digital Links* booklet and watch a Harvard Business Review interview with Kevin Coyne showing how the five principles can be operationalised.

FINDING AN IDEA FOR A SOCIAL ENTERPRISE

The same principles and processes outlined in this chapter can be applied to finding an idea for a social enterprise. The only difference is that you are looking for a social rather than market need. Many unmet needs will be local. They may arise out of social change or inadequate existing services. The challenge is not so much identifying the need, but identifying how it can be met within financial constraints. This might involve reconfiguring the way existing services are delivered, in such a way as to create added value that can then be applied to social objectives.

Just as with self-employment, the spur to set up social ventures can be a 'pull factor', such as an emotional personal experience like bereavement. This can be an extremely effective and motivating driving force. The spur can equally be a 'push factor', such as the UK government's push to spin out many government welfare services through the formation of public service mutuals. Neither motivation diminishes the basic requirement for social need to exist. And in meeting this need, the social entrepreneur should be as socially innovative as possible. Otherwise, why do it? So, they need to think through how these social needs can be delivered more effectively so as to improve the social welfare of those targeted.

One final thought at this point is that a firm does not have to be a social enterprise to achieve, at least some, social goals. As we shall see in Chapter 7, if the founder's values and beliefs are strong enough, a commercial business can also achieve social objectives through social responsibility measures and philanthropy. Being a social enterprise creates some legal restrictions and responsibilities that commercial enterprises do not have and a founder may find that these limit the control they have – which after all is one of the things most entrepreneurs do not like (Chapter 11).

Case insight 4.12 Maggie's

Spotting opportunity for a social enterprise

Every year, over 300,000 people are diagnosed with cancer in the UK alone. Maggie's, or to give it its formal name, the Maggie Keswick Jencks Cancer Caring Centres Trust, offers free practical, emotional and social support to people with cancer and their families and friends. It was set up by Maggie Keswick Jencks, a landscape designer with an international reputation, just before her death from breast cancer in 1996. Maggie lived with advanced cancer for two years before her death. During that time she used her knowledge and experience to create a blueprint for a new type of care. Maggie's centres are built around her belief that people should not 'lose the joy of living in the fear of dying'.

The first centre was built in Edinburgh in 1996. Since then Maggie's has grown rapidly and by 2020 it had 26 centres in the UK and abroad, including Hong Kong and Tokyo. The centres are based upon ideas about cancer care originally laid out by Maggie around the principle that design affects how we feel. All of the centres are designed by leading architects – perhaps also with an eye to attracting donors. Each is unique, being built around a kitchen on an open-plan basis – no closed doors – and designed to be friendly, welcoming and full of light, calming spaces. They use calming natural materials like wood with its muffled acoustics, and plants are dotted all around the buildings themselves. They have gardens and look on to green spaces. Each centre is staffed by health professionals, including a cancer nurse and a psychologist, and a fundraiser. They offer patients, families and carers emotional, social and practical help and support that complements their medical treatment but in a purpose-built space that is both comforting and inspiring.

Each UK centre is located next to an NHS cancer hospital. The 26th was built in the grounds of St James's University Hospital in Leeds. Describing it as engendering 'both fellowship and intimacy ... a place where people can feel at home but which is also a refuge from the everyday world', the architectural critic Rowan Moore concluded:

> *'What would be truly great would be if the ideals of the Maggie's centres were to spread and benefited people affected by many other diseases ... [to] find a way of lending their expertise to other agencies in the NHS. Such humane architecture could become a rule and not an exception. Meanwhile we should appreciate places like this for the achievements that they are.' (*The Observer, *2 August 2020)*

Maggie's now also provides online support for cancer patients. This offers the same kind of support offered by the centres, with blogs and online advice managed by professional psychologists. Maggie's programme of support has been shown to strengthen the physical and emotional well-being of people with cancer. Since 2000, the work of the centres has been commended by the NHS Cancer Plan, NICE and the Cancer Reform Strategy. In 2013 it was highlighted as 'best practice' by the UK National Cancer Survival Initiative Report by the Department of Health.

Access the *Digital Links* booklet to visit Maggie's website and to watch a short animation explaining the concept behind Maggie's and a short clip from a BBC documentary about Maggie's.

Questions:

1. Can the approaches outlined in this chapter develop an idea for a social enterprise?
2. How would you apply them to Maggie's?

SUMMARY

- Connectivity and cognitive diversity – an exposure to diverse influences and ways of thinking plus an openness of mind – are an essential prerequisite for practical creativity.
- The practice of the five 'discovery skills' – networking, observing, questioning, experimenting and associating – can help with opportunity recognition.
- Good business ideas come from creating opportunities or spotting them. You can create opportunities by creating change through radical innovation or market paradigm shift. Creative synthesis - blending an understanding of the technology with an understanding of the market - is needed to link any technological development to a commercial opportunity. You can spot opportunity by analysing change to identify unmet needs and/or by analysing existing products/services to identify inadequacies. In both cases the idea must be linked to a market need, whether or not it is yet exhibited. You develop a solution to a problem people are willing to pay for.
- Radical market innovation involves challenging industry paradigms by questioning sectoral, performance and customer conventions (e.g. the value chain). This is less risky than radical product/service innovation. Incremental product/service or market innovation is easier and less risky.
- Spotting change involves a systematic analysis of the environment to highlight changes (e.g. using PESTEL) and then developing an understanding of what commercial opportunities they might generate (e.g. using mind mapping, futures thinking).
- You can also spot opportunities by finding innovative solutions to existing problems (e.g. using analogy) or highlighting inadequacies in existing products/services (e.g. using attribute analysis, gap analysis).
- Business opportunities also exist in questioning the value chain in an industry to see where additional value can be created (for customers and/or the firm) in some meaningful way.
- There are techniques that can help you spot opportunities arising from inadequate products/services. These include the techniques of analogy, attribute analysis and gap analysis.
- 'Systematic Inventive Thinking' can be used to challenge the features of an existing product/service and see whether they can be reconfigured in a way that creates commercial opportunity.
- The same principles and processes outlined in this chapter to find a commercial business idea can be applied to finding an idea for a social enterprise. The only difference is that you are looking for a social rather than market need.

GROUP DISCUSSION TOPICS

1. How easy is it to come up with a business idea?
2. How are creativity and innovation shown in entrepreneurship?
3. Creativity favours the connected mind. Discuss.
4. How can you increase your 'connections'?
5. How are the five discovery skills linked? Which ones are prerequisites for the others?
6. Do the five discovery skills help develop an entrepreneurial mindset?
7. How can you improve your discovery skills?
8. Using your creativity test results as a base, discuss whether these dimensions adequately measure creativity compared to other measures discussed in this and the previous chapter.
9. Is creativity the same as opportunity perception? What is the link?
10. Why is it so important that a product/service idea is innovative and different to competitors?
11. What attributes do you need to be able to apply creative synthesis to a technological development? How difficult is it to develop them?
12. How can you build social, ethical and/or environmental principles into a search for business opportunities?
13. What factors decide whether a business idea is commercially viable?
14. The commercial viability of a completely new product/service is impossible to evaluate. Discuss.
15. How can you become more aware of the constant changes happening around you and the business opportunities they create?
16. How can you use PESTEL to focus its search for business opportunities into areas where it has greatest competencies?
17. How can you find unsolved problems that may create a commercial opportunity in a systematic way?
18. How can you find out unmet needs that may create a commercial opportunity in a systematic way?
19. How can you uncover product/service deficiencies that may create a commercial opportunity in a systematic way?
20. How easy is it to disaggregate a supply chain?

STUDENT ACTIVITIES

In groups:

1. Use the PESTEL acronym to explore major changes that your society will face in the next five years. From these, select one and, using brainstorming, explore the business opportunities that might arise out of it. Repeat the process for a number of these major changes.
2. Use analogy to come up with a business idea. Start with a problem to be solved and find the way similar problems might be solved in a different context. Alternatively find a natural solution to a problem and consider whether it can be applied to a different circumstance.
3. Use attribute analysis to come up with a business idea. Focus on an everyday product/service, select one feature or aspect of it and ask 'Why does it have to be that way – what benefit does it bring to the customer?' Try it a few times with different product/service features.
4. Use gap analysis to come up with a business idea. Select an everyday product/service, characterise it in two dimensions and use perceptual mapping to plot where competing products/services lie on these dimensions. Is there a gap in the market? Repeat the exercise for another product/service.
5. Select a product/service and use 'Systematic Inventive Thinking' to change the features of the product/service.

START-UP ACTIVITIES

1. Either for your own original business idea or one from previous Student activities, write down as clearly as possible:
   a) A description of the product/service idea – its features;
   b) A description of the types of customers that you think will purchase it;
   c) The needs it will satisfy – the benefits it offers or the problems it will solve;
   d) The names of competitors and why their product/service is not as good as this one;
   e) The further development work still needed on your product/service;
   f) Any other information that might be relevant to its commercial viability;
   g) Decide whether this is the business idea that you are going to pursue.

5 RESEARCHING BUSINESS IDEAS

Contents

- The importance of research
- Market research
- Describing the market/industry
- Market/industry life cycle
- Market/industry concentration
- Market/industry geographic extent
- Estimating market size
- Assessing market and industry competitiveness
- Identifying competitors
- Industry futures
- Scenario planning
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: Markus Winkler on Unsplash

Learning outcomes

When you have read this chapter and undertaken the related exercises you will be able to:

- Define, describe and assess the degree of competition in a market or industry;
- Review future trends in a market or industry and assess how they might affect a start-up;
- Critically evaluate the market and industry forces that might affect a business idea you may have.

Case insights

5.1 New-to-the-world industries
5.2 Savelli (1)
5.3 Cajuu
5.4 Fintech
5.5 Industry futures
5.6 Bill Gates and Microsoft

Explore further links

5.1 Sources of business and market information
5.2 Porter's Five Forces

THE IMPORTANCE OF RESEARCH

Market research is essential before you launch a business. Just imagine being a football manager and not knowing anything about your team (your customers), who you are about to play against and how many players they are allowed to have (your competitors), or even the size of the pitch and duration of the game you are about to play (the nature of the market and industry). And then there is the little matter of the rules of the game (the laws affecting the industry). In such circumstances your chances of success would be slim. The president of Harvard Business School once said: 'if you think education is expensive, try ignorance'.

As we have seen, an entrepreneur can either create opportunity or spot opportunity, but in both cases their creative skills must be linked to a market need. So, they need to find out about market need – who their customers might be and why they should buy from them rather than competitors. They need to identify their competitors and what their strengths and weaknesses might be. This all helps minimise risk and uncertainty and provides some basis on which to make decisions about marketing strategy. For a start-up, any information is probably of value, but the key question that needs to be answered is: why should anyone buy from the start-up rather than from their competitors? If the answer to that question is simply because they are cheaper than competitors then the start-up needs to ensure that their costs are also lower – otherwise they will not survive. Low cost is normally associated with economies of scale – something usually only achieved by larger firms – and it is no coincidence that small firms thrive in markets where economies of scale are less important to customers than other factors such as service quality.

The financial backers of a start-up will expect the founders to have a thorough understanding of their market/industry and the trends within it. Based on this they will expect them to have identified their customers and competitors and estimated the size of their market. If the start-up is launching a new product, not only will they expect it to actually work, but they will also probably expect some market testing (field research) to gauge customer reaction to it, compared to competitors' products.

There are a number of ways you can undertake market research and we shall cover them later in this chapter; however, before getting down to this level of detail the entrepreneur needs to look carefully at the industry or market in which they propose to operate. Unless they start out to create a completely new-to-the-world industry, it is likely that there will be an existing market or industry that sells similar goods or services to the ones they propose. Understanding this industry will help them start to fine-tune and evaluate their idea. It will give them an insight into their potential customers and how to reach them. It will help them identify and assess that competition and start to develop a business model and competitive strategy. Indeed, understanding the shortcomings of companies in an industry can sometimes yield new business opportunities which may lead them to come up with a better or completely different business idea.

> *Before you approach anyone with an idea you must do the research.*
>
> Peter Jones, serial entrepreneur. *The Guardian Media Planet*, May 2015

> *I would have spent more time researching my idea. Although I couldn't afford it at the time, it would have saved me a lot of effort if I had recognized that customers wanted top quality gourmet coffee through machines rather than the instant product that was part of my original business plan.*
>
> Martyn Dawes, founder of Coffee Nation, *Startups:* www.startups.co.uk

MARKET RESEARCH

A start-up needs to find as much relevant information as it can about its market(s), industry, customers and competitors. There are two ways you can do this – desk research and field research. Desk research provides valuable general background information, while field research provides specific information. You should be able to obtain all of the market and industry information discussed so far through desk research, although you may have to use your judgement to analyse it in the way you want. The main characteristics of desk and field research are summarised in Table 5.1.

Desk research

Desk research is what it says – research that you can do from a desk, at home or in a library, using the computer and internet or journals and so on. Desk research is cheap, quick to do, and is usually good for getting background information. However, it will not be specific to any particular business, can be incomplete or inaccurate and may well be out of date. Information on markets, sectors and industries is published in newspapers, trade magazines, industry surveys and reports, trade journals

Table 5.1 Characteristics of desk and field research

	DESK RESEARCH	FIELD RESEARCH
Uses	Background information on: * Industries and markets * Environmental and market trends * Competitors * Customers * Distribution chains * Supply chains * Product development * National and regional economic data	Specific information on: * Customer/consumer needs, causes for satisfaction and dissatisfaction * Consumer reaction to products in development * Direct trial of competitors' product/service performance * Customer reactions to competitors' product/service performance * Premises investigation
Sources/ techniques	* Newspapers and magazines * Trade magazines, journals and directories * Industry surveys and reports * Government reports * National statistics	* Observation and discussion * Face-to-face interviews * Focus groups * Telephone interviews * Text, email or postal questionnaires
Advantages	* Cheap * Quick * Good for background information, particularly on industries and markets	* Reflects your needs * You control quality * Up to date
Disadvantages	* Not specific to a business * Can be out of date * Can be incomplete or inaccurate	* Can be expensive and/or time-consuming * Competitors may find out what the firm is up to * Can be complicated (e.g. sampling, question structure)

or directories, many of which will be available on the internet. There are websites that provide all sorts of information but ultimately the prime source of information in the UK is the British Library, where most national and regional economic and business data and information is housed. Desk research can provide information on product developments, customer needs or characteristics, competitors and market trends. However, for many start-ups, local information is of far more importance than regional or national information, and that might come from chambers of commerce and other local sources of help and advice.

Explore further 5.1

Sources of business and market information

Access the *Digital Links* booklet to find out about sources of business and market information from the British Library, chambers of commerce and trade associations.

Clarifying who will be a firm's customers should enable it to better focus promotion and marketing efforts. It might also help it identify both new customers and, eventually, new products or services. Desk-based market research should help it estimate the size and growth of its market. It might intend to sell its product/service to private or business customers and desk-based market research should help it to understand the profile of both. A private customer profile might include personal characteristics (demographics) such as age, gender, socioeconomic group, occupation, geographic location and other characteristics of the home, stage in family life cycle, and so on. Similarly, an industrial profile might include the type of business, size, sector/industry, location, nature of technology, creditworthiness and so on. It might involve understanding why, where and when customers buy, the structure of established

> *If you ask me how we find new markets, the answer is research, research, research ... For us research is critical when it comes to opening new outlets. We put a lot of work into demographics and social indicators and really know our business.*
>
> Stephen Hemsley, CEO of Domino's Pizza, *The Sunday Times*, 23 May 2004

distribution channels and the nature of economic and other environmental trends that might affect the industry. Remember, you need to understand what the conventions in a market or industry are – even if the firm intends to try to change them. Clearly, while you might be able to find this information for an established market/industry, it is far more problematic for new or emerging markets.

It is just as important to know who a firm's competitors are. Desk research should provide not only names but also information on competitors' product/service offerings, size, profitability, even their operating methods (e.g. whether restaurants are takeaway, self-service etc.). However, judgement is always needed. For example, a pizza restaurant may face competition from a whole range of other local restaurants, not just those offering pizza. Understanding why customers buy from competitors gives a further insight into the needs of customers and ideas about how to combat competition.

Field research

Field research involves going out and collecting new information about customers and competitors that is not publicly available. Informal field research can be invaluable, particularly for start-ups dealing directly with the public. Visiting competitors at their place of business, perhaps buying their product or service and talking to other customers, will give an insight into how they operate. For retailers, location is obviously very important. Once prospective premises have been identified, check out the local trade. Find out how many and what type of customers pass by the location. Are shops in the immediate vicinity an advantage or a disadvantage? The world's biggest retailer, Walmart, was founded by Sam Walton who famously went to rival K-Mart stores with a notepad and pencil to note down exactly what they did and how they did it, and then improved on it. Location can be important for other businesses, for example, proximity to customers or a workforce. Many start-ups locate where the owner-manager happens to live. Some locate where the owner-manager wants to live. Neither is a positive decision unless there are sufficient customers.

Field research can provide a lot of valuable and unique information – but mainly about existing customers. Simple observation and discussion will go a long way without costing much, other than time. However, its informality means that the samples of people approached may not be representative of a particular customer segment and questioning may be less than precise. To be more reliable, respondents should represent the potential customers for a particular product/service. The questions need to be structured so that the subject areas are covered comprehensively and consistently, so that there is no ambiguity and answers from one respondent can compare to another. More detailed field research can involve conducting face-to-face individual or group interviews, telephone surveys, or administering text, email or postal questionnaires. The main characteristics of these techniques are summarised in Table 5.2.

Questions should be in a logical sequence, moving from general to specific, from factual to opinion or behaviour based, from least sensitive to most sensitive. They should try to influence respondents as little as possible. Questions should not 'lead' respondents by implying an answer to the question. And the design of a questionnaire should facilitate interpretation and possible data processing. A very simple piece of advice is to always test out a questionnaire before using it 'for real'.

Table 5.2 Techniques for field research

	PERSONAL INTERVIEW AND FOCUS GROUP	TELEPHONE INTERVIEW	QUESTIONNAIRE
Quality of information	Very good	Good	Good
Quantity of information	Good	Fair	Good
Speed of collection	Good	Very good	Poor
Likely response rate	Good	Good	Poor
Cost (money and/or time)	High	Fair	Fair

The construction of questionnaires in field research involves using different types of questions for different purposes. There are four basic types of questions:

» Closed question – This requires a specific yes/no answer (often by ticking a box) and is best used where factual information is required. It can be used to build quantitative data on responses. For example, 95 per cent of respondents said 'yes'. It takes little time for respondents.

» Multiple choice question – This is where the respondent has a number of options from which to choose. It is also best used for factual information. For example, 'Select the frequency of your monthly visits to this shopping centre' (respondents would then normally be presented with options and asked to tick the appropriate box).

» Scaled question – This is where respondents are asked to evaluate or rate some characteristic on a quantitative scale. For example, 'Rate the quality of service on a scale of 1 (very poor) to 5 (very good)' (often by ticking a box). It takes relatively little time for respondents, but predefines the dimensions of measurement.

» Open question – This requires the respondent to amplify an answer, often expressing an opinion. It is frequently used in conjunction with a closed question to provide some insight or depth to quantitative data, such as when seeking a better understanding of buyer behaviour. It takes time for respondents to answer.

However, sometimes, as we observed in the previous chapter, the only sure way of knowing whether the idea will make a lucrative business is to try it out – launch the business but minimise the risks in doing so. The more original the business idea, the less likely market research is to yield an insight into demand, simply because customers do not understand how the product or service might be used. For some start-ups the easiest and cheapest way to undertake market research is to test-market, for example, using focus groups or trying a pop-up shop. Another approach is called 'lean start-up' (Chapter 6), where start-up costs are kept to a minimum and customer reaction is closely monitored. However, this can still be an expensive way of doing market research if things go wrong, and some basic market research is probably essential for just about any start-up.

DESCRIBING THE MARKET/INDUSTRY

The first challenge is to identify and define the characteristics of the start-up's market and/or industry. Most markets or industries have some underlying structural conditions that help define them and that influence the degree of competition within them. The first step in industry analysis therefore is to describe the key elements of the industry's structure. However, defining this industry can be more difficult than you think. An industry is any group of firms that supplies a market, but markets are rarely homogeneous. After all, they are made up of customers with a wide range of needs. An industry is likely to comprise a number of markets or, more accurately, market segments. The competition within these segments can be very different, and as a result the profitability of individual companies within an industry can vary widely.

For example, the car industry comprises many market segments – hatchbacks, family cars, luxury cars, sports cars, SUVs etc. Do cars in each of these sectors compete against each other? Is Jaguar, a UK producer of luxury sedans and sports cars, a competitor of Honda, a Japanese producer of hatchbacks and family cars? There are clear market boundaries between segments and there is the question as to what extent a car and a car producer in one segment competes against another. Similarly, geographic boundaries to a market might also apply. An isolated convenience store located, say, 10 miles from the nearest other shop might not be competing directly against supermarkets, despite being in the food retail industry, because of its location. The criterion here again is substitutability – are customers willing to travel to the supermarket? However, markets and industries can overlap to some extent. For example, the ready availability of Zoom or Skype means that it is to some extent a substitute for travel. Yet the overlap is so small that you do not see the computing industry competing with directly with the travel industry.

So, an industry is likely to comprise a number of markets. Drawing the boundaries of a start-up's industry and the market segments within it is therefore a question of judgement. It is an important judgement that will define who it thinks it is competing with and, probably, the marketing strategies it then puts in place. The judgement rests on an accurate identification of potential customers, which we cover in the next chapter, and their willingness to buy similar products/services. This chapter outlines three commonly used ways of describing markets or industries, called typologies: life cycle, concentration and geographic extent. All have implications for the firms within them and the opportunities they generate for newcomers.

MARKET/INDUSTRY LIFE CYCLE

The first set of typologies refers to the five stages in the life cycle of a market or industry (Figure 5.1).

Completely new (market paradigm shift)

This is the new market resulting from a market paradigm shift or radical innovation. The market is not proven and demand is very difficult to estimate. Processes and procedures are yet to be developed. There are no competitors. Implications:

- High risk, but also potential for high returns;
- Customers difficult to identify;
- No competitors;
- Gaining first-mover advantage very important;
- Opportunity to dominate the market;
- Likely to be high marketing costs (customers may not understand product/service benefits).

Emerging

This is a market where there is proven demand but the size of the market is still uncertain. The market is growing. Processes and procedures have still not become fully established. There are still no dominant brands or market leaders. Implications:

- Few competitors;
- Customers starting to be identified;
- First-mover advantage still significant;
- Opportunity to redefine processes and procedures that are not operating effectively;
- Still opportunity to dominate the market;

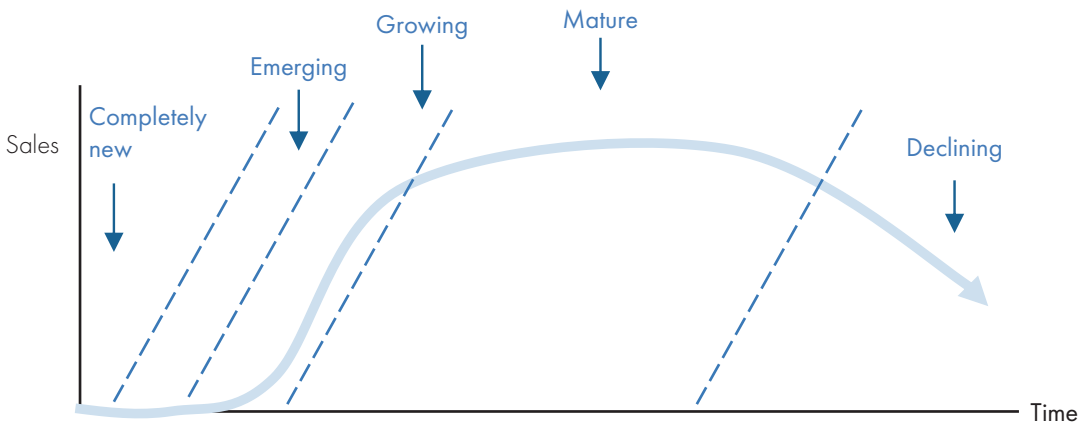


Figure 5.1 Market life cycles

- Marketing costs still likely to be high;
- Barriers to entry probably in the process of being established.

Growing

This is a market where there is proven and growing demand – market research would show it to be attractive. Processes and procedures are still developing as new competitors enter the market. Competition is fierce as companies battle to penetrate the market and gain market dominance. Dominant brands and market leaders are beginning to emerge at the same time as some companies are going out of business. Implications:

- Growing number of competitors;
- Product/service extensions likely to be emerging;
- Buying patterns becoming established;
- Aggressive marketing strategies in a fiercely competitive market;
- Dominant brands beginning to emerge;
- Competitive pricing;
- Market looks good on paper, but entrants may be too late unless their product/service is based upon significant innovation.

Mature

This is an established market with well-documented characteristics. It is large but growth is slow or non-existent. There are established processes and procedures, buying and repeat-purchasing patterns. Few new customers are entering the market. Competitors are established. There is limited innovation. Industry might be fragmented or consolidated (see below). Implications:

- Well-established competitors (market might be fragmented or consolidated);
- Defensive pricing possible (meeting or beating new entrants);
- Difficult to break into market, competition strong;
- Opportunity to innovate based upon existing product/service;
- Opportunity to innovate based upon process or after-sales service;
- Opportunity to innovate based upon established marketing processes.

> *It's always an opportunity when you see a big market that hasn't changed much.*
>
> Ning Li, founder of Made.com, *BBC News Business*, 3 November 2011

Declining

This is a well-documented, declining market with established processes, procedures and buying patterns. There are declining numbers of customers and competitors. Product range is narrowing as weak lines are dropped. There is no innovation. Industry might be fragmented or consolidated (see below). Implications:

- Market has a limited life expectancy;
- Declining range of products;
- Opportunity to consolidate market by becoming a dominant player (probably by buying out competitors);
- May be opportunity to establish niche if reducing competitors means demand is still high;
- May be opportunity to cut costs by re-engineering production process to reflect reducing market demand;

» May be opportunity to buy stock at 'distress prices' from companies going out of business and sell on at a profit;
» Opportunity for radical product/service innovation.

It is usually easier to sell in an emerging or growing rather than a declining market, but it can be hard going if the market is completely new. Backers may tend to prefer emerging rather than completely new markets simply because it proves that demand does exist.

MARKET/INDUSTRY CONCENTRATION

The second set of typologies overlap with life cycles and refer to the concentration of competitors.

Fragmented

This is a market where there are a large number of competitors of about the same size, usually in a mature or declining industry. Implications:

» Well-established competitors;
» Competitive pricing, limited profitability;
» Opportunity to consolidate industry and become market leader (probably by buying out competitors).

Consolidated

> *Don't bother trying to compete in a busy market unless you can be the very best.*
>
> Gabriel David, founder of Luscombe Drinks, *The Sunday Times*, 21 May 2017

This is a market where there are a few, large competitors, usually in a mature or declining industry. Implications:

» Well-established competitors;
» Defensive pricing possible (meeting or beating new entrants);
» Barriers to entry are likely to be high;
» Few entrepreneurial opportunities other than radical product or market innovation.

It is far easier to start up in a fragmented rather than a consolidated market. However, consolidation often happens as industries mature and decline, when some opportunities for mergers or acquisitions start to emerge. Start-ups are best advised to avoid consolidated markets, particularly when the established companies are competing primarily on price, because a new venture is unlikely to have either the experience or the economies of scale that established competitors have. What is more, the market may well be contracting. It is no coincidence that small firms tend to be few and far between in stable, mature, highly consolidated markets – unless they are introducing disruptive innovation that changes the nature of the market (see Chapter 4).

MARKET/INDUSTRY GEOGRAPHIC EXTENT

The final set of overlapping typologies refer to the geographic extent of the market/industry.

Local, regional or national

This is often a new or emerging market; it may become global in time. Implications:

» Gradual geographic roll-out allows marketing mix to be fine-tuned, but at the expense of first-mover advantage;
» Market dominance is easier in smaller geographic markets;
» Some markets (e.g. technology-based) can spread geographically over time from developed to developing countries.

Global

This is a market that is international from the start. Implications:

- Competitors quickly become established in foreign markets;
- Opportunities exist for foreign start-ups where others have followed a local, regional or national strategy;
- Internet-based new ventures have the opportunity to 'go global' at start-up;
- 'Going global' at start-up can be very expensive;
- Opportunity to expand on a country-by-country basis, varying product/service offering as appropriate.

It is traditionally easier to start up in a local market and gradually enlarge the market geographically, but global start-ups are becoming easier to establish because of the internet, allowing product/services targeted at very specific, small customer segments to be sold globally. Sometimes thinking locally can also mean losing the window of opportunity for a good business idea by allowing competitors to gain a national or global foothold.

Case insight 5.1 New-to-the-world industries

Converging markets: redefining business scope

The boundary between markets/industries can become very blurred in the fast-moving technology-driven world of the internet, making the identification of competitors difficult. This is particularly the case when the real fight is for an emerging market that, as yet, is not formally defined. Five US tech giants – Alphabet (owner of Google), Amazon, Apple, Facebook and Microsoft – are currently engaged in just such a battle. In the past these companies have provided hardware, software, internet services and e-commerce; each content to focus on its core market. However, new technology is forcing these old markets to converge. At the same time, they are realising how valuable is the personal data they have on their customers.

The battle now is to become the sole provider of all our digital and physical requirements, offering a vast range of services tailored to our 'needs', all day, every day, anywhere, from the 'best' online platform – a kind of 'digital utility' offering of 'universal internet services' that is also a portal to the physical world. The bigger the network of users and products/services it offers, the more attractive it becomes to users and other e-retailers as well as attracting more advertising and 'click-through' revenue. The bigger the network of users, the more data it gathers from their digital footprint, all harvested automatically in real time. That data can be used for advertising, targeted selling and even sold to third parties. The potential rewards from this sort of monopoly power are enormous. Each of the tech giants is coming to this new market from different existing markets with different products/services and very different strengths and core competencies. However, each has come to dominate and have monopoly power in their main market, often to the detriment of customers and smaller competitors.



Source: Carlos Muza on Unsplash

- Alphabet (formerly Google) started life as a search engine and Google is estimated to have 90% of the search engine market. Alphabet generates most of its income from Google, which in turn generates revenues primarily from advertising, the sales of apps, in-app purchases, digital content products, hardware and licensing and service fees. Google now offers many other services such as Google Chrome (browser), Gmail, Gmail+ (social media), Google Play (offering music, games and other downloads), Google Wallet (for online payments), maps and images as well as cloud-based services. It also owns YouTube. Its Android smartphone operating system dominates the market with an estimated 87% market share and it sells smartphones and tablet computers under the Google brand (manufacturing is subcontracted).
- Amazon started life as an e-commerce site selling books and now sells almost everything and has even moved into the food market not only with deliveries but also with retail

outlets and its own-label food. It is exploring how to deliver physical products using land and air-based robots. It has an app shop, an online payment system, TV and video streaming through Amazon Prime. It entered the hardware market with the Kindle (manufacturing is subcontracted) which comes preloaded with a customer's Amazon account details and social media. Supporting investment in all these areas is its cloud computing facility, from which most of its profits are derived (see Case insight 18.5).

- Apple started life designing and manufacturing computers and has become an iconic brand offering premium-priced electronic gadgets ranging from computers to the iPad, iPod, iPhone, AirPods and Apple Watch (see Case insight 9.1) all using its own closed operating systems: macOS for desktops, (13% market share) and iOS for smartphones (with 12%). It redefined how music was sold through iTunes (Case insight 4.8) and now has an app store selling apps, music, games etc. from which most of its income is now derived. It offers other services such as iCloud and is expanding its advertising network. It has its own retail outlets. It has announced that it is to replace the Intel chips it currently uses with its own and is rumoured to be developing its own search engine (it currently uses Google). In 2021 it plans to introduce a new operating system for iPhones that allows the internet tracking facility to be easily turned off. This makes it difficult for advertisers to measure the effectiveness of their ads and is seen as threatening the advertising income enjoyed by Google and Facebook.
- Facebook remains the dominant social network and has its own email system, photo and video-sharing platforms and owns Instagram and WhatsApp (see Case insight 20.3). It offers a search service based on the data provided by subscribers rather than computer algorithms (as with Google). In 2020 it opened Facebook Shop, allowing US brands to set up store fronts on its social network. Over 98% of its income is derived from advertising.
- Microsoft predates the other four companies and its MSDos operating system dominates the computer market with 83% share. It is also the supplier of the ubiquitous Microsoft Office suite of software. However, it came late to the internet (see Case insight 5.6) and its Microsoft Edge (browser), Outlook Express (email) and Bing (search engine) with its MSN portal have a far smaller market share compared to Google. It has the Xbox video-gaming and entertainment streaming system and owns the video communications company Skype. Attempts to enter the smartphone market have not been successful. It offers server applications and cloud computing services.

A similar pattern is emerging in China with three tech giants: Alibaba Group (Case insight 1.5), Tencent and Baidu. Between them, these companies offer hardware and systems that control most of the internet search, social media and e-commerce transactions in China. The critical difference is that these companies operate in what is effectively a closed market and have close links with the Chinese government. They are also amassing large amounts of data on Chinese citizens and, unlike their Western counterparts, are willing to share it with government. They are even using a tradeable social-credit system to incentivise citizens to 'do good'.

Access the *Digital Links* booklet and watch a short video produced by Microsoft that explores what the near future of mobile technology might look like.

Questions:

1. Why are these product/markets converging?
2. How might you describe this new industry? What is its commercial potential?
3. Do these new, emerging industries need government regulation? Explain.
4. The US and Chinese tech giants are in the same industry. However, they are not yet direct competitors. How do their markets differ? How might this change in the future? What might be the consequences?

ESTIMATING MARKET SIZE

Estimating the size of a new market created by disruptive technological or market innovation can be almost impossible. Estimating the size of a segment of an existing market can be difficult enough. The market itself might be growing or declining and within it some segments might be growing while others are declining. Market research can provide only so much data. If you wish to introduce a new smartphone app, the fact that there are over 1 billion smartphones worldwide is not entirely relevant.

That market is growing rapidly. However, your app might be in English, which limits the market size, and it might be developed for only one operating system. Then there is the question of the channels through which the app will be sold. All of these factors limit the market that you are attacking – even before the question of whether you are likely to achieve your target market penetration.

Market size can be measured by either value or volume (units), but you need to distinguish between the different types of market shown in Figure 5.2.

- Potential market – this is the size of a general market that might be interested in buying a product/service (e.g. 1 billion smartphones);
- Total Available Market (TAM) – this is the size of the start-up's prospective market – those customers in the potential market who might be interested in buying the type of product/service it offers. This reflects the sales of indirectly and directly competing products/services (e.g. English apps for a particular operating system);
- Served Available Market (SAM) – this is the size of the particular target market segment the start-up wishes to serve within its TAM (e.g. particular app function);
- Penetrated market – this is the size of the SAM it actually captures.

The size of the first three markets can probably be estimated using desk research. SAM is the market segment(s) the start-up is targeting, given any restrictions such as demographics, geography, language, technology etc. Defining this involves identifying market segments where the firm and its product/service has some competitive advantage. We return to this in Chapter 8. However, in estimating its SAM the firm should also consider adjacent markets from which customers might be persuaded to switch if its product/service proves successful. Market share is therefore the penetrated market divided by SAM. If an entrepreneur is seeking funding, backers will expect them to try to describe both the TAM and SAM for the product/service, estimate their size and understand the trends within them. They will expect the entrepreneur to be able to explain and justify how they will achieve the penetrated market that they forecast.

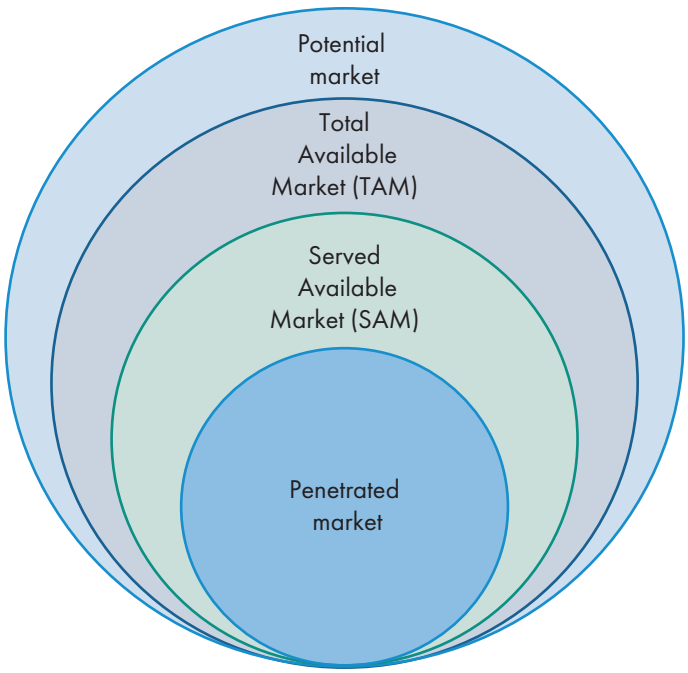


Figure 5.2 Market size definitions

Case insight 5.2 Savelli (1)

Importance of market size

It was 2007 and Alessandro Savelli was an MBA student at the Columbia Business School in New York when he came upon the idea of a luxury mobile phone for affluent women. At the time the smartphone market was showing remarkable growth and the market for luxury-branded handsets was expected to exceed $11 billion in 2009 and grow to over $40 billion by 2013. The major competitor in this luxury market was Vertu (a subsidiary of Nokia) with a phone targeted at men and turnover estimated at $700 million in 2008. Savelli's idea was for an expensive niche phone, something more akin to jewellery, emphasising fashion and status rather than technology. Delayed by the financial crisis of 2008, his idea gained traction, attracting equity backing from family, friends, business angels and venture funds (Chapter 19) and a start-up team that included a range of market and technology experts. They undertook market research, including focus groups and, in parallel, started the design and development process, selecting an agency specialising in watch design rather than phone design to head this up. This meant that, despite using the Android operating system, phone technologies, which were bought in from Asia, had to be adapted to fit the design aesthetic. The phone's distinctive curved design reflected a serpentine, S-shaped line and, depending on price which ranged from $9,000 to $120,000, had encrusted diamonds in the casing. The mark-up (cost of goods to retail price) ranged from 4x to 7x, depending on the model, in line with high-end jewellery and wrist watches, leaving a comfortable margin for the company and the retailer. Customers could also customise their own phone. The phones were largely hand assembled in Geneva and a range of 15 models finally went on sale in 2013. By this stage the venture had attracted over €3 million of venture funding and a further €3.8 million was raised in 2014 to help take the project to market.

Despite this investment in what was apparently a well-researched and attractive business idea with a well-connected board of directors, this unique product never sold in sufficient numbers to make it viable. By 2015 only 200 phones had been sold generating revenue of about €1 million – half the sales projection in the business plan. Thirty-five of these were purchased by an Abu Dhabi sheikh as gifts to give to celebrate his 35th birthday. So what went wrong? As usual, there was no single reason, rather a number of factors that combined.

Perhaps the major reason was the company's inability to clearly communicate a value proposition or benefits to its target market (see Chapter 8). The phone was sold through the jewellery section of retail chains such as Printemps in Paris and Harrods in London. Distribution was extended to stores in the most luxurious and elegant areas, where international target customers (mainly Asian, Russian and Arabic) were located: France (Saint-Tropez, Cannes, Monaco, Paris, Courchevel), Italy (Milan, Rome, Capri,



Source: Julien M. Hekimian/Stringer/Getty Images

Porto Cervo), and Spain (Marbella, Altea). In 2015 distribution was extended to stores in the Middle East (Abu Dhabi and the UAE). In these stores Savelli was competing against established high-end designer brands like Cartier and Louis Vuitton. However, since the brand was unknown, retailers were generally unwilling to place orders. Because of its high cost and unproven market demand, they were also unwilling to devote much space to the product and the company could not afford to place many phones in stores on a sale-or-return basis. Shop assistants in these departments knew little about technology and were unable to demonstrate the additional services the phone offered, although how important these were is unclear. For example, the phone featured a preinstalled global concierge service which helped users with whatever they needed – from remote usage support to the purchase of a theatre ticket or the hiring of a private jet. The service was never used. The company never generated any significant revenue from the services offered on the phone.

This communications failure was despite an apparently wide-ranging communications campaign that was successful in gaining coverage in a range of lifestyle, luxury and business-orientated media. The company also created its own profile page in all social media networks. It hosted eight prestigious events in its first year (e.g. offering one of its phones in the charity auction at the gala dinner during Milan Fashion Week in 2014).

Another factor was that technology proved more important than the company anticipated and the longer in the market, the further Savelli fell behind. When Savelli was launched there were well-established smartphone brands in the market, not least the iconic

iPhone. And, being a small firm, Savelli could not afford to keep up to date in the developing Android OS technology that it chose to adopt. This had been partly the cause of the delay in product development and resulted in the smartphone being technologically obsolete even when it was introduced, without certain features and already three releases behind the current Android OS release.

To some extent Savelli had been unlucky because the environment changed so much in the period between idea and market launch. It affected at least two of its major target markets – Russia and China. These markets never materialised. The economic sanctions imposed on Russia in 2014 and the fall in oil price heavily weakened the Russian rouble and the purchasing power of Russian customers. The crackdown on corruption in China in 2012 caused a collapse in the market for expensive gifts such as luxury phones. Moreover, the decision to float the exchange rate between the Swiss franc and the euro in 2015 led to a strong appreciation in value of the Swiss franc and a resulting increase in euro-denominated prices. Savelli never remotely achieved high enough volumes to benefit from any economies of scale and never came to serve a sufficiently large market better than its competitors. It failed to create a sufficiently large market space to make the business viable. Its market niche was just too small.

Access the *Digital Links* booklet and watch a promotional video for the Savelli phone and a video showing a $20,000 competitor, launched a couple of years later – Sirin Labs' Solarin phone.

Questions:

1. What do you learn about the viability of a business idea from this case?
2. Why was Savelli not successful?
3. Would more funding have ensured the success of this venture? Could more funding salvage the venture?
4. Would you start a business based upon a new type of smartphone? Explain.

Source: Giachetti, C. (2018) Smartphone Start-Ups: Navigating the iPhone Revolution, London: Palgrave Macmillan.

ASSESSING MARKET AND INDUSTRY COMPETITIVENESS

Desk research should tell you about the profitability of existing markets and industries – and this might influence an entrepreneur on their choice of start-up. The competitive forces in an industry indicate the nature and degree of competition within it and therefore usually explain its existing profitability and are often taken as an indication of future profit potential. A monopoly exists where a single firm dominates a market, usually because of high barriers to entry. Monopolies can make high profits. Most manufacturing markets and many service markets are oligopolies – dominated by a small number of large companies – where there may be significant barriers to entry. The markets where there are monopolies and oligopolies are likely to be large, but can then be vulnerable to being segmented – split up by offering differentiated products/services to better meet the needs of different market segments. Small markets often show higher levels of profitability than large for the simple reason that they can be more easily dominated by a single firm offering these differentiated products/services. These are called 'niche markets' – a topic we cover in Chapter 7.

Porter (1985) developed a useful structural analysis for looking at an industry and assessing the degree of competition within it. This is based upon the number of competitors (fragmented vs consolidated), industry growth (point in life cycle) and the degree of product differentiation. The relative power of customers (the fewer there are, the higher their buying power) or suppliers (the fewer there are, the higher their power) in a market is important. For example, if an entrepreneur is selling to the big supermarket chains their buying power will normally mean profit margins will be squeezed. If competitors can enter a market or industry easily then they will, if margins are attractive. As well as the threat of new entrants to a market, there is also the threat of substitute products/services. How likely are customers to switch if new ones appear? Porter described the five forces at play:

1. Competitive rivalry – The competitive rivalry of an industry is central to the analysis. Rivalry will depend on the number and size of firms within an industry and their concentration (fragmented vs consolidated), its newness and growth (point in life cycle) and therefore its attractiveness in terms of profit and value added together with intermittent overcapacity. Crucially important is the extent of product differentiation, brand identity and switch costs. The greater the competitive rivalry, the less the ability of a firm to charge a high price.

2. Threat of substitutes – How likely are customers to stop buying a product/service? This revolves around the relative price performance of substitutes, the switch costs and the propensity of the customer to switch, for example, because of changes in tastes or fashion. The greater the threat of substitutes, the less the ability of the firm to charge a high price. So, for example, a small firm selling a poorly differentiated product in a price-sensitive fashion market would find it difficult to charge a high price.
3. Threat of new entrants – Barriers to entry keep out new entrants to an industry. These can arise because of legal protection (patents and so on), economies of scale, proprietary product differences, brand identity, access to distribution, government policy, switch costs, capital costs and so forth. Switch costs are the costs of switching to another product. A firm whose product is protected by patent or copyright may feel that it is relatively safe from competition. The greater the possible threat of a new entry to a market, the lower the bargaining power and control over price of the firm within it.
4. Power of buyers – This is determined by the relative size of buyers or customers and their number and concentration. The fewer there are, the higher their buying power. It is influenced by the volumes they purchase, the information they have about competitors or substitutes, switch costs and their ability to backward integrate or develop their own source of supply. The extent to which the product they are buying is differentiated in some way also affects relative buying power. The greater the power of the buyers, the weaker the bargaining position of the firm selling to them. So, for example, if buyers are large firms, in concentrated industries, buying large volumes with good price information about a relatively undifferentiated product with low switch costs, they will be in a strong position to keep prices low.
5. Power of suppliers – This is also determined by the relative size of firms and the other factors mentioned above – the fewer there are, the higher their power. So, for example, if suppliers are large firms in concentrated industries, with well-differentiated products that are relatively important to the small firms buying them, then those small firms are in a weak position to keep prices, and therefore their costs, low.

> *The ability to play your own game rather than playing the game of a competitor is exactly where you want to be as a company.*
>
> Jeff Weiner, CEO of LinkedIn, *The Sunday Times*, 14 July 2013

This analysis has been extended by adding a sixth force – the attraction of complements (rather than competitors) within an industry that add value to other product/services (Johnson et al., 2017). For example, the McAfee computer security system complements the Microsoft Office suite of software and the availability of online content adds value to smartphones. Complements act in the opposite way to substitutes but complementary products/services can divert profits from one or other firm, depending upon relative market strength. Identifying companies with complementary products/services may therefore help identify strategic alliances or partnerships for the future.

Two important points stand out from Porter's analysis. Firstly, the higher the degree of differentiation and inbuilt switch costs – the costs of switching to another similar product/service – the more likely a business is to succeed. The strategy implication of this is to try to build switch costs into the business model for any new product/service. Secondly, there is the question of the number of competitors (concentration). Typically, the fewer competitors, the more likely a start-up is to succeed – although this might mean there is a very limited market for its product/service. However, this generalisation depends on the market power of these competitors. If a start-up enters a market where there are few competitors, they might combine to deter its entry. An entrepreneur needs to think very carefully before entering a market dominated by a few big companies because they will have well-established market positions and the resources to fight off new entrants.

Explore further 5.2

Porter's Five Forces

Access the *Digital Links* booklet and watch:

- A short Harvard Business Review animation explaining Professor Michael Porter's Five Forces and how they affect competition in an industry.
- A Harvard Business Review interview with Michael Porter.

Case insight 5.3 Cajuu

Supply chain and competitive advantage

After graduating from the University of Manchester, Habil Ibrahim, a finance professional for nine years, launched Cajuu in 2018. Cajuu is a family business that imports cashew nuts into the UK from Ibrahim's family in the Makonde Plateau in Tanzania. The company sells roast, seasoned nuts to wholesalers, retailers (through some 75 outlets) and direct to customers (through its own website). The nuts come with a variety of seasonings packaged in tubes and on trays with dips. Cajuu also sells date bites. It promotes and sells its products using social media such as Facebook. The company also supplies larger volumes of plain nuts to wholesalers.

Cashew nuts come from within a 'shell' that itself is contained within an 'apple'. Each by-product of the nut has some commercial use, but the greatest value lies in the nut itself. Cashew nuts are the second biggest export item from Tanzania but one of the problems for the economy is that the greatest value addition to the nut comes from processing, which starts by extracting the nut from the shell, and most nuts produced in Tanzania are exported to India, unprocessed. One reason for this is that the cashew shell contains a liquid that is caustic and therefore extraction usually involves machinery and chemicals.

What sets Cajuu apart is its ethical stance and family links with a developing country. Cajuu offers farmers higher prices than bulk buyers of nuts in return for the guaranteed supply of the best nuts. It also works with them to improve yields and makes donations to the farming communities. Most importantly, however, Cajuu nuts are extracted by hand at the farm and Cajuu supplies equipment and gloves to its farming partners to help them avoid contact with the cashew shell liquid. This allows them to process the nuts at the farms thereby retaining more value added, rather than the shell and nut being exported for extraction. It also helps reduce the overall carbon footprint.



Source: Habil Ibrahim

Ibrahim took the GET2 test (see Explore further link 3.2) and scored 83%, meaning he was described as 'highly enterprising' with 'a tendency to start up and manage innovative projects'. His scores are shown below in Figure 5.3.

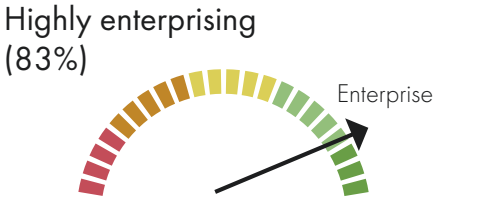


Figure 5.3a Overall GET2 result

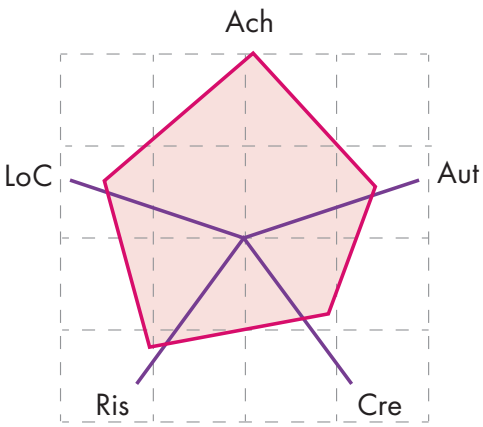


Figure 5.3b GET2 plot

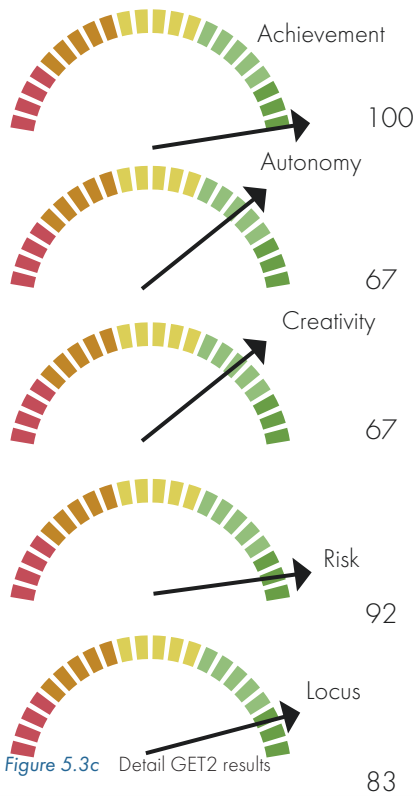
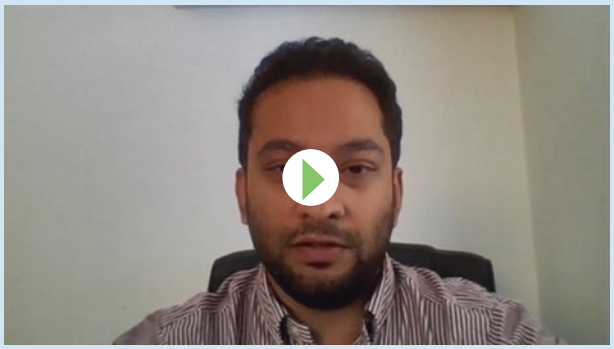


Figure 5.3c Detail GET2 results



Get into the entrepreneurial mindset. Access the *Digital Links* booklet to visit the website and watch an interview with Habil Ibrahim exploring his mindset and his reactions to the GET2 results. There is also a video telling the story of Cajuu.

Questions:

1. Does the link Cajuu has with Tanzania confer any competitive advantage? Explain.
2. What do the GET2 test results tell you about Ibrahim?

With disruptive innovation or market paradigm shift it may just be that there is no real, direct competition – at least until new entrants appear in the market. This brings us to looking at the barriers to entry in the market and, in particular, the legal protection a product/service might enjoy (Chapter 11). Again, if an entrepreneur is seeking funding, backers will expect them to have a thorough understanding of competitors (real or otherwise) and their strengths and weaknesses compared.

IDENTIFYING COMPETITORS

Identifying specific competitors for a product/service is just as important as estimating market size and the degree of competition within it. It is not sufficient to be able to talk in generalities about the nature of a market or industry and the degree of competition within it. An entrepreneur should be able to name their competitors, identify how serious they are and how they can be beaten. There are three types of competitors:

» Direct competitors – those offering similar or identical product/services. These are the most important because they compete directly. An entrepreneur needs to understand just how their product/service is different and better, and how they will convince customers to switch to them.

» Indirect competitors – those offering close substitutes. A truly innovative product/service may have no direct competitors but will still need to persuade potential customers using the 'inferior' competitor offering to switch.



Source: Florian Schmetz on Unsplash

» Future competitors – those who could enter the market in the future. If a new venture is successful it will attract competitors. The entrepreneur needs to think who these might be and how they might be countered.

Desk research should enable an entrepreneur to evaluate existing competitors in terms of their product/service offering, size, profitability, operating methods and distribution channels. It may give them clues about how the market or industry is changing. They need to form an assessment of the strengths and weaknesses of competitors' products/services compared to their own and in the context of changes in the market or industry. Ultimately the entrepreneur will have to make some judgements

about whether they are attacking the same customer segments as competitors and the quality of the competitors' value proposition compared to their own. What are the differences? How sustainable is the competitive advantage upon which the value proposition is based? We shall return to these issues in the next chapter.

Porter (1980) said that there were four elements to understanding competitors' behaviour now and in the future. He emphasised the need to understand competitors':

1. Current strategy – what is their strategy? This may be reflected in what the firm does and not necessarily what it says it is doing.
2. Objectives – to understand why it has these strategies and how they might change, you need to identify what the firm's objectives are. For example, gaining market share requires different strategies to maximising profitability.
3. Assumptions about industry – to understand why it has these strategies and objectives you need to identify the dominant logic within the firm (and probably the industry). This can lead to weaknesses in their strategies and help identify 'blind spots' in their ability to respond to competition.
4. Resources and capabilities – this determines if and how competitors might respond to competition and the scale of the response. Competitors with large cash reserves can be very dangerous for start-ups. Competitors without the capabilities of the start-up can give the start-up a competitive advantage.

Comparing any business to that of a competitor requires a deep understanding of the market and industry. Any start-up is only as good as the skills and capabilities of the founder (and any team they assemble) and how they compare to those of the competition. The more unique these competencies, the more likely the business is to succeed. We look at this in Chapter 7. However, it also depends on how good the business model developed for the product/service is. This is something we develop through the following chapters. And at some point, when all the elements of this jigsaw puzzle are assembled, the entrepreneur needs to start assessing how good the business and its product/service are, compared to its competitors. To do this brutal honesty is required – listening to people with different opinions about the business idea and the market/industry it is competing in. This may lead the entrepreneur to question their original business idea and its viability. But questioning is not bad and there are many ways that a product/service can be improved.

Case insight 5.4 Fintech

Industry attractiveness

Fintech (short for financial technology) is changing the face of the financial services industry with the application of disruptive technology. No country has seen the boom in start-ups in this emerging sector more than the UK, where many are located at 'Level39', an accelerator within One Canada Square at Canary Wharf in London, close to many far bigger financial institutions. The industry comprises many sectors. The digital bank sector of fintech has been moving swiftly to provide banking services without the costly buildings and employees needed to staff traditional bank branches. Digital-first fintechs have been able to offer a portfolio of financial services (called the 'supermarket' model) all delivered on a smartphone and typically without the fees charged by traditional banks. But the sector has gone from a few digital banks to dozens each competing to lure away customers from the well-established and solidly entrenched traditional banks, often offering niche service rather than a comprehensive range of financial services.

The floatation in 2020 of Ant Group, the owner of the Chinese payments business Alipay, with a valuation of some $200 billion – bigger than most banks – seems to provide the fintech industry with encouragement since the company was only started in 2004 and has only been a separate entity since 2014. Alipay is a digital wallet that now has insurance, lending, credit scoring and wealth management businesses. However, the circumstances surrounding its success in China are very different to the situation in the West. Alipay was founded by Jack Ma as a means of facilitating online payments for his main venture, the e-commerce company Alibaba (see Case insight 1.5). At the time customers in China did not trust traders to deliver goods ordered online. Alipay overcame this trust barrier by withholding payment until goods were delivered. This led to booming online sales for Alibaba and allowed Alipay to be spun out into a separate company that was renamed Ant Group. The company now has some 1.3 billion active annual users and makes up

one-third of all Chinese electronic payments. The group made profits of some £2.3 billion on turnover of about £7.9 billion for the six months to June 2020, suggesting a profit margin of 30% – far higher than mainstream banks or the fintech businesses copying this 'supermarket' model. Most have been able to sign up customers but have been unable to generate profits. There appear to be two issues. The first is simply the volume of transactions Ant is able to command, giving it the economies of scale smaller markets do not offer. The second is that it achieved this on the back of the Alibaba e-commerce platform, an opportunity not open to Western digital banks, where Amazon dominates the e-commerce market. Western digital banks are trying to get customers to deposit funds with them before they do anything else – a far harder proposition than the one that gave Ant Group its dominant market position. Perhaps the real rivals to fintech are platforms like Amazon, Apple, Google and Facebook, as they are already embedded into people's lives.

In the West the niche sectors of banking have often proved to be the greatest opportunities for fintech start-ups – where banking has been disaggregated and the internet platform used to provide a better or cheaper service. For example, Wise (formerly TransferWise: Case insight 4.1) allows customers to transfer funds internationally more cheaply than through the conventional banking system. Many of these services compete primarily on price because of their low cost base. Other fintech start-ups have focused on the additional benefits they can offer traders and customers by using their systems as an interface with existing financial structures (see Case insight 12.4: wiGroup).

Crowdfunding has become a significant fintech sector. Platforms such as Zopa (UK) and Lending Club (USA) facilitate peer-to-peer (P2P) lending. Platforms like Crowdcube (Case insight 19.4) facilitate commercial equity funding. There are even platforms facilitating funding for social enterprises (see Case insight 19.5: Co Cars and Ethex). Some platforms like Kickstarter in the USA (Case insight 19.3) offer 'rewards' or 'gifts' rather than, or as well as, equity. Although in its infancy internationally, the industry grew quickly to start with but is now showing evidence of consolidation, with some smaller P2P and rewards lenders struggling or even going into administration. In the UK, Growth Street, a platform specialising in lending to small firms, said it would begin to wind down its business in 2020, after it failed to attract sufficient funding. P2P lender RateSetter was taken over by Metro Bank in 2020 for only £2.5 million just three years after a funding round valued it at £200 million. It had suffered high levels of loan defaults in part as a result of the coronavirus pandemic.

The fintech industry has been attractive to start-ups over the last decade but it remains largely unregulated in most countries and open to fraud. For example, Wirecard, a German fintech company founded in 1999 providing technology to help process payments, collapsed into insolvency owing €3.5 billion in 2020 after it was revealed that some €1.9 billion reported missing from its accounts simply did not exist. The auditors said 'there were clear indications that this was an elaborate and sophisticated fraud'. Its chief executive was subsequently arrested. Wirecard was listed on the stock market in 2005 and joined the Germany blue-chip Dax 30 share index in 2018 valued at €24 billion.

Questions:

1. What do you need to start a new business in this sector?
2. Is fintech still an attractive industry for a start-up? Explain.

INDUSTRY FUTURES

The overall attractiveness of a market for a start-up is therefore based upon the opportunities the market offers balanced by the threats that it poses, particularly from competitors. The whole process is an art rather than a science and there is no prescriptive approach. However, the weakness with many of the approaches outlined so far is that they can focus too much on the current market and industry situation. It does not provide the entrepreneur with any tools to help them look at the future, which is where the real interest of a start-up lies. Unless there are structural reasons, current levels of industry profitability are unlikely to be a good predictor of the future because competitors are likely to enter an attractive industry. So, an entrepreneur needs to understand the current industry and market structures and then look at how they might change in the future, identifying trends such as emerging new technologies, new market entrants, changes in market structure etc. In the case of radical innovation, the past is certainly not a good predictor of the future as the market is almost certain to be changed in ways that are difficult to predict. However, any product/market innovation that attracts profitable customers is almost certain to attract a competitive reaction – and possibly from competitors with greater resources.

Trying to understand how changes might affect industry competitiveness and the prospects of a start-up is not easy and involves a lot of judgement. Nevertheless, some of the tools and techniques we used to find a business idea in the previous chapter can equally be applied to exploring how an industry

might look in, say, five years' time, after a start-up has entered the market. For example, PESTEL analysis can be used to identify the future influences on a market or industry. These influences can then be applied to the broad trends you have identified through research into the market or industry. Is the industry expanding or contracting? Is it consolidating or fragmenting? Is competition intensifying or are products/services becoming more differentiated? The futures thinking technique can then be used to build up a scenario of how direct and indirect competitors might react to the entry into the market of the start-up and where future competitors might come from. How will all this affect the industry? How will this affect the start-up? You can then brainstorm to explore how the firm might react to these trends and competitors. What strategies might be adopted? Will the product/service idea need to be modified or changed? Will new markets need to be identified and entered?

The sorts of general questions that are seeking to be answered in any look at the future are:

- What drives competition?
- What are the sectoral, performance and customer conventions that competitors adhere to, and how important are they to customers?
- What are the main dimensions of competition?
- How intense is competition?
- How can a firm be different and obtain competitive advantage?

Case insight 5.5 Industry futures

Post-coronavirus winners and losers

The 2020 coronavirus pandemic caused an economic recession. But some industries and sectors fared better than others. Indeed, some actually saw sales increase because of it. It is always safer to start up in a growing, rather than a contracting, industry. So which industries are the winners and which are the losers?

The high-street retail sector has been hardest hit since many countries have experienced lockdowns where people have worked from home. The result is that footfall in high streets has fallen dramatically. But even here there are differences. The food sector has remained buoyant, and convenience stores have benefited most. Across the board there has been an increase in home delivery services and many smaller food retailers have been quick to offer boxed fresh food delivery (Case insights 12.1: J&B Wilde and Sons; and 13.2: Best Fruit). Retailers of non-essential goods have seen the sharpest decline in sales and many have ceased trading (Case insight 20.2: Monsoon Accessorize). Those without an online presence have been particularly badly hit, while those with established systems have actually seen a growth in demand (Case insight 12.2: Boohoo). The retail sector generally has always seen a high number of start-ups alongside a high number of closures (called 'churn') and online has gradually been eating into high-street sales, a trend that the pandemic has accelerated and is expected to continue.

Although production has often been disrupted by the pandemic, sales of some physical products such as medical products (Case insights 2.4: Vaccitech; and 2.5: Astex Therapeutics), bikes (Case insight 18.2: Brompton Bicycle) and electric scooters have boomed. Sales of other products often associated with high-street retailers, such as fashion items, have suffered. Because people have been locked-down, parcel and other delivery services, such as takeaway food, have done well (Case insights 7.6: Deliveroo, Uber Eats and Just Eat; 12.5: Mamanpaz; and 13.3: Food-ATM).

Businesses in the service and leisure sectors such as restaurants, theatres, gyms etc., including social enterprises, have done badly because of lockdowns and social distancing (Case insights 2.7: Seven Stories; and 16.1: Adrenaline Alley). One thing these businesses have in common is their high fixed costs which still need to be paid even if there is no income (Case insight 13.4: TechHub) and where these have been minimised, for example by franchising operations, survival is more likely (Case insights 11.3: Specsavers; 11.4 Flying Tiger Copenhagen; and 18.1: Monkey Music). However, sales are still expected to be disappointing because of the resulting recession and drop in disposable income. Alongside this, holiday and travel firms have been badly hit, with any come-back not expected until 2022 (Case insight 15.1: Hays Travel). Lockdowns may have created greater awareness of the environmental impact of travel generally, but the effect of this is uncertain.

Perhaps the biggest winners have been online platforms generally, such as Zoom, Google, Apple and Amazon (Case insight 18.5). Tech and online products/services generally have done well. Home entertainment such as Netflix and online games (Case insight 9.4: Fortnite) have boomed. Fintech businesses continue to thrive (Case insight 4.1: TransferWise

(now Wise)). Sales of new tech products, particularly those related to environmental sustainability, such as solar panels (Case insight 4.2: Azuri Technologies and M-Kopa) and biotechnology innovations (Case insights 6.4: Galy; and 6.6: Ioncell®) continue to do well. The move away from fossil fuels like coal and oil parallels the move to wind and solar technologies. The implication of this is that the supply of the minerals needed for batteries (lithium, aluminium, copper, indium and selenium) will become the currency of political power.

Looking further to the future, Bernard Marr (*Forbes*, 30 September 2019) foresaw a number of trends in technology that will create opportunities for start-ups:

- Artificial intelligence (AI) is already being custom engineered for specific tasks aimed at improving customer service in companies like Amazon, Google and Microsoft. However, Marr foresees the opportunity for new providers to offer a range of more tailored applications and services to companies for specialised tasks at a lower cost.
- The expansion of 5G networks means that mobile networks will offer greater and more stable connectivity. This, combined with the ability of computers to 'see' (e.g. face recognition in smartphones), will create opportunities for an even wider range of business applications, like autonomous vehicles (see Case insight 4.11: Starship Technology) and robots (see Case insight 17.2: Google Glass).
- Blockchain technology, which allows transactions to be recorded but secured because of its encrypted and decentralised nature, is already used by companies like FedEx and Walmart. This technology has wider applications, for example in recording the source and provenance of products to ensure they meet certain legal or environmental requirements (see Case insight 7.1: Nin Castle and Reverse Resources).
- We already use virtual reality (VR) (e.g. in computer games) and augmented reality (AR) (e.g. as Snapchat filters) and are starting to mix the two (called mixed reality: MR) whereby users can interact with digital objects. Marr believes the use of this is likely to extend from gaming and leisure into other areas such as training and simulation.
- Advances in technology (particularly AI), biotechnology and genomics offer opportunities to make personalised and predictive health care more widely available.

Entrepreneurs thrive on change, and markets and entire industries are changing rapidly as a result of the 2020 pandemic and the rapid advance of technology. There are opportunities to be found, as long as the threats can be avoided.

Questions:

1. What sectors, markets or industries do you think present the greatest opportunities in the near future? Explain.
2. What are the greatest threats facing start-ups in the near future?

SCENARIO PLANNING

Scenario planning is another technique that tries to assess how possible future situations might impact on a firm. It allows you to take Porter's static Five Forces analysis and add to it the extra dimension of competitive reaction. If a start-up's innovation causes radical changes to markets it is particularly useful to 'game plan' how competitors might react. Trends and drivers of change identified from the PESTEL analysis can be built into the scenarios. These scenarios must be logically consistent possible futures, based around the strengths and weaknesses and other key factors influencing the firm and its competitors. Often three are constructed: an optimistic, a pessimistic and a 'most likely' future. Optional courses of action or strategies can then be matched to these scenarios. In effect, the scenarios are being used to test the sensitivity of the start-up's business model and strategies. Scenarios allow assumptions about the status quo of the environment to be challenged. After the financial crisis of 2008, Lego started using scenario planning as part of its annual budgeting process, allowing it to build contingency plans for each 'crisis' scenario that it identified.

Scenario planning is a practical example of the use of the more complex game theory to better understand situations and help with decision-making. It helps generate questions and debate about future strategies rather than providing concrete answers to dilemmas. It allows the entrepreneur to explore 'what if?' situations and is at its most powerful when used alongside the business model frameworks outlined in the next chapter.

This review of the future should generate a series of opportunities and threats (or risks) that a firm might face in five years' time. It needs to think through how it might deal with them. This involves identifying a series of critical success factors – things it needs to get right to ensure its survival and success (although there is no such thing as a 'guarantee' of success). These vary from industry to

Case insight 5.6 Bill Gates and Microsoft

Looking to the future

In the 1990s Microsoft dominated the computer software market with its Windows Operating System and Microsoft Office suite. In 1995, five years before he stepped down as CEO, Bill Gates wrote an internal memo that has become increasingly pertinent:

> *'Developments on the internet over the next several years will set the course of our industry for a long time to come ... I have gone through several stages of increasing my views of its importance. Now I assign the internet the highest level of importance. In this memo I want to make it clear that our focus on the internet is crucial to every part of our business. The internet is the most important single development to come along since the IBM PC was introduced in 1981.'*

However, the company did not react. New developments that threatened to cannibalise its main source of revenue were not allowed to surface. Instead all its resources were targeted at defending its existing dominance of the software market. By 2014, Microsoft had only just started to focus on the importance of the internet and was falling behind competitors. With sales of Windows and Microsoft Office falling sharply, it had been forced to announce a 'far-reaching realignment of the company' to enable it to respond more quickly to change, 'focusing the whole company on a single strategy'. This involved disbanding product groups, making redundancies and reorganising itself into functional lines such as engineering, marketing, advanced strategy and research. It also started to focus on the threats and opportunities posed by the internet.

Question:

1. How difficult is it to 'predict' the future? Why should you try?

industry, market to market and firm to firm. They might emerge therefore out of industry best practice. They might come out of scenario planning and will certainly be amplified as the business model is developed (Chapter 6–13). Chapter 7 in particular will outline some generic business models that imply specific critical success factors and Chapter 13 will highlight certain financial metrics that need to be monitored to ensure profitable survival.

This review of the future should also generate strategic options – actions the firm might undertake if the risks or opportunities actually materialise. The more strategic options that a firm can identify, the more flexibility they have. They are sources of real value to the entrepreneur and potential investors. Companies that present many options and/or opportunities are more attractive than those with fewer. In the same way, resources that can be used in a number of different ways offer flexibility and are therefore more attractive to own than those with limited use, which should therefore be rented or bought in. A start-up needs to think creatively about how the resources it needs can be obtained. They do not always need to be purchased and owned.

SUMMARY

- An entrepreneur needs to be able to identify and describe the characteristics of the market or industry within which their start-up will operate. Commonly used typologies include life cycle, concentration and geographic extent. However, drawing the boundaries of a particular industry can be difficult and is a question of judgement.
- Porter's Five Forces can help assess the degree of competition within a market or industry, and hence its potential profitability.
- Desk research is cheap and quick. It should help estimate the size of a market and identify a firm's competitors. Field research involves interaction with potential customers.
- Total Available Market (TAM) is the size of the potential market – those who might be interested in buying the particular product. This reflects the total sales of competing products. The Served Available Market (SAM) is the size of the target market segment the firm wishes to serve within the TAM. The penetrated market is the size of the SAM the firm actually captures. Its market share is the penetrated market divided by the SAM.
- The profitability of individual companies within an industry can vary widely implying that the choice and, just as important, execution of business model and strategy are probably more important than the choice of industry.

» Interest in industry analysis is about trying to predict the future – the threats and opportunities the entrepreneur and the start-up might face. Techniques such as PESTEL analysis, brainstorming, futures thinking and scenario planning can help do this.

» Any analysis should generate a series of threats and opportunities and strategic options that a firm might undertake if they actually materialise. The more strategic options identified, the more flexibility a firm has. It should also generate a series of critical success factors – things it needs to get right to ensure survival and success. These will be amplified and developed within the business model.

GROUP DISCUSSION TOPICS

1. How do you define an industry and a market?
2. Why is market research important? What information can it generate for a start-up?
3. What information can you get from desk/field research? How would you use the different sorts of information? What are the advantages and disadvantages of each?
4. What information is market research unlikely to generate?
5. Market research tells you nothing of importance about a radical innovation or completely new markets. Discuss.
6. How important is market research as the business grows?
7. The better your idea, the more likely there is to be competition. Discuss.
8. Is it easier to start up in a fragmented or a consolidated market?
9. Competition is always fiercest in the most attractive markets/industries – those where there is greatest customer demand, and therefore profit potential. Discuss.
10. Why are there business opportunities in mature and/or declining markets?
11. At what stage(s) are industries likely to develop a 'dominant logic' and become complacent?
12. Should a start-up always be attracted to an industry where there is little competition?
13. Is it better to have big-company or small-company competitors?
14. Why might an entrepreneur perceive themselves as having no competition?
15. If the future is so important, what is the point of looking back and doing market research?
16. What would it take to get you to start up your own business?

STUDENT ACTIVITIES

1. Undertake research into a selected market or industry. Using the typologies outlined in this chapter, describe its characteristics. Assess the degree of competition within it.
2. Assess the future of this market or industry in five years' time using the techniques outlined in the chapter (you might try 'best-case' and 'worst-case' scenarios).

START-UP ACTIVITIES

1. Research the general market and industry for product/service at a macro level:
   a) Find out as much as you can about the size, growth and structure of the market, market trends, customer demographics, buying patterns, established channels of distribution etc.
   b) Describe the particular market you are targeting – your TAM (e.g. local vs national, other characteristics). Repeat the exercise for your SAM. Explain any differences.
   c) Identify your specific competitors and describe the strengths and weaknesses of their competing products/services. Assess the degree of competitive rivalry in the industry using each of Porter's Five Forces (1 = low, 5 = high) and arriving at a final overall score.
2. Estimate the size of your market (SAM and TAM).
3. Undertake a PESTEL analysis on the market/industry to identify the key influences or trends that might affect it over the next five years. Identify those that might have the greatest impact on your business (good and bad) and from this list the critical success factors – the things you need to get right to ensure your survival and success.

PART 2

START-UP

This section is essentially practical, showing how to go about launching a new venture with minimum risk and maximum chance of success.

Chapter 6 Lean methodologies and business model frameworks

This chapter outlines the methodologies and frameworks that allow business ideas to be explored systematically, minimising risk and maximising market information and feedback.

Chapter 7 Developing the business model

This chapter starts to put the flesh on the bones of a business idea by developing its business model. It explains a number of widely used 'generic' models, highlighting their operational imperatives, and provides research-based insight into those models that are most likely to be successful.

Chapter 8 Market segments and value propositions

Chapters 8, 9 and 10 show how to develop the marketing aspect of the business model. This chapter shows how to construct an attractive value proposition for different target markets. It highlights the importance of the firm's values and shows how these can be communicated through branding and design.

Chapter 9 Developing the marketing mix

This chapter shows how a marketing mix can be developed to support a coherent, consistent marketing plan. It emphasises decisions about real and virtual distribution channels and pays particular attention to pricing strategies.

Chapter 10 Sales and marketing communications

This chapter focuses on how to develop an appropriate marketing message to attract target customers and shows how this should be tailored to take a customer along a journey to become a loyal advocate of the product/service. It explores the use of different media to communicate this message. Finally it looks at how to develop selling skills.

Chapter 11 Setting the legal foundations

This chapter is largely factual, covering the legal things that need to be done to launch a business. It explains legal issues around safeguarding intellectual property, legal forms of business, different forms of partnership, corporate governance and taxation.

Chapter 12 Developing the operations plan

This chapter looks at how operations for different types of businesses can be planned and how key operating activities and critical success factors are identified.

Chapter 13 Managing risk

Managing risk is important for start-ups and this chapter outlines how both known and unknown risks can be dealt with. It highlights an important failing of many entrepreneurs – that they may be tempted to gamble more with downside (failure) rather than upside (opportunity) risks.

Chapter 14 Recruiting and managing people

This chapter explains how staff and a venture team can be recruited and highlights issues about how they are best managed and controlled.

Chapter 15 Financial forecasting and control

Finally, this chapter explains how financial forecasts covering profit, breakeven, cash flow and balance sheet can be drawn up and then used to monitor the performance of a business. These forecasts underpin the consistency and feasibility of the entire business model.



MEET THE ENTREPRENEURS



Access the *Digital Links* booklet via the companion website to watch interviews with various entrepreneurs on how they started their venture.

6

LEAN METHODOLOGIES AND BUSINESS MODEL FRAMEWORKS

Contents

- Design thinking
- First-mover advantage and risk
- Lean start-up
- Affordable loss
- Developing a business model
- New Venture Creation Framework
- Business Model Canvas
- Lean Canvas
- Developing and testing a business idea
- Low-cost market testing and trading
- Go/no-go decision points
- Setting performance metrics
- Accelerators and Incubators
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: Bernard Hermant on Unsplash

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand and explain the design thinking approach to new product/service development and its relationship to lean or agile start-up methodologies;
- Understand the risks facing the launch of a new product/service and how the concept of affordable loss can limit this;
- Understand and explain what goes into a business model and how the frameworks outlined in this chapter might be used to develop one;
- Critically analyse a business model using the New Venture Creation Framework;
- Critically analyse the criteria used to assess commercial viability of a new product/service at initial screening;
- Understand how SMART performance metrics can be set and used to monitor the success of a new product or service launch.

Case insights

6.1	FBR (Fastbrick Robotics)	6.4	Galy
6.2	Dropbox	6.5	FudgePots
6.3	Soraya Sikander, 'artpreneur'	6.6	Ioncell®
		6.7	StellenBosch LaunchLab

Explore further links

6.1	Design thinking	6.5	Business Model Canvas
6.2	Lean start-up	6.6	Low-cost market testing and trading in the UK
6.3	Business models		
6.4	New Venture Creation Framework		

DESIGN THINKING

Coming up with a business idea is only the first step in the journey towards launching it onto a market. Design generally is an important way of identifying and differentiating a product/service from those of competitors – a topic we shall return to in Chapter 9. However, 'design thinking' (also called 'customer-centric design') is a different lens that is worth using to look at the creative process behind generating a new business idea – a process of finding solutions to problems from the perspective of the user of a product/service, rather than just creating distinctive objects or shapes. It is a holistic way of thinking rather than a clearly defined set of processes, similar to the discovery skills outlined in Chapter 4. The term is closely associated with the lean start-up methodologies covered in this chapter.

The origins of design thinking can be traced back to Simon (1969). Although there are many versions of a design thinking process with numerous stages, Simon talked about it being a seven-stage process:

1. Define: Identify the real problem to solve – not necessarily the obvious one – and define the design brief in a way that is unconstrained by existing solutions.
2. Research: Observe how people deal with the problem and how similar problems in different contexts are handled.
3. Ideate: Think outside the box – look at the problem from different perspectives and come up with as many different ideas and options as possible. This may involve a multidisciplinary approach and periods of divergent and convergent thinking. Do not close down options too early. The stages so far are all concerned with finding a good idea – although not necessarily one that is commercially attractive.
4. Prototype: Experiment with prototype solutions to see which work.
5. Choose: This is a process of synthesis which helps select the one that works best or the *ones* that work best. Different solutions might be used to solve slightly different problems or meet the needs of different groups of people.
6. Implement: Try out the solution(s) and monitor effectiveness. Prototype solutions – both products and services – need to be tested, iterations developed and refined.
7. Learn: Always learn from both success and failure.

Design thinking is evident in the design of some high-tech products where software and hardware are integrated and made intuitive, simple and even pleasurable to use. And for this it needs to meet both people's practical (left-brain) and emotional (right-brain) needs – what is often called 'the user experience'. Companies that follow this approach develop value propositions that not only offer a promise of utility but also one of feeling or emotion (Chapter 8). Kolko (2015) gives the example of automotive design which might offer not only 'safe and comfortable transportation in a well-designed high-performance vehicle' but also a promise that 'you will feel pampered, luxurious and affluent'. But design thinking is not just confined to product design and value propositions, it is holistic and seeks to integrate all the 'touch-points' a customer might have with the product and the service associated with it, rather than just the fragmented elements of the marketing mix. This is why Apple takes as much care over the design of its packaging as it does with the product itself.

To achieve these ambitious objectives involves working in collaboration with users – and that usually means that a prototype needs to be built so that you can observe how users interact with it. This approach requires a customer focus and a willingness to learn about their needs, constantly refining a product/service offering to better meet them. The approach involves a number of principles, which are consistent with developing a coherent, integrated business model:

» Empathy with users – this goes to the core of finding a commercial business idea – understanding customer needs and finding solutions to problems they face. These needs are both functional and emotional (heart and head). Companies like Samsung achieve this, in part, by sending designers out to see how customers use their products.

» Discipline of prototyping – it champions the use of prototypes to explore the effectiveness of potential solutions to problems. Kolko (2015) observed that this often involves real customers but iterations of a prototype must be done quickly.

» Tolerance of failure – innovation is risky and, as with brainstorming, generating new ideas is a numbers game. The more ideas there are, the more likely one will be a good one, but that involves generating many ideas that are not. Failure is therefore to be expected. The trick with a failing project is to limit financial exposure, terminate it quickly and learn from it – all principles of the lean start-up methodology we shall outline later in this chapter. As Thomas Edison, the inventor of the light bulb, said: 'I have not failed, not once. I've discovered ten thousand ways that don't work.'

Verganti (2009) observed that not all 'design-driven innovations' come from the market (market-pull) – such as making existing products better, easier to use or more distinctive. Design thinking can create whole new markets through technology-push or through market paradigm shift. This can be achieved by giving products/services 'new meanings' – emotional, psychological and sociocultural rather than just utilitarian reasons for purchasing them. Customers come to view the product in a different light. He argued that for truly breakthrough products/services, you must look beyond customers to those he calls 'interpreters' – 'experts', like Steve Jobs, who deeply understand and shape the markets they work in. Although in advance of their markets, they are absorbed in them, understanding trends, styles, materials and technology. However, they are able to rise above the dominant logic by recognising and questioning it. They are also able to influence the market through their insight, powers of persuasion and marketing skills. They have a vision and then take that vision to customers, persuading them that this new 'meaning' has value. However, this strength may also be a weakness because it can fail to take account of that prevailing market space and the business model required for a commercially viable business idea (Phadke and Vyakarnam, 2017).

Design Council UK uses a simple four-stage model to represent the design process that is a little more straightforward. The 'double diamond' graphic in Figure 6.1 represents the alternatively divergent (right-brain) and convergent (left-brain) modes of thinking in the four phases of the process, underlining the idea that the best innovations involve both brain systems:

Phase 1 ➔ Discover – the stage when the initial idea or inspiration needs to be found, based on identifying user needs.

Phase 2 ➔ Define – when these needs are interpreted and aligned to business objectives resulting in the definition of the design project.

Phase 3 ➔ Develop – when design-led solutions are developed, iterated, built and tested. This will involve multidisciplinary prototype development and testing.

Phase 4 ➔ Deliver – when the resulting product is finalised, approved and launched, followed by evaluation and feedback.

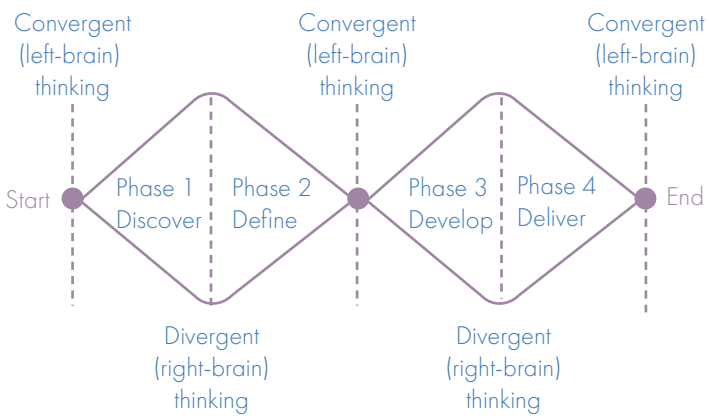


Figure 6.1 The double diamond design process

Explore further 6.1

Design thinking

Access the *Digital Links* booklet to view:

- A short Harvard Business Review animation explaining the concept of design thinking.
- A Harvard video case describing Apple's approach to innovation, management and design thinking.
- A free booklet from Design Council UK which explains how to use the double diamond model to design services and also includes suggestions on some easy-to-use design tools.

FIRST-MOVER ADVANTAGE AND RISK

Implicit in the design thinking approach is the development and testing of a prototype. Throughout this process there is constant measurement of success (or failure) and feedback so as to learn from this and adapt the product/service. However, this process involves costs and time. These must be weighed against the risk of launching an untested product/service, one that is not attractive to customers and ultimately might fail. Nevertheless, a good business idea has a window of commercial opportunity. Launch timing for any product/service is critical – but particularly for something innovative. Delay the launch and there is the risk of losing that window of opportunity that gives 'first-mover advantage' in the market – novelty value may be lost and competitors may have time to copy the product/service or prepare competitive strategies. Launch too early and the market might not be ready for a product/service that is just 'before its time' and not understand what it does and the benefits it offers. This means that customers need 'educating' about it before it goes into full-scale production – leaving the education costs with the early entrant and an opportunity to launch later into an 'educated' market with a competitor. Moreover, there is the risk that the product/service or marketing strategy is ill-prepared or untested and customers turn against it, leaving the market wide open for competitors. Either way, launching too early can often be even more disastrous than launching too late. And every market is different. Often products launched first in the USA will not find a market in other countries until years later. This has led one researcher to suggest a policy of 'active-waiting' – delaying launch until the market needs are clearer (Sull, 2005). Timing is crucial, which leads us to the link between risk and the time taken to get to market, shown in Figure 6.2. Finding that important 'window of opportunity' is a difficult judgement call.

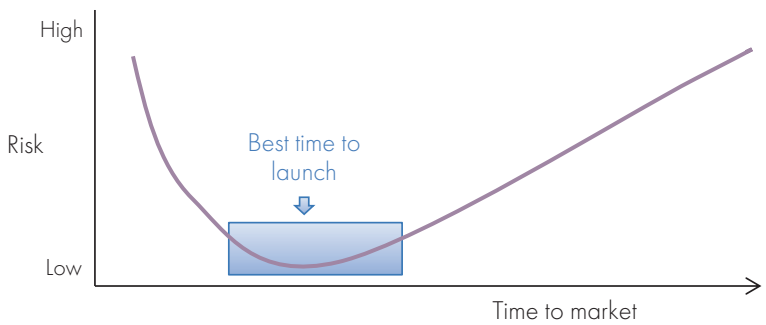


Figure 6.2 Risk and time to market

One reason for getting the timing wrong arises from whether innovations come through technology-push or market-pull. Market-pull innovations are derived from customers' needs. They are more likely to succeed because the timing, by definition, is right. Innovation based upon technology-push may not yet meet a customer need simply because customers cannot visualise how the new product/service might be used. This is why Google has had a low-cost, try-it-out, experimental approach to much of its more radical innovations – perfecting them as it learns what the market really wants. Market research can mislead when it comes to disruptive technology-push innovations. This was the case with IBM when it found that market research into the idea of the personal computer suggested that customers were unwilling to pay for this product. History proved market research wrong and entrepreneurs like Steve Jobs had the vision to see the potential of the personal computer, despite what customers at the time thought.

First-mover advantage is important in the tech industries and many companies decide to launch as quickly as possible, despite the risks. As a consequence, many tech start-ups do not make a profit early in their lives, content instead to generate users. Indeed, tech firms continue to make losses well after their launch and even after becoming listed on a stock exchange. The Swedish music streaming service Spotify, launched in 2006 and listed on the US stock exchange with a value of $24.2 billion, has a huge user base and 100 million paying subscribers but remains loss-making (forecast at $320 million in 2019). Tech investors tolerate these losses because they hope that their company will, at some point in the future, dominate the market that it has pioneered and be able to make monopoly profits. There are two other reasons why losses might be tolerated. Firstly, the data gathered on users may be of commercial value in the future. Secondly, the company might be sold to a competitor eager to grab market share (Spotify's competitors are Apple and Google). At the end of the day, the decision when to launch a business is always going to be a judgement call based on incomplete and uncertain information.

LEAN START-UP

Identifying the risks associated with launching a start-up revolve around identifying the specific shortcomings in a new product/service and its business model. Market research and focus groups are likely to help with incremental changes to existing products/services, but radical innovations are more difficult to identify and evaluate. Customers just cannot understand how a radically new product/service might be used. If practical, what is needed is some form of limited market testing of the actual product/service and its business model.

Ries (2011) developed what he called 'lean start-up' methodologies to address this problem. These were closely related to what has been called 'agile' methodologies, originally used by software designers, which have now found their way into other industries. Rather than developing a fully finished product/service it is an incremental approach to development that involves a continuous process of planning, experimentation, implementation, market testing, evaluation and integration of the results prior to proceeding to the next level of approval and development of a project – a continuous process until final launch. The lean start-up concept is that the product/service is not launched in a perfect, but rather in a pared-down, but workable, state. This 'minimum viable product' (MVP) is one with just enough features to satisfy early customers. Customer feedback is then used in an iterative fashion to further tailor the product/service to the specific needs of customers – a process Ries called 'validated learning'. In this way, no valuable time or money are invested in designing features or services that customers do not value. The process can be summarised:

Idea → Plan → Develop MVP → Market test → Evaluate results → Learn

It is a continuous process that repeats as many times as necessary.

The idea of small-scale market entry and testing to gain market information prior to full product launch, particularly for new entrepreneurial ideas, is well established (e.g. Chaston 2000, 2015). This approach gives that important first-mover advantage and minimises costs while, importantly, reducing market risks when the product/service finally reaches a wider market. However, an MVP

> *The beauty of being an entrepreneur is that, if the first idea doesn't work, you can come up with a second and a third until you come up with a workable concept.*
>
> Duncan Bannatyne, serial entrepreneur, *Daily Telegraph*, 5 March 2009



Source: Braden Collum on Unsplash

may still not convince customers of the utility of a product/service if it is just too far 'before its time'. On the other hand, if the market does exist it should throw up the modifications that need to be made prior to launch. The question is when is the MVP sufficiently ready to launch? If the MVP is so underdeveloped that it does not fulfil even the most basic functional requirements then customers might well reject it. This might be a very different outcome to the one if they had been offered an MVP with greater functionality. Further, an MVP with poor functionality may spell disaster in the market for the fully functioning final version if the reputation of the brand is tarnished. What is more, testing the MVP and modifying the prototype can take time, even if the entrepreneur has the resources required. Modifying the MVP or waiting until there is a fully functioning prototype risks losing that window of opportunity that gives first-mover advantage. These dilemmas revolve around the decision about what constitutes a 'minimum viable product', and the decisions when to launch both the MVP and the final product remain judgement calls.

The lean start-up approach works well for some products such as software and web-based product development, particularly when new features can be trialled on the back of the core product. This is an approach often taken by Google. However, for high-investment (often disruptive) innovations, the product itself may have to be substantially right first time – it must work. Any imperfections in an MVP risk customer rejection and may damage subsequent development of the brand reputation. Imagine asking Apple if it would have been happy to launch a 'minimum viable' iPhone.

Explore further 6.2

Lean start-up

Access the *Digital Links* booklet to watch:

- A video animation explaining MVP.
- A talk by entrepreneur Steve Blank, explaining MVP.
- A Harvard Business Review interview with Professor Jeff Dyer about MVP.
- A short lecture by entrepreneur Eric Ries explaining the lean start-up concept.
- A Harvard Business Review interview with Professor Jeff Dyer on experimenting with new ideas.

AFFORDABLE LOSS

Associated with a lean start-up is the concept of 'affordable loss' which involves setting a loss or budget that the entrepreneur can afford if the project proves unsuccessful and then launching the MVP to discover customers' reactions. In this way the entrepreneur gains as much information as possible rather than trying to predict from the outset the risks and returns associated with it. Setting an affordable loss and then running the project allows the entrepreneur to evaluate the opportunities produced by this investment, rather than trying to evaluate the attractiveness of the predictable (or unpredictable) upside of the project from its very inception. This approach is particularly attractive for radical innovations because it means the entrepreneur does not have to worry as much about the accuracy of their market predictions. Affordable loss can be set with certainty, depending on the entrepreneur's situation.

Case insight 6.1 FBR (Fastbrick Robotics)

Prototype development

People have been laying bricks to build houses for over 6,000 years, but that might be about to change. In 1994 Mark Pivac, a former aeronautic and mechanical engineer with experience in 3D computer-aided design (CAD) software, had an idea that brought together different technologies to produce a 'mobile dynamic stabilising robot', solving the problem of stabilising a robot in a moving environment. The idea evolved over a long period, originally focused on an application that did not have commercial potential. However, in 2005 there was a shortage of bricklayers in Australia and he started thinking about applying the concept to the problem of bricklaying. He obtained funding to develop his idea and by 2008 he had built hundreds of prototypes, but more importantly, filed patents safeguarding his IP. The prototypes stood undeveloped for many years until he started working with his brother, Mike Pivac, to commercialise the idea. Mike had previously started and run a number of businesses but was recovering from a serious back operation at the time. His involvement proved pivotal in commercialising the company's technology, business plan and machine development strategy. He forged relationships with investors, builders, suppliers and future customers.

It took almost eight years and some US$7 million, however, to finally develop a working commercial prototype. In 2016 the Hadrian 105 construction robot built the first cemented, multi-room block structure without human intervention from a 3D CAD model. This proved the technology worked. By 2017 a commercial version, the mobile Hadrian X, was produced for the market – a steel, aluminium and carbon fibre composite lorry-mounted machine capable of laying up to 1,000 bricks per hour in a fully automated process, making it possible to build the brick structure of a house in just two days. The robot element can also be mounted onto other bases such as tracks, barges or cranes. It can work by itself 24 hours a day for 365 days a year.

Bricks are fed onto a conveyor belt that travels along a long (28 metres) robotic arm, or telescopic boom, and are gripped by a claw-like 'hand' that lays them out in sequence on the pre-prepared groundwork, directed by a laser guiding system. A 3D CAD system works out the shape of the house, and the robot then calculates where each brick should go, leaving spaces for wiring and plumbing. It even scans and cuts the bricks if they need to be reshaped. Mortar or adhesive is then delivered under pressure to the hand of the arm and applied to the brick. Central to this process is FBR's Dynamic Stabilisation Technology (DST™), which measures movement caused by wind, vibration and inertia and counteracts it in real time using algorithms to ensure precise placing of the bricks:

> *'I invented DST™ to solve the problem of stabilising a robot at the end of a long moving boom, originally for an application that didn't have enough demand to justify its development cost. A decade later, a building boom converged with a shortage of bricklayers, driving the cost of laying a brick up to $1.25. I knew my idea's time had come. Once in a lifetime, if you're lucky, something you invent gets the opportunity to tackle a major global need. So we scaled up, built our own testing facilities and brought together brilliant minds from across the globe to bring this idea to life.' (Mark Pivac, https://www.fbr.com.au/view/our-tech)*

The home construction industry is notoriously resistant to innovation but demand for homes is growing and there are increasing shortages of bricklayers worldwide – which may make change inevitable. Potentially this technology could make house building faster, safer and cheaper. As a result, in 2017 FBR signed working agreements with US giant Caterpillar, who invested US$2 million with an option to invest another US$10 million, Saudi Arabia, who were looking to purchase 100 robots, and Mexico's GP Vivienda to develop social housing. In 2018 it signed a partnership agreement with Wienerberger Group, a major European building materials producer, to develop, test and manufacture optimised clay blocks for the Hadrian X construction robot. These will subsequently be used in a pilot project in Europe and launched in Wienerberger markets together with the Hadrian X robot.

Access the *Digital Links* booklet to visit the company website and to watch the FBR robot in action.

Questions:

1. What events were pivotal in taking this project forward? Were they predictable? What lessons are there in this for creativity and innovation?
2. Why was building a working commercial prototype so important?
3. Why is FBR seeking partnerships, rather than just rolling out the Hadrian X itself?

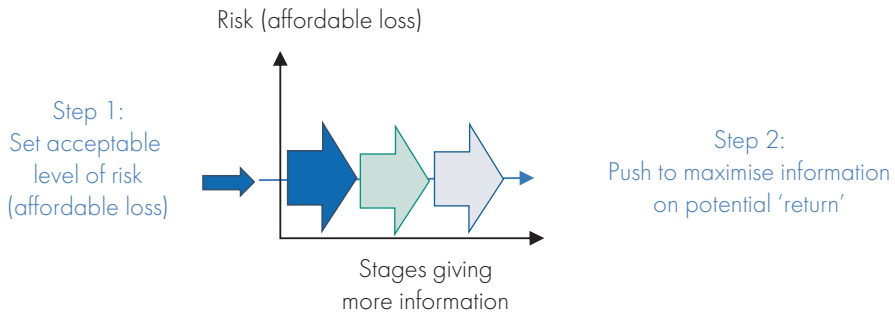


Figure 6.3 Setting risk and maximising return

The approach involves setting stages for a project, limiting the financial exposure at each stage, and then deciding whether to continue based on the information gained at the end of that stage. It is a two-step process shown in Figure 6.3. Firstly, set the acceptable level of risk by setting the affordable loss and then push to maximise the information gained about the returns from the project. This process might be repeated as more information is obtained and the MVP modified accordingly. The final 'return' can then be evaluated more accurately. The approach can be combined with networking and/or partnering to leverage up the affordable loss or budget, not only through money, but through the other resources of the network or partner (such as knowledge, skills or finance), only finally using larger amounts of finance to develop a business model that best fits the project.

Sarasvathy (2001) provided empirical evidence for this approach based upon a study of how 27 successful entrepreneurs approached business decisions compared to a group of professional executives. The study found that while executives wanted to research opportunities and assess potential returns before committing resources, the entrepreneurs were far more inclined to go to market as quickly and cheaply as possible and assess market demand from that.

Lean start-up methodologies provide an agile, low-cost/low-risk way to rapidly assess the potential risk and return of a business idea. They help minimise this risk through the knowledge and information gained by a limited launch of the MVP. Affordable loss sets a downside maximum to the loss the entrepreneur might face if the business idea proves commercially unattractive. It mirrors the incremental approach entrepreneurs typically take to decision-making – gaining knowledge as they proceed – and the way they limit their financial exposure as much as possible at each stage. The key to the approach is close customer knowledge and relationships and having mechanisms to receive their honest feedback. Ries (2011) gave the example of the start-up strategy of Nick Swinmurn who founded the US online shoe retailer, Zappos. Instead of building a website and a large database of footwear, he tested his business idea by taking pictures of shoes from local stores, posting them online and selling them through his website, buying the shoes from the stores at full price. Although he did not make a profit, this method quickly validated his business idea, with minimum cost and risk.

DEVELOPING A BUSINESS MODEL

The business model is the route to taking a business idea to market – a plan of all the things the entrepreneur has to do once they have developed the product/service. It is the strategic framework that gives the business idea direction and generates its competitive advantage and will have a very large impact on whether or not the business idea will be successful. A good business idea can fail because of a bad model and a poor idea can survive because it has a good one. The reality is that the business model is just as important as the product/service idea itself, even for radical innovations (Giachetti, 2018).

Developing a business model involves producing plans about how the product/service will be produced and marketed, the resources (both human and financial) needed to do this and the resulting costs and revenues. Each element of the model is dependent on the other parts. Developing the model

Case insight 6.2 Dropbox

Lean start-up

Dropbox is a file hosting, cloud storage and transfer service founded by MIT students Drew Houston and Arash Ferdowsi in 2007 with initial funding from seed accelerator Y Combinator. It was launched in 2008. The beta phase of version 1.0 was offered to private clients in 2010 and Dropbox Business made the service available to larger teams in 2011. After further testing a collaboration tool was introduced allowing users to collaborate in developing and processing text. Dropbox is now available to the general public using a freemium business model with free file storage and transfer up to a certain size, with paid subscriptions available for extra storage capacity and additional features. Dropbox Business offers more functionality for teams, including collaboration tools, advanced security and unlimited file storage and recovery.

Dropbox's development is a good example of lean start-up and the company is a keen advocate of the methodologies. Before bringing the product to market, Dropbox tested the concept in two stages. During these stages there was no functioning prototype. Stage 1 tested the product with a limited number of users. Stage 2 involved the production of a video demonstrating the core features of the product – cloud-based storage and file transfer. This attracted some 75,000 views by early adopters and as a result the company received extensive feedback that helped it simplify and develop the product's functionality. It used a product called Votebox – an online voting system based upon open-source software – to establish a dialogue with users about product features and continues to use this to filter out the best features of various Dropbox products.

Dropbox was also an early implementer of personalised applications. When it identified users who did not use a particular application it would send them information on it and how it might be used. Users who had used up their allowable storage were emailed with offers of additional storage.

These techniques helped the company to gain valuable user feedback and quickly penetrate its market. Regular communication helped build a loyal user base that was able to help with product development. Dropbox's attempts to increase users through traditional marketing methods in its early days proved unsuccessful. Instead it offered free additional storage to existing users who successfully recommended Dropbox to new users. Within 15 months users grew from 100,000 to 4 million.

Based in San Francisco, Dropbox now has over 500 million users. Despite having never made a profit (although it reports positive cash flows), when it raised private capital through an IPO in early 2018 it was valued at $12 billion.

Access the *Digital Links* booklet to visit the company website and to watch the original video explaining the Dropbox concept (an MVP demonstration), as well as two interviews with Drew Houston, one in 2013 and the other in 2017, showing how the business model changed.

Questions:

1. How have lean start-up methodologies helped Dropbox?
2. How much can these methodologies tell us about monetisation and the financial return from the product?
3. Can the lessons from Dropbox be transferred to other start-ups not based on the internet?

involves iterations – going back over the building blocks to ensure consistency and coherence in the model – so that the operations plan mirrors the marketing plan and there is sufficient money to finance this. Alter how a product/service is produced or delivered and its price may have to be altered, which in turn affects how it is marketed. This is a continuous process of refinement. What is important is that all the elements of the business model are consistent and deliver the value proposition (marketing benefits) to each targeted group of customers.

There are a number of generic business model frameworks that provide pictorial and/or verbal structures to aid understanding and development of a business model. The best are minimalist and simple – they force focused thinking and succinct communication. Nevertheless, the structure they use provides a coherent but flexible framework that helps the team develop their ideas. A framework needs to be flexible as it will probably change as feedback and market information become available. However, it also needs to ensure consistency, so that if one element of the model is altered another can be adjusted appropriately. As John Kay (1995) explained:

> An organizational framework can never be right, or wrong, only helpful or unhelpful. A good organizational framework is minimalist – it is as simple as is consistent with illuminating the issues under discussion – and is memorable … [It] provides the link from judgment through experience to learning. A valid framework is one which focuses sharply on what the skilled manager, at least instinctively, already knows. He is constantly alive to strengths, weaknesses, opportunities, threats which confront him … A successful framework formalizes and extends their existing knowledge. For the less practiced, an effective framework is one which organizes and develops what would otherwise be disjointed experience.

We shall outline three business model frameworks; the *New Venture Creation Framework*, the *Business Model Canvas* and the *Lean Canvas*. All three models cover similar ground and are consistent, although they do use slightly different terminologies. However, the New Venture Creation Framework develops the elements of a business model in a sequential manner consistent with the developing a new business (e.g. operations and resources needed depend on the marketing strategy adopted). It also uses a structure that facilitates its transformation into a more formal business plan that can be used to raise finance. The advantage of using any of these business models in this way is that they are (relatively) quick to develop and easy to change, allowing new business ideas to be tried out. These frameworks create a common language and a mechanism for communication. They allow an entrepreneur to:

- Develop their competitive strategy, by modifying their target markets, value propositions and their marketing, operations and financial plans;
- Explore in a structured way innovative alternatives and options, asking the important 'what if?' question and always trying to understand the linkages and implications of different product/market offerings, while allowing new business models to be tested against established ones (see Chapter 7);
- Identify patterns and ensure consistency in the elements of the business model;
- Experiment with different versions to see which critical assumptions are most realistic (revenue model, pricing, sales, costs etc.);
- Identify strategic options, each option contingent upon different circumstances. The more options that can be identified, the more flexibility there is in formulating, or indeed changing, a strategy after launch. Not all options need to be constrained by current resources or the current competitive position. These constraints might change over time and sometimes the vision for the business might generate options that transcend the constraints anyway.

Only when the entrepreneur is satisfied with the model created in this way would they go on to 'fill in' more of the details and perhaps write up a more formal business plan.

> *Innovation matters, but it isn't everything. You need an economic model that makes sense – it's no good being original if there is no demand for your product or service at a price that generates a surplus.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 21 May 2017

CHAPTER 6

Explore further 6.3

Business models

Access the *Digital Links* booklet and watch a Harvard Business Review video explaining the difference between strategy and a business model.

NEW VENTURE CREATION FRAMEWORK

The generic business model adopted by the New Venture Creation Framework (and used as a chapter framework in this book) comprises the five sequential, linked stages shown in Figure 6.4 (Burns, 2014, 2018). This involves moving from the value proposition for the target market segment(s), through the marketing and operations plans, to the resources available and/or needed to implement them and finally pulling the model together by developing the financial implications. Within each stage there are a number of critical building blocks. Each stage in the model is dependent on the other parts and the

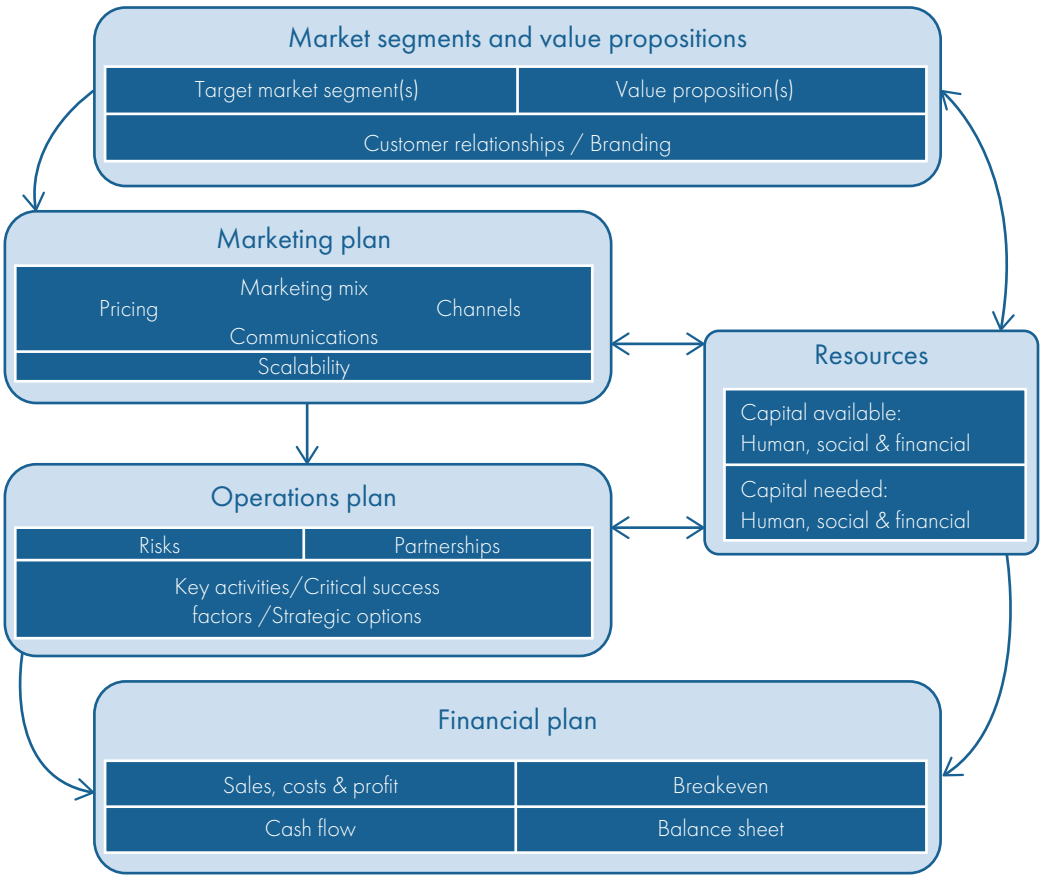


Figure 6.4 The New Venture Creation Framework business model

Source: Burns (2018).

arrows imply a sequential process of development (the model was designed for a start-up and is linked to sequential chapters of a book). It can be used and modified as changes in the MVP prototype become necessary:

1. Market segments and value propositions (Chapter 8) – This stage involves identifying key customers or groups of customers (target market segments) and their specific needs so as to tailor the value proposition for each group. The value proposition is the bundle of products or services that satisfies customers' needs or solves their problems. This includes emotional as well as physical needs and therefore how customer relationships might be cemented through the values embedded in the product/service and its branding.
2. Marketing plan (Chapters 9 and 10) – The marketing plan describes how to target these customers and deliver the value proposition to them through a consistent marketing mix (product/service, price, promotion, channels of distribution etc.), persuading them to purchase the product/service and then become loyal, repeat customers, and how the venture might be scaled up beyond launch.
3. Operations plan (Chapters 11–13) – The operations plan highlights the practical things that need to be done to launch a new venture; the key activities, critical success factors and strategic options, available if plans change. This involves identifying the risks facing the venture and how they will be monitored and mitigated, for example through partnerships.
4. Resources (Chapters 14 and 19) – This stage identifies the resources or capital available as well as needed for the venture; human, social and financial. The capital available and the capital needed influence and are influenced by the business model.

5. Financial plan (Chapter 15) – This stage involves pulling the plan together to show the financial consequences of the decisions made in developing the business model: sales, costs, profitability, breakeven and cash flow.

This framework can easily be used to develop a written business plan, which is usually required if external finance needs to be sought. Figure 6.5 shows how the business model for a low-cost airline such as easyJet, Ryanair, Southwest Airlines or AirAsia might look using the worksheet from the framework.

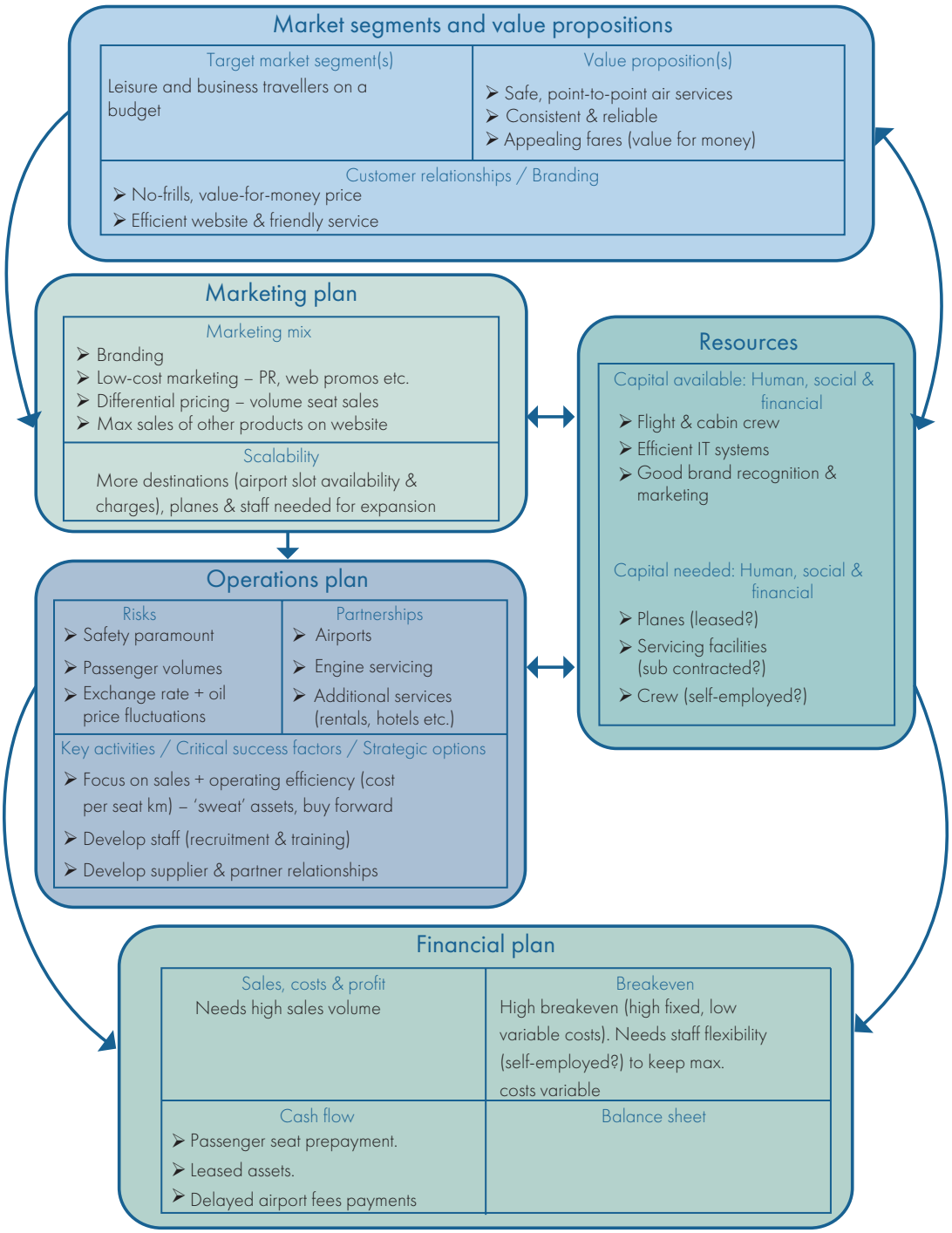


Figure 6.5 New Venture Creation Framework for a low-cost airline business model

Explore further 6.4

New Venture Creation Framework

Access the *Digital Links* booklet to visit the New Venture Creation website. It contains videos explaining the Framework and a range of learning resources and online tools that can be downloaded for free. There is a worksheet similar to Figure 6.5 which is also available as a Microsoft® PowerPoint slide showing the worksheet with simulated sticky notes that can be written on and 'posted' onto it. There are also a series of interactive exercises that allow the framework to be built up stage by stage based upon a business start-up idea, as well as a pro-forma business plan into which the exercises from each stage can be copied.

BUSINESS MODEL CANVAS

While the New Venture Creation Framework was designed to facilitate the development of a business model for a new product/service or a business start-up, the Business Model Canvas, developed by Osterwalder and Pigneur (2010), is a more generic model for larger businesses with established products/services and is widely used by consultants and trainers. For this reason, a variant called the Lean Canvas was developed. While the Business Model Canvas covers the same ground as the New Venture Creation Framework, there is no sequential process and different elements of a business model are emphasised. It comprises nine inter linked building blocks shown in Figure 6.6, each influencing the

<table>
<tr>
<td rowspan="2">8 Key partnerships:
The network of suppliers and partners that make the business model work</td>
<td>6 Key activities:
The most important things needed to do to make the business model work</td>
<td rowspan="2">1 Value proposition:
The product/service bundle that creates value for each customer segment</td>
<td>3 Customer relations:
The types of relationships intended with each customer segment</td>
<td rowspan="2">2 Customer segments:
The different groups of people or organisations that are intended to be reached</td>
</tr>
<tr>
<td>7 Key resources:
The most important assets required to make the business model work</td>
<td>4 Channels:
How it is intended to communicate with and reach each customer segment</td>
</tr>
<tr>
<td colspan="3">9 Cost structures:
All the costs that will be incurred in order to operate the business model</td>
<td colspan="2">5 Revenue streams:
The cash generated from each customer segment</td>
</tr>
</table>

Figure 6.6 The Business Model Canvas

Source: Strategyzer.com.

other. At its core is the *Value proposition* (box 1). On the right there are four blocks of the business model that are driven by value to customers: *Customer segments* (box 2), *Customer relations* (box 3), *Channels (of distribution)* (box 4) and the resulting *Revenue streams* (box 5). The remaining four blocks on the left are driven by business efficiencies: *Key activities* (box 6), *Key resources* (box 7), *Key partnerships* (box 8) and the resulting *Cost structures* (box 9). Osterwalder and Pigneur's innovatively designed book certainly provides a stimulating pictorial structure for better understanding and developing business models as well as numerous examples of real business models for companies such as Apple, Google, Skype and Amazon and well-known products that can be sketched onto the Canvas so as to identify predictable patterns.

Osterwalder and Pigneur encouraged the challenging of conventional business models using six techniques (all covered in this book) in conjunction with their Canvas:

- Generating new ideas – encouraging questioning of the 'dominant logic' of how to do things in a particular industry;
- Prototype development – encouraging alternative business models that might add value for customers to be explored;
- Storytelling – encouraging the ability to articulate the concept behind the product/service and how it creates value for customers;
- Customer insights – encouraging the development of a deep understanding of customer needs, even if they are not always derived directly from the customers themselves;
- Scenario development – building on customer insights and development in the competitive environment to make future possibilities more tangible;
- Visual thinking – encouraging the drawing or sketching out of the business model on the Canvas and using sticky notes to explain it, thereby making abstract concepts more concrete.

Explore further 6.5

Business Model Canvas

Access the *Digital Links* booklet to visit the Business Model Canvas website which has a copy of the Canvas and online tools that can be downloaded for free and used to apply it. Also watch six video animations explaining how to use the Canvas.

LEAN CANVAS

Although he acknowledged that 'it may have been easier to lay out a new canvas differently', Maurya (2010, 2012) modified the Business Model Canvas to better suit web-based start-ups and similar small-scale projects. Shown in Figure 6.7, he called this the Lean Canvas. He modified four of the original nine blocks in the Business Model Canvas:

Box 2 ➔ *Customer segments* became *Unfair advantage*. This was just another name for 'competitive advantage', which is what any marketing plan should seek to gain. Despite its importance, he justified the exclusion of 'Customer segments' on the grounds that it was included in 'Channels' (original box 4).

Box 6 ➔ *Key activities* became *Solutions*. These were the solutions to the problems that Maurya added to the Canvas (new box 8). He justified the exclusion of 'Key activities' [original box 6] on the grounds that it was too 'outside-in' – 'helping outsiders looking in to understand what the start-up did'.

Box 7 ➔ *Key resources* became *Key metrics*. He defined this as 'the few actions that matter' – what we have called 'critical success factors'. He justified the exclusion of 'Key resources' on the

grounds that 'we need fewer resources than ever to get a product to market' – a claim that might be questioned.

Box 8 ➔ *Key partnerships* became *Problems*. These were the key problems that the value proposition seeks to solve for customers. Meyer admitted that 'Key partnerships' was the hardest block to remove and, for me, partnerships remain an important way of identifying an approach to solving the problems of risk and resources faced by any start-up as well as signalling a way of working in the future.

Maurya highlighted the feedback loops needed to monitor customer feedback on an MVP – a learning cycle that turned ideas into products, measured customers' reactions to these products, and then decided whether to persevere or change the idea. This process might be repeated as many times as necessary.

"Start small, build a successful business model first before committing large sums of money. You want to minimize as much risk as possible before taking the plunge. Even for fund-raising, you can get a lot more capital once you have a proven, revenue-driven model."

Seth Lui, founder of SETHLUI.com, https://www.moneykinetics.sg/build-a-business-in-singapore/

<table>
<tr><td rowspan="2">8 Problems:

The key problem(s) that the value proposition seeks to solve for customers</td><td>6 Solutions:

The solutions to the problems faced by customers</td><td rowspan="2">1 Value proposition:

The product/service bundle that creates value for each customer segment</td><td>3 Customer relations:

The types of relationships intended with each customer segment</td><td rowspan="2">2 Unfair advantage:

The advantage over competitors offered by this problem solution</td></tr>
<tr><td>7 Key metrics:

The few actions that matter – critical success factors</td><td>4 Channels:

How it is intended to communicate with and reach each customer segment</td></tr>
<tr><td colspan="3">9 Cost structures:

All the costs that will be incurred in order to operate the business model</td><td colspan="2">5 Revenue streams:

The cash generated from each customer segment</td></tr>
</table>

Figure 6.7 The Lean Canvas

Case insight 6.3 Soraya Sikander, 'artpreneur'

Developing a business model

Born in Pakistan and based in the UAE, Soraya Sikander is an artist who has made her passion for painting into a business venture. She started painting as a child and went on to train at a number of art institutes around the world. After graduating from university, she launched her career with a solo exhibition at Unicorn Gallery entitled 'A Floral Symphony'. The exhibition sold out at preview. Since then she has earned critical acclaim and enjoyed commercial success with collectors worldwide. Her landscape paintings have been exhibited in the UAE, UK, Netherlands, Singapore and China and she has established herself as a well-known contemporary painter. She likes to discover new ways to present visual arts to the public, merging art with technology, collaborating with educational institutes and creating maximum awareness about her industry. She attributes her success to a passion for the arts, commitment, hard work and, above all, keeping a positive attitude.

Sikander also teaches art history, impressionist-style painting as well as academic drawing. She has become known as an

<table>
<tr>
<td rowspan="2">Key partnerships:
The American University of Ras al Khaimah.
Art galleries.
Charities.</td>
<td>Key activities:

Design and development of artworks and exhibitions.

Maintenance of web and mobile applications.</td>
<td rowspan="2">Value proposition:
Artwork and painting by a professionally trained artist at affordable prices.
Customisation with a minimal charge.</td>
<td>Customer relations:
Long term.
Subscriptions.
Promotions.</td>
<td rowspan="2">Customer segments:
Art lovers.
Public and government offices.
Private firms.
Tourists.</td>
</tr>
<tr>
<td>Key resources:
Sweat equity.
Artwork inventory.
Gallery.
Brand name (when created).</td>
<td>Channels:
Direct, website, mobile application, exhibitions.</td>
</tr>
<tr>
<td colspan="2">Cost structures:
Raw material costs.
Owner's salary.
Exhibition charges.
Market and promotion costs.</td>
<td colspan="3">Revenue streams:
Sale of artwork.
Extra charges on customisation.
Consultation and training.</td>
</tr>
</table>

Figure 6.8 Business model for Majoor Art

'artpreneur', setting up a training programme under the 'Fine Art Intensive Training Programs' held twice a year in UAE and Pakistan. She now intends to set up a business called Majoor Art, through which she can promote arts and painting, and has applied for incubation at the Innovation Center for Entrepreneurship (ICE) at the American University of Ras Al Khaimah in the UAE. ICE usually charges a monthly rent to start-ups and, in return, they receive a free business licence, access to facilities and regular expert advice. However, instead of a rent agreement, Sikander has negotiated a 25% equity-based deal, according to which the university also agree to provide her a gallery space within the campus.

Sikander has been advised to adopt a 'lean start-up model' for her venture. She has a website on which her paintings are displayed and initially intends to target the university's multiple stakeholders as her primary market. In the next phase, she plans to develop a mobile application, which will allow users and subscribers to take virtual tours of her gallery, get a notification on new artwork, and even purchase paintings through the app. The artificial intelligence within the application would inform her about the types of paintings viewers prefer and she would be able to customise the paintings and build an 'on-demand' model for subscribers. The third phase of business development would be to organise well-publicised exhibition events across the UAE so as to broaden her market. This staged approach would provide Sikander with a low-risk way to test and grow the business. The final phase of expansion would involve launching a book store chain, selling books on drawing, painting and art history. She also plans to collaborate with schools and colleges for possible training and consultancy services. She has produced a business model for Majoor Art, using the format from the Business Model Canvas, which is shown in Figure 6.8

Access the *Digital Links* booklet to visit the website and to watch a video introducing you to Soraya Sikander.

Questions:

1. What do you think of Sikander's business model?
2. Which elements are crucial for success?
3. Is a lean start-up a good way to approach this sort of business? Explain.

This case was contributed by Dr Tahseen Arshi, American University of Ras Al Khaimah, UAE.

DEVELOPING AND TESTING A BUSINESS IDEA

Building on design thinking and incorporating lean/agile methodologies, the process of developing and testing a business idea can be broken down into six stages:

1: Initial screening → 2: Concept development → 3: Product specification → 4: MVP development → 5: Market testing → 6: Business model formulation

Figure 6.9 sets out this process in greater detail. The product/service development phase (stages 1 to 5), incorporates a screening process using market/industry research to test for commercial viability. The feedback loops between stages 1–2 and 3–4 allow the MVP to be improved. Stage 5 involves market testing of the MVP. Stage 6 involves developing the business model. This also will need to be tested before the final product/service launch. Stages 5 and 6 generate data that needs to be evaluated. We look at the metrics that might be used to judge success or failure in the next section. The feedback loops throughout the cycle allow learning to take place and the product/service to be improved. This continues even after the launch and may result in changes to the business model – a topic we return to in Chapter 17.

1. Initial screening

Assuming that the idea is technically feasible, initial screening should start by the entrepreneur checking to ensure they and/or their team have the skills and competencies to produce and deliver the product/service. Any skills gaps can be addressed by recruiting appropriate staff (Chapter 10) or developing partnerships (Chapter 11). Once this is done, screening will probably revolve around assessing the commercial viability of the business idea. Assessing this at such an early stage is difficult, especially for radical technology-based innovations. It will probably involve desk-based market and industry research, identifying competitors, distribution channels, market conditions etc. – which will also feed into decisions about the business model (stage 6). This screening process continues throughout stages 2, 3 and 4. However, anything other than a rough assessment of commercial viability may not be possible until the market testing stage (5) – and even then it may still be little more than a 'guesstimate'. All the time the entrepreneur is trying to estimate the Served Available Market (SAM) for the product/service, and to do that they really need to have a business model (stage 6). Once they have a business model they can start to assess sales potential and set targets for the penetrated market. Table 6.1 sets out a checklist of criteria that could be used to evaluate the commercial attractiveness of a business idea before detailed

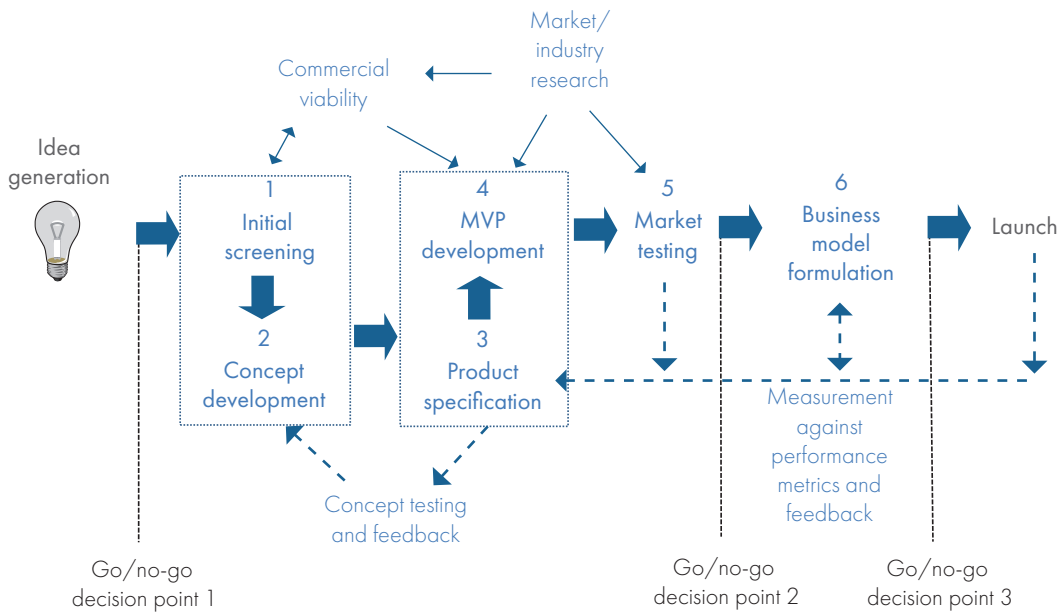


Figure 6.9 Developing and testing a business idea

Table 6.1 Commercial viability checklist

» Identified market need or gap in market	» Not easily copied
» No, few or weak existing competitors	» Identifiable risks that can be monitored and mitigated
» New or growing market	» Scalability
» Clearly identified customers	» Sustainability
» High profit margins	» Financeable

financial forecasts have been developed. The criteria are developed further in the next chapter (page 173). They ultimately boil down to having a viable business model.

2. Concept development

If the initial screening proves the business idea is attractive the concept will have to be 'fleshed out' with more details about all aspects of the product/service such as its physical appearance, how it might be delivered and marketed etc. This may involve a simple text description, a computer simulation and/or storyboarding – something that can be shown to prospective users or bosses to see how they react. It should involve minimal costs. Google provides a tool called Sketchup to help do this but professional designers can help create storyboards and sample videos and the work can always be outsourced. They can also use CAD systems to draw up more detailed models of a concept.

3. Product/service specification

Once the concept has been 'fleshed out' the product/service needs to be specified in detail. These specifications form the basis for the MVP and should give some indication of costs. Product specifications contain all the information needed to build the product with its specific features and functionalities - how it looks and what it is intended to do. They provide a technical description outlining performance standards and any other details such as engineering specifications that make the product safe and usable. They might include technical drawings, screenshots or photographs, but these images do not have to be perfect as they can be modified at later stages. Less important details, such as colour etc., can be left to a later stage. The process of specifying the product/service may result in changes to the detail of the concept design to reflect ease or cost of manufacture, durability etc. For a service the prototype is likely to be, in effect, this specification.

4. MVP prototype development

As we have seen, developing a product prototype is a process of experimentation, where numerous iterations of an idea are created and tested to see whether they provide the desired result. The MVP prototype needs to have just enough features to satisfy early customers. This might be a website or a physical product with minimal functionality. It might be possible through digitally enabled simulations or through 3D printed prototypes. All the time, practicality must be weighed against market needs and what competitors are currently offering. Steve Jobs copied the idea of a computer mouse from Xerox. But whereas its mouse required expensive lasers to track its movements, Apple's MVP used the ball from a roll-on deodorant to track its movements on a flat surface and Apple went on to develop a simple low-cost alternative. The functionality of the MVP might be gradually improved if this process is repeated – producing what is often called a 'beta version'. Airbnb, Spotify and Zappos all tested beta products before launch. At some stage thought needs to be given to whether the 'intellectual property' (IP) of the product/service can be safeguarded (Chapter 11). Feeding into this is research into the market or industry – the need to check the way other businesses may be approaching the market. Is the proposed approach viable? Who are the competitors? What is their supply chain? What are the

Case insight 6.4 Galy

Proof of concept and scaling

The annual Global Change Award, funded by H&M Foundation, aims to encourage the development of ways to reduce the harmful environmental impact of garment production. The award offers €1 million to be shared between five winners and one year of support to take them to the next stage in their business. This includes an intensive one-week boot camp, individual team coaching, industry networking opportunities and access to expertise on circular economy. It is open to early-stage innovators.

The 2020 winner of a prize of €300,000 was a company called Galy with founders Luciano Bueno, Paula Elbl and Letícia Luz from Brazil but based in the USA. The team developed a way of using biotechnology (using cells, not plants) to create lab-grown cotton, and were looking for funding to help them move from lab scale to commercial manufacturing. Producing 1 kilo of cotton requires 10,000 litres of water. In recent years, production of cotton has decreased while the demand has increased. Some studies predict demand will exceed supply by 20 million tons annually by 2030. This technique offers significant environmental advantages over the traditional way of growing cotton on big farms: it uses less water (80% less), fewer chemicals and no land, it emits far less greenhouse gases and it is ten times faster. It is not dependent on soil or weather conditions. The price of this cotton, when scaled up, should be the same as for the high-quality cotton on the market today. The approach used should be applicable to other plant-based products. The Galy mission is simple: 'To save the planet by finding alternatives to produce all the things we love, but better.'



Source: Mia Moessinger on Unsplash

We look at another winner of this award in 2016 to see how far they have got with their innovation in Case insight 6.6.

Access the *Digital Links* booklet to visit the company website and to watch a video about the Global Change Award and another video showing how the Galy process was developed.

Question:

1. Other than the money, what are the advantages of receiving this award?

plans to combat competition? How is this product/service different? Is this gap in the market real? Is the required supply chain viable? If the product/service is a success can it be scaled up? Can it be scaled up quicker than competitors? Is there anything to be learnt from the way competitors operate? The practicalities of producing the product/service must be weighed against the needs of customers and the commercial viability of the concept. Commercial viability is never certain, particularly at this stage, but studying the market and industry should give some clues. This whole process is iterative and the product/service may need to be modified as more is discovered about customers and their needs.

5. Market testing

Underpinning the process is the constant need to check the commercial viability of the business idea or innovation. These checks, together with market and industry research, will influence the form of the prototype product/service. The entrepreneur needs to be assured that there is a viable market for it. Who are the customers and why will they buy the product/service? This begs the question about setting a price. The product/service may need to be modified to suit the price customers are willing to pay. Assessing commercial viability might be achieved through market research, focus groups or various forms of market testing, for example, trying out a retail idea as a 'pop-up' stall. Gaining information in this way

limits the risks faced and the information feeds back to influence the final form of the product/service. Market testing should provide a critical piece of the jigsaw puzzle about whether a business idea will sell and the new venture is viable, and should help estimate the market size. The founders of Innocent Smoothies in the UK market tested their drinks at a music festival. They set up two bins underneath a banner saying: 'Should we give up our jobs to start this business?' One said 'yes', the other 'no'. By the end of the festival the 'yes' bin was overflowing. Their drinks business went on to become a great success.



Source: Alamy Stock Photo/Artur Marciniec

6. Business model development

This is the final pre-launch stage. With an MVP that potentially can be delivered at a commercially viable price the next step is to map out the marketing strategy. This involves developing a full business model which can be market tested possibly through a limited launch of the MVP. We start this process in the next chapter. Once again the results may suggest changes in the business model or product/service.

LOW-COST MARKET TESTING AND TRADING

There are many low-cost ways of testing market demand for a product. In the UK we have 'car boot sales', in the USA, 'garage sales', in Canada, 'trunk sales', and in many countries, products are just sold by the side of the road. Indeed, you can make a living selling things in this way. More recently, as the high streets have more and more vacant shop sites, 'pop-up', temporary shops (and even restaurants) have started to appear, testing out new product/service concepts.

The internet allows an entrepreneur to now reach a far wider group of customers than these physical markets and at a relatively low cost. Sites like Amazon, eBay and Alibaba can be used to sell goods and offer a low-cost way of testing market demand. They also offer to host 'storefronts' for small merchants where 'buy-it-now' goods can be offered. This allows them to achieve visibility and brand loyalty which was previously only gained through traditional advertising or local shoppers. However, while these sites can offer an international reach, the fees they charge are increasing and the growth of social media means that new lower cost outlets are now emerging. For example, there are thousands of Facebook pages dedicated to buying and selling products. The FaceBay community page (known as Fbay) was launched in 2010 and now has tens of thousands of members. To join you simply 'like' the page and then you can trade with members. These sites can be geographically based, thus facilitating the exchange of goods and services for cash.

There are likely to be a number of locally based internet trading sites in any location: simply Google 'for sale' and a postcode or zip code to find them. For example, in Bristol in the UK there is a site where some 500 parents buy, sell and give away things like clothes, toys or furniture, mainly for children. This, like many groups, is open only to members, but membership is open. Twitter is also an increasingly popular and free way of trading: simply enter '#forsale', then another '#' followed by the location. Anything from properties to computer games are offered for sale in this way. Many classified ads websites now also have their own official Twitter accounts. The important thing with all these low-cost ways of buying and selling is that there is no official system of vetting and it really is a case of 'buyer beware' – hence the importance of location.

Most countries have alternative low- or no-cost internet sites that buy, sell or exchange goods. There are also apps such as 'Shpock' (a UK app launched in 2014) that enable users to buy and sell goods through a virtual boot sale. This is particularly useful for local sales. Details of the sale item, including photos, can be uploaded and buyers visit the site and contact the seller directly. Another app called 'Zapper' buys DVDs, CDs, games, mobiles or electronic devices by scanning in their bar codes using a free-to-download app. It then gives a price and, if accepted, the goods can be sent to Zapper free of charge and they will forward payment.

> *The reality is that very few businesses invent a market for their products and services. Many, however go on to reinvent markets by filling gaps with standout offerings ... There's no other way to find out whether or not you will be successful other than just doing it. It just helps to test the water before you do.*
>
> Richard Branson, founder of Virgin Group, 18 August 2015 on: www.virgin.com/richard-branson/how-know-if-your-business-idea-good

Case insight 6.5 FudgePots

Market testing

FudgePots makes handmade Welsh fudge flavoured with exotic Bengali spices. The founders are Catrin Thomas and Rita Som, two Welsh girls who met in London working as editors in a scientific publishing house. They left to bring up young families and ended up living just a few miles apart in Wales. In 2018 they decided to set up a food business together alongside the freelance editorial work they were continuing to undertake. Since Thomas's family business had been making and selling fudge at festivals, county shows etc. during the 1970s, making fudge seemed a natural choice, although Som's Bengali heritage meant that these recipes were going to be different, featuring aromatic spices. They tried out various recipes with neighbours over the summer of 2018 in time to launch the business from a trestle table at a local golf club's Christmas market, quickly followed by local farmers' markets in Penarth and Cowbridge. They sold a range of traditional and spiced fudge. The fudge was a success and people started reordering online from the hastily built website. The year 2019 was spent attending regular markets and food festivals around South Wales, until the coronavirus lockdowns came into force in March 2020. That caused a reappraisal and today they are talking to several shops that are looking forward to reopening, drawing up plans for a major rebrand.

Question:

1. What would you advise Thomas and Som to do now?

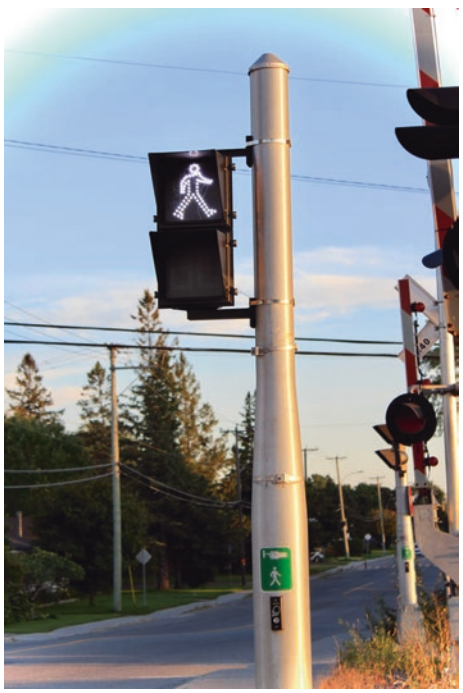
These low-cost ways of market testing can also be low-cost ways of market trading. They avoid the high fixed cost of bricks-and-mortar retailers and often piggy-back off the popularity of larger internet storefronts. And, while the sales at any one location or in any one storefront might be limited, if the entrepreneur has a number of them they can soon generate substantial income.

Explore further 6.6

Low-cost market testing and trading in the UK

Access the *Digital Links* booklet and find links to websites where you can:

- Advertise and sell goods (other than Amazon and eBay).
- Find out when and where a car boot sale is taking place near to you in the UK.



Source: Chris TDL International on Unsplash

GO/NO-GO DECISION POINTS

Go/no-go decision point 1

There are points where an entrepreneur will want to take stock and consider whether they actually do want to launch a particular new venture at all or, subsequently, modify the original business idea (see Figure 6.9). The first, very early, decision point comes immediately after coming up with an idea for a new venture. Many of the issues facing the entrepreneur revolve around their personal motivations – the 'push' and 'pull' factors and 'barriers' outlined in Chapter 1 – and their fears about taking the leap into the uncertainty of entrepreneurship. They will seek to answer questions like:

- Is this what they really want to do and are they well suited to being an entrepreneur?
- Does being an entrepreneur fit with their aspirations for their life at this time, and in the future?
- Do they have or can they develop an entrepreneurial mindset?
- Do they have the skills and capabilities needed to launch this particular business? Most people base their business upon skills, experience or qualifications that they have already gained from a previous job or through a hobby.

- Where there are gaps, are they confident that they can assemble the resources they need (human, social and financial)?
- Most important of all, are they willing to take the risks involved in starting a new venture?

Business ideas may (and often do) emerge from experience of an industry where the employer is not making the most of some opportunity or cannot be persuaded to take it up. Nevertheless, although it may be difficult to assess viability at this point, the entrepreneur must decide whether they are willing to commit more time and effort and go to the next stage to investigate the idea further. Even if the business idea is a good one the entrepreneur might not be the right person to take it to market. If this is the case, they might need to find a partner or they might be able to sell-on the idea. Whatever their motivations, they need to undertake an honest evaluation of their personal viability as an entrepreneur before they move on to the next decision point.

Go/no-go decision point 2

The next decision point comes after stages 1–5 have been undertaken: initial screening undertaken; the concept developed; product/service specified; MVP developed and market tested. The results of the market testing may mean the product/service needs to be modified and the process repeated a number of times. But at this point the entrepreneur should have more information on the viability of the product/service and its potential attractiveness to customers.

Go/no-go decision point 3

All the time the entrepreneur is trying to assess *commercial* viability – whether customers will buy the product/service *at the price they want to charge* – and that depends not just on the product/service but also the development of an attractive business model. At this point a lot more should be known about the viability of the product/service and it may be possible to make the decision whether or not to launch the business. However, even at this point there is no certainty. A good business idea has a window of commercial opportunity. Too early or too late and it is unlikely to be successful, and it will only have a finite life cycle. Commercial viability usually hinges on the profits the firm is projected to make compared to the risks it faces. And even for a social enterprise, revenues should at least cover costs. Detailed financial projections may therefore be required (Chapter 15), and if the venture requires external finance a full business plan (Chapter 17). But plans are rarely 100 per cent accurate, and firms need to monitor the effectiveness of their business model against customer reaction and be willing to modify it to better fit the realities of the marketplace. Nevertheless, lean start-up methodologies combined with the business model frameworks outlined in this chapter help maximise the chances of success and minimise the costs of failure.

SETTING PERFORMANCE METRICS

Testing an MVP means decisions have to be made on how the tests are conducted and the information required from them. It could be that success or failure is based on simple binary outcomes such as whether a certain key activity or objective is achieved or not (e.g. a working prototype might be needed, or the business model might have implications for the assets to be purchased, or key contracts with partners or customers might need to be secured). However, it might be more useful to measure performance through degrees of achievement (e.g. number of website views over a period). These quantifiable measures of performance are called 'performance metrics'. They can involve the measurement of operating or financial metrics (e.g. quality levels, sales etc.) by a target date or within a given time frame. They can be inward (e.g. sales) or outward (e.g. market share) focused. There are a whole range of financial metrics that can be used to control and measure the performance of a business as a whole (see Chapter 15). Performance metrics for key activities are often called 'key performance indicators' (KPIs) and can form the basis for bonuses for staff.

The appropriate performance metrics used to evaluate the success or failure of a lean start-up project needs careful thought. Each stage may need its own performance metrics to judge success or failure and take it to the next stage. Each set of metrics must provide information to improve the particular product/service offering – there are no generalisable metrics to use. They need to be 'SMART': Specific for purpose; Measurable; Achievable; Relevant to the success of the project or the business; Time constrained. Establishing appropriate metrics is a three-step process:

1. Identify the stage or process that needs to be monitored and controlled.
2. Establish the quantifiable outputs of that process.
3. Establish the targets against which to judge that performance.

Maurya (2016) highlighted the problems of firstly selecting the right metrics to monitor and secondly finding the time and resources to gather and analyse them. Even then the link between cause and effect and any corrective actions needed may not be clear. Performance can be measured against non-financial metrics. A website business might monitor regular or active users/visitors; page views; average page views per user/visitor. A call centre might use calls answered; calls abandoned; average handling time; average waiting time, among others.

Often internet start-ups have focused simply on user numbers rather than income generation and many well-known internet companies have achieved a stock market listing without ever having made any profit. Like Ries, Maurya was very much focused on internet start-ups and advocated the use of a metric that monitored 'traction' – 'the rate at which a business model captures monetisable value from its users' – in essence, linking the metrics to some target financial milestone(s). For example, an online magazine or newspaper could monitor web-page views as a key operational metric because they are directly linked to advertising revenue.

Associated with the lean start-up approach is the concept of 'pivoting', defined by Ries (2011) as a 'structured course correction designed to test a new fundamental hypothesis about the product, strategy, and engine of growth'. This is where the performance of the product/service at some stage leads the entrepreneur to decide to make radical changes to the business model. We shall look at this in more detail in Chapter 17.

ACCELERATORS AND INCUBATORS

There are many sources of help and advice available to nascent entrepreneurs and start-ups in most countries. Accelerator programmes are designed to help give promising start-ups the final push into the market. These are sponsored 'boot-camps' or training programmes for entrepreneurs and their teams, that offer training and support from mentors with different skills and investors with different backgrounds. They are designed to facilitate rapid conceptualisation, prototyping and development of a business idea within a tight time frame – typically three months. Programmes also provide a wide range of networking connections.

Many accelerator programmes are located in buildings where start-up teams share a range of advice and support such as training, mentoring and serviced office space – called 'business incubators'. Business incubators have an ecosystem designed to encourage and facilitate start-ups. Often these spaces are specifically designed to facilitate interaction and knowledge exchange, although there are also some virtual, online incubators.

Selection for accelerator programmes is competitive (typically less than 5 per cent are selected) and is usually based upon pitches or presentations of the business idea. Seed finance is often offered by or available through a sponsoring organisation (government or a company), sometimes in exchange for equity. At the end of the programme teams are usually expected to demonstrate their product/service.

There are two types of accelerators:

» Public start-up or 'seed' accelerators/incubators – these are general programmes open to all start-ups. There are many government-subsidised incubators offering these programmes that are open to any start-up, although some have a specific industry or technology focus and might be based in research

Case insight 6.6 Ioncell®

Preparation for commercialisation

Ioncell® is a technology that turns used textiles, pulp or even old newspapers into new textile fibres sustainably and without harmful chemicals. The process uses a novel solvent to convert cellulose into soft but strong fibres even when wet. The solvent is environmentally friendly, can be recycled and is not flammable. These resulting strong fibres can be made into clothing using dry-jet wet spinning technology and have other technical applications. These fibres feel soft and are strong even when wet and have already been made into fashion clothing (it can be dyed like cotton and viscose) and other products like smartphone covers. The process was developed as a research project by Ali Harlin, Michael Hummel, Ilkka Kilpeläinen, Pirjo Kääriäinen, Herbert Sixta and Marjaana Tanttu based at Aalto University in Helsinki and won €300,000 in the 2017 Global Change Award (see Case insight 6.4). So where have the team got to by 2020 with this business idea?

The funding from the award allowed the team to focus on further development of the technology as well as preparing for commercialisation. They set out the following road map for commercialisation:

2018: Technology and product development.

2019: Technical concept ready and proven in lab scale. Construction of pilot.

2020: Piloting.

2021: Proof of concept.

2022: Technology ready for industrialisation.

2023: Start of commercial production.

So far the team have made over 15 different demonstration products from the material. The project received a big boost when Aalto University granted Ioncell® funding to build a pilot plant within the university, the first time the university had done anything like this. Due to open in 2020, this is a small factory where textiles can be produced for further testing. So far the project is on schedule. Michael Hummel commented:

'This is an unprecedented undertaking and describes the trust we have received for this development. It will be an exciting but also intensive and critical phase. But the team has increased its competencies tremendously since its early days and we are confident to master this next step.'

To date the project has relied on awards, grants and public funds. The next step is to find industrial partners or funding for further upscaling:

'We will focus on garment and fabric manufacturers, and clothing and apparel businesses to support us in the further development and tailoring of the technology.' (https://globalchangeaward.com/winners/)

The project is the result of four completed and six on going PhD theses and has received significant academic attention, so far generating 38 peer-reviewed papers and over 430 academic citations.

Access the *Digital Links* booklet to visit the Ioncell® website and to watch two clips showing how Ioncell® is produced, how it is spun into yarn and the qualities of the product as well as one of the pitches the team made for funding.

Questions:

1. What has been the role of public and private support and investment in the development of Ioncell®?
2. Should the team produce Ioncell® themselves or license the product?
3. What does the team need to do to find industrial partners? What sort of companies should they target?

and technology parks. There are also some private incubators offering support (see TechHub, Case insight 13.4). These programmes do not require start-ups to offer equity involvement and often have a continuous, rolling intake.

» Corporate accelerators/incubators – these have their objectives set by a sponsoring company. Many well-known companies sponsor these sorts of accelerators – Google for Entrepreneurs (Berlin, London, Madrid, Saoul, São Paulo and Warsaw), Disney Accelerator, Microsoft Ventures Accelerator (Tel Aviv), Barclay Accelerator, Nike + Accelerator (Techstars), Telefónica and others. Sometimes these are linked to competitions and awards (see Galy and Ioncell®, Case insights 6.4 and 6.6). Some are open only to intrapreneurs or venture teams from the sponsoring company while

others might mix internal and external project teams to encourage cross-fertilisation of knowledge and ideas. Some might be open to start-ups in specific areas of technology, allowing the sponsoring company to stay close to new developments and funnelling start-ups towards corporate venture capital investment by the sponsoring company. Others might simply be generating good PR for the sponsoring company.

Phadke and Vyakarnam (2017) found that incubators were typically focused on providing support for technology start-ups facing early-stage problems such as the technology itself and framing the business proposition in the context of the competitive environment (customers and markets). By way of contrast, accelerators tended to take over from incubators once the technology was proven and specialised in specific product/market spaces or defined technology areas, typically providing expertise through mentors. This was the case for Galy (Case insight 6.4). The authors also found that partnering with smaller firms was a powerful way for larger firms to 'acquire' innovative products and services through access to technologies they did not have, insights into market spaces and the ability to 'synthesize radically different products and services and to create new business models with the potential to transform the competitive marketplace'.

Case insight 6.7 StellenBosch LaunchLab

Incubators and accelerators

An increasing number of incubators and accelerators have been established across the world in recent years. According to the World Bank, there are more than 90 in Africa alone. The StellenBosch LaunchLab is supported by the StellenBosch University's Innovus programme in collaboration with the University of the Western Cape and the University of Capetown. It aims to facilitate university and industry spin-outs and start-ups by developing a community of entrepreneurs. It offers rental space (hot-desks, offices and workspace), ICT infrastructure and training programmes, linking to the students from the universities. Its 'Ideas' programme is a vehicle for taking concepts and early-stage start-ups from idea to reality with this support and with the connections available from a network of corporate partners. Corporate partners introduce innovation challenges from their industries to prospective entrepreneurs and vice versa. Selected ideas move into the 'Build' and/or later-stage 'Countdown' programmes. The LaunchLab incubation programmes offer business skills training focused on the needs of the entrepreneur – developing their value proposition and business model alongside identifying target markets and customers. Its 'Makerspace' facility allows entrepreneurs to develop prototypes. It uses mentoring, business networking and funding events that introduce entrepreneurs to bankers, business angels, venture capitalists and other potential partners.

LaunchLab has helped dozens of start-ups. For example, AzarGen is a biotech company that focuses on developing human therapeutic proteins using advanced genetic and synthetic biology techniques in plants. Sxuirrel is an online platform that helps you find and list different kinds of flexible space in your community – storage, parking, venues etc. Sudonum uses call tracking and data analytics to help businesses understand the effectiveness of their marketing and prove return on investment.

Access the *Digital Links* booklet to visit the LaunchLab's website and to watch a short video which promotes the LaunchLab.

Questions:

1. What sort of start-ups do incubators and accelerators aim to recruit? How reliable is selection? What selection criteria would you use?
2. What role do universities play in incubators and accelerators?
3. What benefits does a stakeholder in an incubator or accelerator get?

SUMMARY

- Design thinking is a holistic way of thinking rather than a clearly defined set of processes. It is an approach to new product/service development that seeks to marry the practical (left-brain) and emotional (right-brain) needs of customers.
- Lean or agile start-up involves developing a minimum viable product (MVP) with just enough features to satisfy early customers. Customer feedback is then used in an iterative fashion to tailor the product/service to the specific needs of customers – a process called 'validated learning'. It is a continuous process until final launch:

  Idea → Plan → Develop MVP → Market test → Evaluate results → Learn
- Affordable loss involves setting a loss or budget that is affordable if the project proves unsuccessful and then launching the MVP to find out as much information as possible. This is a process that might progress over a number of stages.
- Timing of a product/service launch is crucial: too early and the market might not be ready for a product/service, too late and you risk losing first-mover advantage.
- A business model is the plan for how a business competes, uses its resources, structures its relationships, communicates with customers, creates value and generates profits. The chapter outlined three business model frameworks that provide pictorial and/or verbal structures to aid understanding and development of a business model: the New Venture Creation Framework, the Business Model Canvas and the Lean Canvas. They are minimalist and force focused thinking and succinct communication.
- Business idea development involves the six stages shown in Figure 6.9:
  1. Initial screening.
  2. Concept development.
  3. Product specification.
  4. MVP development.
  5. Market testing.
  6. Business model formulation.
- Performance metrics are quantifiable measures of performance that can be set to judge the success of a project by a target date or within a given time frame. They can be inward or outward focused. Performance metrics for key activities are often called 'key performance indicators' (KPIs) and can form the basis for bonuses for staff. Performance metrics need to be 'SMART': Specific for purpose; Measurable; Achievable, Relevant to the success of the project or business; Time constrained.
- Accelerator programmes give promising start-ups the final push into the market. There are public and corporate accelerator programmes. Often programmes are housed in buildings called 'business incubators' which offer a range of facilities to the start-up.

GROUP DISCUSSION TOPICS

1. How important in the buying decision is design compared to other elements of the product/service such as its functional qualities and the marketing of it?
2. How important is emotion (right-brain) compared to logic (left-brain) in a customer's buying decision?
3. How important is creativity (right-brain) compared to analysis (left-brain) in design thinking?
4. If all design-driven innovation comes from the market then it is of no use for radical product innovation. Discuss.
5. What are the advantages of lean start-up compared to market research? Are they mutually exclusive? What are their different uses?
6. What does a minimum viable product mean?
7. Lean start-up only works for high-technology businesses. Discuss.
8. If Steve Jobs had given customers pared-down, but workable versions of the first Apple computers, how do you think they would have reacted and what information might he have gained?
9. The amount of 'affordable loss' varies from person to person and company to company and is therefore not an objective approach to risk management. Discuss.
10. Setting an 'affordable loss' is like deciding on the stakes for a poker match – but it might mean that you cannot enter the high-stakes games and therefore miss out on the high returns. Discuss.
11. What are the advantages and disadvantages of setting an 'affordable loss' compared to setting a properly costed out budget for market research?
12. How do you judge when it is best to launch a new product/service?
13. What are the advantages and disadvantages of using a framework like the New Venture Creation Framework or the Business Model Canvas to help develop a business model?

14. Which of the frameworks outlined in the book do you prefer? Explain.
15. If your business model is constantly changing to suit changing circumstances, when (if ever) should it be formalised into a business plan?
16. Is success always measurable?
17. Are performance metrics always objective or can they be influenced?
18. How can you market test without having a price for a product/service?
19. You cannot estimate the size of the market for a radically innovative product/service. Discuss.
20. You cannot estimate the size of the market that a new product/service will capture without knowing the reaction of competitors. Discuss.

STUDENT ACTIVITIES

1. Critically analyse the business model in Figure 6.5, fleshing out the details of what the bullet points under the five headings involve. What are the model's strengths and weaknesses? Is anything missing? Looking at the 'key activities' section of the Operations plan, what are the critical success factors and are there more strategic options?
2. Select any recently introduced new product/service and apply the criteria listed in Table 6.1 to try to assess its commercial viability. What does this tell you? How did the company go about obtaining the information it needed to have sufficient confidence to launch the product/service?

START-UP ACTIVITIES

1. Select one of the business model frameworks outlined in this chapter and complete as many elements of it as you can at this stage. As you continue to work through this book amend the contents to reflect changes in your thinking.
2. Plan how you will develop and test your business idea. Reflect on whether there is a low-cost approach to testing the market and build this into the plan. Decide on the metrics needed to measure performance.
3. Based on what you currently know, is the business commercially viable based upon the criteria in Table 6.1? Make a list of the criteria that you are uncertain of and, as you continue to work through this book, make sure that these criteria are finally satisfied or contingency plans developed.

7

DEVELOPING THE BUSINESS MODEL

Contents

- Values, mission and vision
- Entrepreneurs and planning
- Generic business models
- Generic business models and competitive advantage
- The niche business model
- Internet business models
- Securing sustainable competitive advantage
- Characteristics of an attractive business model
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: William Iven on Unsplash

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand the importance of values and beliefs for the founder of a business and identify what are your values and beliefs;
- Write a mission and vision statement;
- Understand the advantages of using a planning framework for a new venture;
- Understand the different sorts of business models that have been developed and how best to secure sustainable competitive advantage.

Case insights

7.1 Nin Castle and Reverse Resources
7.2 Morgan Motor Company (1)
7.3 Tyrrells crisps and Chase vodka
7.4 Strava
7.5 Pinterest
7.6 Deliveroo, Uber Eats and Just Eat Takeaway.com

Explore further links

7.1 Effectuation
7.2 Competitive advantage
7.3 Keeping strategies simple

VALUES, MISSION AND VISION

Not all entrepreneurs are the same. As discussed in Chapter 1, people starting their own business do so for many different reasons and want different things from their business, reflecting their different priorities in life. It is important that their own values are reflected in the values, mission and vision of their new venture. In many ways this venture is an extension of them and their personality. Often people start their own businesses because they find it difficult spending their working lives in organisations that do not share their values and beliefs. Social enterprises in particular will want some specific values, mission and vision reflected in how the organisation operates. Indeed, for a commercial enterprise strong, ethical and social values can also enhance a business model and create a clear brand identity.

Values and beliefs

Values are core beliefs. The values and beliefs of the founder of an organisation shape its culture (Schein, 1990). They shape how an organisation does business and how it treats all its stakeholders. They are enduring, non-negotiable and underpin the mission, vision and strategies of a business. They may well have an ethical dimension that appeals to many people. However, they must be believable and authentic, reflecting the true values of the founder since they will have to both articulate those values with words but also reflect them in their actions – 'walking the talk'. It therefore follows that it is usually difficult for a founder to pretend for very long that they have values that are not authentic. They get found out. Strong values and beliefs should help create a bond of trust with stakeholders, cementing relationships, and all relationships are based upon mutual trust, underpinned by mutual self-interest and demonstrated by reciprocity (Dubini and Aldrich, 1991; Larson, 1992).

> *Our values are things that help us get in a state of mind and motivate us to get the results we want. You want something that attaches emotionally to each person in the team.*
>
> Barbara McNaughton, founder of Elements, *The Times*, 25 February 2014

Every organisation develops a distinctive culture that reflects certain underlying values, even if they are never made explicit. If the founder does not make their values explicit there is always the risk that they might be misunderstood or misinterpreted – which is why many companies actually write them down. Values need to be reflected in the business model the founder adopts when they launch the business – their ethical underpinning and social policies. In other words, these values need to be reflected in the value proposition offered to customers. They need to be embedded in the systems and structures of the business, so that everybody can see clearly that the business intends to deliver on its promises to customers and other stakeholders. As the business grows and staff are recruited, they form part of the cognitive processes that help shape and develop the culture of the organisation. The culture within an organisation is important and we shall return to it in Chapters 14 and 16. Shared values form a bond that binds the organisation together – aligning and motivating people. Organisations with strong values tend to recruit staff that are able to identify with these values and thus they become reinforced. They also help create a bond with other stakeholders and underpin a strong brand identity.

> *One of the most important aspects of any business is its ethical code, a statement of the principles governing the way it operates and its employees behave.*
>
> Duncan Bannatyne, serial entrepreneur, *Daily Telegraph*, 5 August 2009

Mission

The mission of a business is a clear statement of its purpose. The mission statement states what the business aims to achieve and how it will achieve it. It therefore usually defines the scope of the business by including reference to the product/service and its value proposition; customer segments that are being targeted; and the benefits they derive from the product/service. It will often state the nature of the firm's competitive advantage; reference its vision for what it wants to become; and refer to the values it holds. A good mission statement stops an organisation straying into markets where it has no competitive advantage, clarifies strategic options and offers guidance for setting objectives. Ideally a mission statement, like a vision statement, should be short and snappy. They can take many forms, but Wickham (2001) suggested the following generic format:

> *(The company)* aims to use its *(competitive advantage)* to achieve/maintain *(aspirations)* in providing *(product/business scope)* which offers *(value proposition)* to satisfy the *(needs)* of *(customer segments)*. In doing this the company will at all times strive to uphold *(values)*.

Vision

A vision is a shared mental image of a desired future state – an idea of what the business can become. However, while Read et al. (2011) observed that many entrepreneurs do not have a vision for what their business might become when they start up, having a vision becomes increasingly important as a business grows. Building a shared vision is the prime role of the leader of an organisation and we shall show how this can be done in Chapter 14.

The role of a vision is to inspire and motivate staff and stakeholders (including the founder) to achieve shared goals. It gives existence within an organisation to that most fundamental of human cravings – a sense of meaning and purpose – creating a sense of 'in-group' identity. Although grounded in the business mission, a vision is more emotional (right-brain) than analytical (left-brain), something that touches the heart. It should be attractive and aspirational, something that engages and energises people. However, it must be sufficiently realistic and credible that it is believable – stretching but achievable. It is usually qualitative rather than quantitative (that is the role of the objectives). It can be intrinsic, directing the organisation to do things better in some way, such as improving customer satisfaction or increasing product innovation. It can be extrinsic, for example beating the competition.

Vision and mission statements for a social enterprise are no different than those for a commercial enterprise, except of course for the social purpose. So for example, Case insight 1.7 looked at The Big Issue Foundation. Their mission statement is: 'to connect vendors with the vital support and personal solutions that enable them to rebuild their lives; to determine their own pathways to a better future'.

> *The secret is to have vision and then build a plan and follow it. I think you have to do that, otherwise you just flounder about ... You change your game plan on the way, as long as you are going somewhere with a purpose.*
>
> Mike Peters, founder of Universal Laboratories, *The Sunday Times*, 11 July 2004

Strategic intent

Hamel and Prahalad (1994) studied firms that had successfully challenged established big companies in a range of industries. They said that to reconcile this lack of fit between aspirations and resources the successful firms used 'strategic intent'. This necessitates developing a common vision about the future, aligning staff behaviour with a common purpose and delegating and decentralising decision-making. They argued that 'the challengers had succeeded in creating entirely new forms of competitive advantage and dramatically rewriting the rules of engagement'. They were daring to be different. Managers in these firms imagined new products, services and even entire industries that did not exist and then went on to create them. They were not just benchmarking and analysing competition, they were creating new marketplaces that they could dominate because it was a marketplace of their own making. However, strategic intent is not wishful thinking – which leads to terrible decision-making. It is more purposeful; identifying potential obstacles and how they might be overcome, setting staged goals that are achievable, and creating a route to a destination that followers want to, and believe they can, arrive at.

The values, mission and vision of a business should be consistent and reinforce each other. The entrepreneur can then start to set the goals they want to achieve and build the strategies that enable them to be achieved. These are built into the business model and reflected in the marketing, operating and financial plans. As we move from long to short term, tactics reflect the day-to-day operating activities, like sales promotions or staff recruitment. As shown in Figure 7.1, while strategies and tactics might change rapidly in an entrepreneurial firm, values, mission, and vision are more enduring. Together, they form the 'road map' that tells everyone where the business is going and how it might get there, even when one route is blocked in the short term.

> *I am often asked what it is to be an entrepreneur ... If you look around you, most of the largest companies have their foundations in one or two individuals who have the determination to turn a vision into reality.*
>
> Richard Branson, founder of Virgin Group, from Anderson (1995)

> *Reach for the stars and you will get there (or at least close). Aim low and you'll get there too.*
>
> Elizabeth Gooch, founder eg solutions, LaunchLab (www.launchlab.co.uk), 13 January 2009



Figure 7.1 Strategy development

Kotter (1996) recommended seven principles to follow in order to communicate a vision effectively:

1. Keep it simple – Focused and jargon-free
2. Use metaphors, analogies and examples – Engage the imagination
3. Use many different forums – The same message should come from as many different directions as possible
4. Repeat the message – The same message should be repeated again, and again, and again
5. Lead by example – Walk-the-talk
6. Address small inconsistencies – Small changes can have big effects if their symbolism is important to staff
7. Listen and be listened to – Work hard to listen, it pays dividends.

Case insight 7.1 Nin Castle and Reverse Resources

An entrepreneurial journey

Nin Castle is co-founder of Reverse Resources, an Estonian-based company started with Ann Runnel and Dea Lasting in 2017. Reverse Resources develops software that enables fabric and garment factories to map, measure and track leftover fabrics and scraps so that they become traceable through their life cycles. It works with major global garment manufacturers to help them restructure their supply chain with the aim of encouraging the development of a circular economy – one that reduces waste and reuses and recycles fabric, saving money for manufacturers and ensuring the reputation of retailers. Reverse Resources estimates that some 25% of fabrics are 'wasted' in the process of garment production and that amounts to some 400,000 tons in Bangladesh alone. It has received a number of awards and funding: it received €20,000 from the Climate Launchpad and Climate KIC accelerator programmes, €150,000 from the Global Change Award (Case insight 6.4) and €300,000 from the Dutch Postcode Lottery Green Challenge. But how did Nin Castle get to this point?

Castle graduated from Brighton University with a fashion degree but felt uneasy about some of the environmental issues relating to the industry, in particular the volumes of clothing going to landfill. So when she decided to start her own business designing and manufacturing clothing with a friend, it used only hand-picked, locally sourced, recycled fabrics – called 'up cycling' or 'remanufacturing'. Called Goodone, the business was launched in 2006 from a disused car showroom in Brighton – a large open space into which they put two makeshift beds and a couple of secondhand sewing machines. Cloth was bought from a local charity shop that allowed them to go through all the bags of textiles that the shop was sending to the rag factory at the cost of £1 a bag. The pair exhibited at fashion shows, made use of grants and undertook business training, winning a number of awards. They sold the clothes they produced through local boutiques. The income generated was modest, but they enjoyed the lifestyle. Castle explained:

> *'We had no funding, were living on housing benefit and doing part-time jobs to try and get the business up and running ... We were full of enthusiasm and rather naive as we really thought that our tiny business could make an impact on the huge fashion industry.'* (The Daily Telegraph, *5 February 2009)*

Her partner left the business in 2008 to take up full-time employment and Castle started developing other interests. She spent August 2009 in South Africa working for a project designing and producing clothes in a township outside Cape Town for sale in the UK. Clare Farrell joined as co-designer in 2010. Although by 2014 Goodone was supplying outlets in the UK and around the world, as well as selling from its website, income remained modest and to supplement it both Castle and Farrell taught at fashion colleges, specialising in 'upcycling' and 'remanufacturing'. In 2015 Goodone was wound down but Castle continued as a teacher in Fashion and Sustainability at UAL Central St Martins in London, which is where she met the other founders of Reverse Resources. They each have different but complementary backgrounds: Ann Runnel is CEO with a background in economics, Dea Lasting is software development lead with a background in that area. Reverse Resources now has a team of nine spread around the world.

Access the *Digital Links* booklet to visit the Reverse Resources' website and to watch the pitch that won Reverse Resources the €300,000 from the Postcode Lottery Green Challenge.

Questions:

1. Nin Castle has always been interested in fashion and environmental sustainability. Has the experience of starting and running Goodone helped with the development of Reverse Resources? Was nine years of running Goodone worthwhile?
2. How can environmental responsibility be reconciled with commercial business? Explain.
3. Reverse Resources has received extensive grant support. Is there a viable business here? Explain.

ENTREPRENEURS AND PLANNING

In Chapter 3 we observed that entrepreneurs typically do not seem to like formal research and planning (an analytical left-brain activity), preferring to let strategies evolve on a step-by-step basis instinctively, intuitively and without formal structures as they 'learn-by-doing' (a more intuitive right-brain approach). This was the conclusion reached by Sarasvathy (2001) who undertook a study of how 27 successful US entrepreneurs approached business decisions. The entrepreneurs all had at least 15 years of entrepreneurial experience, including successes and failures, and had taken at least one company public. They were presented with a case study about a hypothetical start-up with the founder facing ten decisions. The rationale for these decisions was then explored in more detail. Some years later the same research was conducted on a group of successful professional executives in large organisations, allowing contrasts and comparisons to be made between the entrepreneurs and the executives. Sarasvathy concluded that the entrepreneurs came to decisions based upon something that was christened 'effectual reasoning' or 'effectuation' (making something happen), which was contrasted to the causal or deductive reasoning used by the professional executives in the study.



Source: Kelly Sikkema on Unsplash

Sarasvathy came to five main conclusions about how these successful entrepreneurs approached planning and decision-making. All these conclusions are mirrored in the entrepreneurial mindset outlined in Chapter 3:

1. While the executives set goals and sought to achieve them sequentially and logically, the entrepreneurs' goals were broad and evolved over time based on whatever personal strengths and resources they had, creatively reacting to contingencies as they occurred. Entrepreneurs start with the resources they have and go to market quickly. They do not wait for perfect knowledge or the perfect opportunity.
2. While executives wanted to research opportunities and assess potential return before committing resources, entrepreneurs were far more inclined to go to market as quickly and cheaply as possible and to assess market demand from that. This approach was labelled 'affordable loss' (outlined in Chapter 6), representing the maximum amount they could afford to lose in the event of failure. They set this by evaluating opportunities on the basis of whether that loss was acceptable, rather than trying to evaluate the attractiveness of the predictable upside.
3. The entrepreneurs did not like extensive, formal research and planning, particularly traditional market research. This was explained in terms of them not believing that the future was predictable (and that the upside could be evaluated), preferring instead to believe in their own ability to obtain the information needed to react quickly to changing circumstances. They believed that while they could not predict the future, they could control it, or more precisely, 'recognize, respond to, and reshape opportunities as they develop' – which results in successful entrepreneurs often being seen as 'overconfident' with regard to predicting future outcomes (Forbes, 2005), which was another character trait highlighted in Chapter 3. They use uncertainty to their advantage by developing contingencies and remaining flexible rather than slavishly sticking to existing goals. However, it was significant that they adopted more formal structures as their businesses grew; as the study put it, they became both 'causal as well as effectual thinkers'. Research by McCarthy and Leavy (2000) showed that strategy development changed from emergent to deliberate as firms went through recurrent crises followed by periods of consolidation.

4. Also prominent was the entrepreneurs' propensity to partner with stakeholders – customers, suppliers and advisors – to help them shape the business – reflecting the importance of building relationships. New ventures rarely have the resources to undertake all the tasks required to make the business work, so partnering gives them an important extra resource (Sorenson et al., 2008). They use networks of partnerships to generate knowledge, leverage resources and make the future become the reality. By way of contrast, the executives tended to know exactly where they wanted to go and then follow that set path without seeking partnerships.
5. It was noticeable also that the entrepreneurs were less concerned about competitors than the executives. This might be explained in terms of their high internal locus of control or inherent self-confidence (Forbes, 2005), but the study explained it in terms of them seeing themselves as on the fringe of a market or creating an entirely new market through some sort of disruptive innovation. They believed they were different or better than competitors in a way that gave them a differential advantage.

There are lessons to be learned from this research. Firstly, an entrepreneur's approach to developing strategy and decision-making is subtly different to traditional frameworks. It is the difference between vision and strategic intent. While they have a vision of the future, because of the uncertain and unpredictable environment they face, they prefer to make incremental decisions and let strategies 'emerge' as situations (and markets) become clearer. This does not negate the need for strategic frameworks that can help with decision-making and strategy development. The three business model frameworks outlined in the previous chapter are minimalist and should be easy to use, illuminating issues and helping to develop broad, flexible strategies that can change as market circumstances change. Used continually, they provide the link between the experience of running the business and emerging strategy – a simple 'learning-by-doing' framework. For the less practised, these frameworks help organise and develop what would otherwise be an unstructured and disjointed experience. Secondly, although the entrepreneurs in the study did not like extensive, formal research, we have already seen that there are many quick, cheap and less 'formal' ways of finding out about an industry and market. The ultimate test, however, is the marketplace itself and the lean start-up methodologies outlined in the previous chapter provide a structure for evaluating the commercial viability of a project – a simple 'learning-by-doing' framework.

> *You jump off a cliff and you assemble an airplane on the way down.*
>
> Reid Hoffman, founder of LinkedIn, *BBC News Business*, 11 January 2011

Ohmae (2005) used the Japanese word *kosoryoku* to describe what is needed to develop entrepreneurial strategy in an uncertain environment. He explained that it meant something that combined 'vision' with the notion of 'concept' and 'imagination', but, unlike imagination, it has no sense of daydreaming but is rather an ability to see what is invisible and shape the future so that the vision succeeds – similar to developing strategic intent: 'It is the product of imagination based on realistic understanding of what the shape of the oncoming world is and, pragmatically, the areas of business that you can capture successfully because you have the means of realising the vision.' We shall return to strategy development in Chapter 17.

Explore further 7.1

Effectuation

Access the *Digital Links* booklet to watch a short animation explaining the principles of effectuation.

GENERIC BUSINESS MODELS

Chapter 6 outlined three frameworks for planning and developing a business model. These are just frameworks. They describe how a business runs – nothing more. What goes into them is important and this is a firm's competitive strategy – how it plans to beat other firms. There is no 'best' model or 'one-size-fits-all' solution to what is the best competitive strategy. An internet search will reveal that

there are dozens of different models available. However, there are some generic models that form the basis of competitive strategy. They underpin most others and have stood the test of time. They are consistent with fundamental ways of creating sustainable competitive advantage. Porter (1985) called them 'generic marketing strategies', Treacy and Wiersema (1995) called them 'value disciplines'.

Low price (low cost)

The oldest business strategy of all is to sell simply on low price. This is consistent with an economist's perfect market in which supply by many businesses and demand by rational buyers determines the price that achieves optimal efficiency, which usually means at the lowest costs. Where customers value low price more than anything in the marketing mix it is important to think carefully about how that low price might be achieved. Usually low prices can only be achieved through low costs, and if there are economies of scale to be had, a firm must achieve them quickly to survive in a competitive market. Operational excellence is needed to achieve this. These sorts of products are virtually commodities, undifferentiated and not tailored to specific customer needs, perhaps because these needs are too homogeneous. However, new flexible manufacturing technologies with just-in-time scheduling and the internet allowing customers to 'design' or configure products to their own specification mean that efficiency can often be combined with variety, making more products than ever 'homogeneous'. In markets that value low price, fierce competition for market share is likely to lead to a market with a few dominant big players – big companies – that are both efficiency and cost focused. The entrepreneur enters an established market like this at their peril because a new venture is unlikely to have either the experience or the economies of scale that established competitors have. Nevertheless, there may be an opportunity to create ancillary revenue streams alongside the low-priced product/service that make this business more viable.

There are also two strategic dimensions to business models that combine to affect the price a product/service is able to command (and therefore the profit the firm is likely to make). They also have important implications for how operations are organised. These dimensions are differentiation and customer focus or intimacy. The more a product/service is different to that of competitors and the closer and more focused the firm is on the needs of customers, the higher the price the product/service is likely to be able to command. These dimensions are important and can be applied to a wide range of businesses to produce fundamental ways of creating sustainable competitive advantage. A highly differentiated product/service offering, targeted at a focused market segment is called a 'niche business model'. For a start-up this offers the best chance of success. At the other extreme, an undifferentiated product/service being sold to anybody – an unfocused market – is a commodity. This sells mainly because of the price charged – the lower the better. These business models are shown in Figure 7.2.

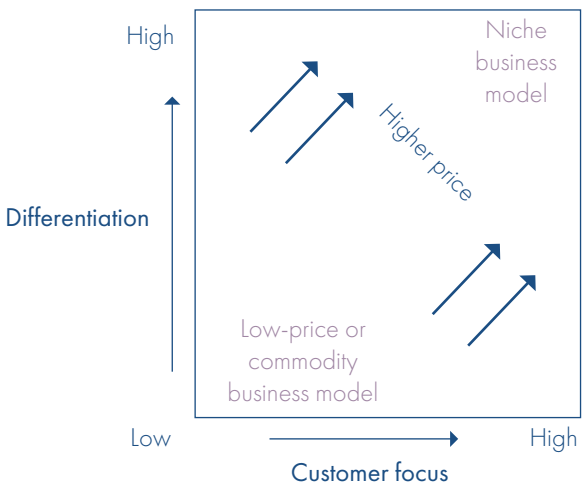


Figure 7.2 Generic business models

High differentiation

High differentiation is where customers value the other elements of the marketing mix more than price and are therefore willing to pay a premium. Often the key elements of differentiation are the ability to offer the best quality or most innovative products (e.g. Apple or Rolls-Royce), but the more product/service 'benefits' offered (or needs satisfied), the more ways the product/service will be different to competitors. The more different it is, the more able it is to command a high price; however, these differences must be important to and valued by customers. A start-up with a strongly differentiated product/service should move quickly to establish itself in the market, developing a brand and making extensive use of its reputation. Differentiation is easiest when it is combined with a focused target market because it is easier to tailor the product/service offering more precisely to the needs of that smaller market. However, if sales increase and the market expands it is possible that the ability to maintain that customer focus will diminish. At the same time success will attract imitators who may attempt to resegment the market, by emphasising particular 'benefits' (e.g. better customer service) thereby achieving greater customer focus.

The ability to differentiate stems from the core competencies or capabilities of the entrepreneur and their business. In a longitudinal study Rassmussen et al. (2011) showed that the more unique these were, the more difficult they were to copy, hence the greater the firm's ability to differentiate itself and the more successful it was likely to be. In his review of the literature, Grant (2012) also concluded that all the evidence points towards differentiation having a greater potential for success than low cost.

> *When you've got single-digit market share – and you're competing with the big boys – you either differentiate or die ... The idea of building a business solely based on cost or price was not a sustainable advantage.*
>
> Michael Dell, founder of Dell Corporation, (1999), *Direct from Dell: Strategies that Revolutionized an Industry*, New York: Harper Business

High customer focus or intimacy

High customer focus or intimacy is where knowledge of customer needs is greatest, allowing the product or service to be more closely tailored to their specific needs. The key to having a high customer focus is the ability to have a close relationship with them. It goes hand in hand with effective market segmentation. It is often based on good customer service. Customer loyalty is likely to be high and there is the opportunity to develop a strong brand image. Small companies can thrive with this strategy because the smaller the market size, the more effective the segmentation, and hence the customer focus, is likely to be. It can be particularly effective when combined with a highly differentiated product or service offering that gives the company a niche market. The danger with customer focus is that the size of the market segment may be too small to be viable.

> Both differentiation and customer focus provide significant opportunities to achieve economies of scope – also called 'synergy'. This arises when the costs of an intangible asset such as product development or market research, or the cost of establishing a strong brand image (e.g. Apple, Mercedes Benz) can be spread over a range of products or services.

> *If you set up a company selling widgets like the bloke down the road and the only difference is that yours are cheaper, you'll make a living but that's all you'll achieve. If you can be truly differentiated and unique, then you've really got something.*
>
> Martyn Dawes, founder of Coffee Nation, Startups: wwwstartups.co.uk

Different business models can exist successfully side by side in the same industry if it is sufficiently large and heterogeneous. For example, the business model for low-cost airlines like Southwest Airlines, easyJet and AirAsia is very different to that of flagship carriers like Delta, British Airways and Emirates. Yet both business models survive, appealing to different target market segments. Dell and Apple coexist in the personal computing market but with completely different business models serving different market segments with different value offerings. There is certainly no golden formula for success.

Each of the generic strategies implies different imperatives for the business. These are shown in Table 7.1. Each has implications for the operating activities of the business and some of these imperatives may be critical success factors. Sometimes these imperatives can be conflicting, particularly between low cost/low price and the other two strategies, and their application is a matter of judgement. We shall look again at these business imperatives in Chapter 12 when we develop the operations plan.

Table 7.1 Generic strategies and business imperatives

HIGH DIFFERENTIATION	HIGH CUSTOMER FOCUS	LOW PRICE/COST
* Understanding the basis for the differential advantage * Building on the differential advantage * Building barriers to entry * Building the brand * Continuous innovation * Encouraging creativity and innovation	* Maintaining close relationships with customers * Keeping in touch with and understanding changes in customer needs * Maintaining customer loyalty * Maximising sales to existing loyal customers (economies of scope) * Building the brand	* Maintaining cost leadership through economies of scale * Continually driving down costs * Achieving high sales volumes * Improving efficiency * Standardisation

GENERIC BUSINESS MODELS AND COMPETITIVE ADVANTAGE

So how do you decide which generic model might best suit a particular product/service? Treacy and Wiersema (1995) said that to help decide this there are four questions that need to answered:

1. For each dimension (differentiation and focus), what proportion of customers make this their primary or dominant decision criterion? In other words, how important is each value discipline (generic model) to each market segment?
2. Which competitors provide the best value in each of these value dimensions? In other words, who is the major competitor in each discipline?
3. How does the product/service compare to the competitor's product/service on each dimension?
4. If a product/service falls short of the value leaders in each dimension of value, how can this be remedied? Of course, if a new product/service does fall short the real question is whether it can compete at all. In which case a sufficiently different business strategy probably needs to be constructed.

You might ask whether the research tell us which strategies are most likely to deliver sustainable competitive advantage and hence maximise the chances of success for a start-up. The answer is that all of them have that potential – there are many examples of successful firms following many of them. However, the potential or odds are not the same. All the evidence points to high differentiation having a greater potential for success than low price/cost for a start-up and this is more easily achieved when applied to a focused target market. However, the bigger that target market, the more vulnerable it is to further segmentation based upon even greater customer focus.

The competitive advantage of a business stems from its core competencies or capabilities. The more unique these competencies, the more difficult they are to copy and the greater the opportunity to differentiate. For a start-up these competencies revolve around the skills and capabilities of the founder, the business opportunity they have identified and the uniqueness of the way they intend to service the market they have identified – i.e. their business model. These can be combined with other valuable or unique assets the business might have, such as equipment, trademarks, patents, brand and so on (called strategic assets) that allow the business to differentiate itself, and it is this that leads to sustainable competitive advantage. The more unique the core competencies and strategic assets of the firm, and the more difficult they are to copy, the greater the potential to differentiate its product/service, and thereby the greater its ability to create sustainable competitive advantage. Investors recognise this (Lusch et al., 2010; Macmillan and Seldon, 2008).

Explore further 7.2

Competitive advantage

Access the *Digital Links* booklet to watch:

- A short Harvard Business Review animation explaining the concept of core competencies and its link to competitive advantage.
- A short animation explaining the link between generic strategies and competitive advantage.

THE NICHE BUSINESS MODEL

It is therefore the strategy of high differentiation that has the greatest potential for success, so long as it is based upon a realistic and honest understanding of these competencies and strategic assets and a robust business model that emphasises these unique elements. It allows a firm to charge higher prices and combat competition. This is more easily achieved when applied to a focused target market. Market focus involves understanding in depth the needs of relatively few customers, and therefore there is more scope for differentiation. It often involves targeting smaller markets, and is therefore an attractive strategy for a start-up with limited resources. And because the target market is small, the start-up may not attract many competitors, at least initially. This niche business model – with high differentiation within a highly focused market – is the one most likely to succeed for a start-up. It is called a 'niche business model'. What is more, the internet now allows an attractive market niche to be sold to on a global basis. So once a start-up dominates the market niche in one country it might be able to move on to another.

> *Be very sure you have something unique that can't be replicated easily.*
>
> Angie Coates, founder of Monkey Music, *The Sunday Times*, 30 November 2014

There is usually a trade-off between price and the other elements of the marketing mix. The stronger or more distinctive and different the other elements, the higher the price a product/service is normally able to command. Too many small firms compete primarily on price because they

Case insight 7.2 Morgan Motor Company (1)

A niche business model

One company that arguably could make even higher margins by charging a higher price for its products is the Morgan Motor Company. Founded in 1909 by Henry Morgan, it is the oldest privately owned car manufacturer in the world. It is based in Worcestershire. In 2018 it had a turnover of over £34 million, generating profits of £3.2 million, and employed about 246 people. The company was sold to the Italian investment group InvestIndustrial in 2019, but the Morgan family still maintain a minority holding. Morgan is a unique car manufacturer in a niche classic car market.

Morgan manufactures and assembles quintessentially British sports cars. Every Morgan is hand-built and looks like it came from the 1930s. Although the engines are now state of the art (bought in from BMW) and every car now has numerous computers, the chassis is unique and hand-crafted from wood. Each car is different, with a choice of thousands of body colours and leather upholstery to match. It takes some seven weeks to assemble a car, and customers are invited to the factory to see the process. There is now also a visitor centre and museum hosting some 30,000 visitors each year. Morgan sells only about 850 cars a year, half overseas. Demand exceeds supply and there is a waiting list of six months (which at times been as long as ten years), cushioning the company from the vagaries of the market. It has a loyal and active owners' community with more than 5,000 members and 50 clubs globally.

We look at issues around family ownership in Case insight 21.5.

Access the *Digital Links* booklet to visit the company website and watch a promotional video for Morgan cars.

Questions:

1. Why is this a niche business?
2. What are the pros and cons of this business model for Morgan?

Case insight 7.3 Tyrrells crisps and Chase vodka

Turning a commodity into a niche business

Aged 20, William Chase bought his family farm for £200,000. Twelve years later, aged 32 he went bankrupt only to become a millionaire by the age of 48. This roller-coaster story is all based around the humble potato harvested from his 1,500-acre farm in Herefordshire, UK. Potatoes are a commodity product and the price they fetch can rise and fall sharply. Chase was never going to get rich in this business but torrential rain in 1992 meant the crop could not be harvested and had to be left to rot in the fields, leaving him deeply in debt. He decided to file for bankruptcy and leave the UK. When he returned a year later, he decided to borrow the funds to buy back the farm from the receivers, and start up again. To make extra money, he started buying potatoes from other farms and selling them to supermarkets. The business was surviving but Chase became increasingly frustrated that supermarkets would reject potatoes that weren't 'cosmetically perfect'. To his surprise he found out that rejected potatoes in the UK were being bought up by the US crisp-maker Kettle to make what they called 'posh-crisps' (crisps = chips in the USA) – potato crisps which were cut a little thicker than the mass-market brands, and fried by hand.

Despite having no crisp-making experience Chase launched Tyrrells crisps in 2002, based at the family farm. Selling through up-market retailers like Fortnum and Mason and Harrods, the crisps were hugely successful. Chase sold them to the retailers for £1 who would then sell them to consumers for £2, giving Chase a net profit of 35%. He maintained the 'posh' image by refusing to sell through some supermarkets like Tesco. Chase added new flavours and new vegetable ranges. By 2008 turnover had reached £14 million. Chase had been very 'hands-on' but as the operation grew it needed professional managers and he decided to sell the business to investment company Langholm Capital for £30 million.

This set the scene for Chase's next venture, again based at the family farm. Chase Distillery was launched in 2008 initially distilling high-quality vodka from locally grown potatoes. The



Source: Hans Braxmeier from Pixabay

vodka was distilled up to 119 times using an exceptionally tall 70-foot-high rectification column. Again the product was pitched up-market, retailing at about £35 a bottle, twice the price of many vodkas. The range was gradually extended to include flavoured vodkas and fruit liqueurs. The distillery now also produces gin, which uses vodka as its base spirit. The alcohol is then infused with botanicals. This range has also been extended to include flavoured gins.

Access the *Digital Links* booklet to visit the companies' websites and to watch videos about Tyrrells and Chase Distillery.

Questions:

1. What made Tyrrells crisps a niche product when the business launched?
2. Why are Chase vodka and gin niche products?
3. How easy are these products to copy? What does this tell you?
4. William Chase went bankrupt once and initially had no knowledge of crisp-making or distilling spirits. What does this tell you about his personality?

do not understand how the other elements might add value to the customer and they believe the other elements of their marketing mix are insufficiently different from that of their competitors. One small firm producing motor components found itself competing unsuccessfully against a large multinational that consistently undercut it on price. It decided that it could not survive with a value proposition relying on operational excellence/low cost and decided it needed a rethink. It researched its customers and the market and found there were many opportunities for products manufactured to a high technical specification in which quality and supplier reputation were more important than the price charged – a product leadership/differentiation value proposition – so it decided to switch its strategy. Low volumes and high price for specialist products proved to be a more sustainable strategy and, over time, it was able to develop close relationships with a few of its regular customers and became an established niche player in what otherwise might be seen as a highly competitive industry.

> *You need to figure out how you can be better or different. What are you doing that hasn't been done before?*
>
> Troy Collins, founder of Endource, *The Sunday Times*, 5 March 2015

Following a niche business model involves maximising the value proposition to a closely defined target customer group. It involves understanding the needs of this group – the benefits they are really looking for from the product/service – and translating that into a marketing mix. The smaller the group, the more homogeneous their needs are likely to be. Sometimes the original target market identified can be profitably broken down into smaller market niches. Meeting the needs of each new niche may involve either adding costs, by adding more valued product/service features, or subtracting costs, by eliminating less valued features. For each niche there is the question of the price they are willing to pay for this improved and differentiated product/service – a topic we shall cover in the next chapter. Some of the needs of the different market niches you identify may not be profitable to target. It is all a question of judgement. This iterative process is likely to have implications for the resources needed for the start-up.

The practical problem for most start-ups is that these two measures of differentiation and customer focus are not binary. Most businesses can differentiate themselves – to some extent – just as they can achieve customer focus – to some extent. It is the question of how differentiated and customer focused they are that determines the price they are able to charge. And that is a question of judgement.

INTERNET BUSINESS MODELS

Because of their general applicability, we have looked in some detail at the generic business models. However, numerous other models can be just as successful and have been used successfully by internet businesses, although most are variants of the generic models. You are only limited by your imagination. Some new business ideas, particularly those involving internet-based virtual content ('knowledge products'), require considerable ingenuity to develop business models that generate income rather than just users. There is the issue of how to price this sort of 'product'. Once developed, it is available for downloading again and again at virtually zero cost to the producer. We look this problem in the Chapter 9. On the other hand, online content can often be easily accessed and copied by end-users, even if access is restricted. It can take time to 'monetise' a new internet-based business idea – longer than it does to design the product or service itself. Novel internet business models can generate income quickly and some have led to market paradigm shifts, creating whole new markets (see Case insight 7.5). Nevertheless, it is often the case that users have to be found first in order to prove the concept, and only afterwards can ways of monetising it be found – another reason to adopt the lean start-up methodology.

Here are just some of the better known and more established ways of monetising an internet business model. Some are basic e-commerce models:

- Direct sales model – where products/services are sold directly online and delivered by post (e.g. Amazon);
- Bricks-and-clicks model – where traditional retail is combined with the direct internet sales model either with postal delivery or customer collection (e.g. most large retailers such as John Lewis);
- Subscription model – where customers subscribe for the online product/service (e.g. newspapers such as *The Financial Times*). This requires specialist content that is of real value to the online customer and is often coupled with some sort of free trial usage to demonstrate its value. Because of the surge in 'fake news' in 2017, many newspapers saw a resurgence in their subscription levels;
- Affiliate model – where the internet platform helps to sell a product/service, without necessarily taking ownership, in return for commission (e.g. Amazon);
- Pay-as-you-go model – where you pay for what you use or consume (e.g. some smartphone contracts).

Some are models that are designed to encourage sales:

- Freemium model – where the business gives away something for free such as a 'basic' service but extras or premium services are charged for (e.g. Spotify). This is most common in service-based businesses where the marginal cost of an additional customer is very small;
- Auction model – where online shoppers bid for products (e.g. eBay);
- Flash sales model – where daily deals are offered to registered customers (e.g. Groupon);
- Bait and hook model – where special deals are offered that lock customers into buying a particular product or service because the costs of switching are high (e.g. smartphones).

Some are models designed to generate income in different ways:

- Advertising model – where the internet platform is paid for advertisements being placed on the website (e.g. YouTube, owned by Google). To persuade advertisers, the platform needs to have high levels of focused website traffic. This therefore works particularly well for popular niche sites, although it is becoming increasingly competitive with more and more websites. However, the reality is that most of the revenue is going through just two internet giants. In 2016 it was estimated that 99 per cent of the USA and 89 per cent of the UK growth in digital advertising expenditure went through two companies – Google and Facebook. Examples such as YouTube illustrate how hard it can be to monetise free content even when there is significant website traffic. Advertising will also restrict screen content for the platform. What is more, increasingly platform content has to be tailored for mobile devices where the screen is much smaller and the opportunity for advertising is therefore even more limited. It is estimated that 90 per cent of Facebook's turnover now comes from mobile ads;
- Pay-per-click model – where clicks onto an advertiser's link are paid for (e.g. Google). This is just a variant on the affiliate and advertising models;
- Open business models – where value is created through collaboration between partners (e.g. price comparison websites);
- Multi-sided market – where there are multiple income streams using a number of these models, one subsidising another. This model is also seen across tech-markets, with income from a market in which a company is established being used to subsidise its growth in another (see Case insight 5.1).

These models are not mutually exclusive. Often more than one model is used alongside another. We look at issues around the pricing of virtual products in Chapter 9.

> *Publishers shouldn't be so dependent on anyone else's platform. It's a bad business decision. You don't own your audience, you're renting your audience – and that can turn off any time. When the algorithm shifts, everybody feels it.*
>
> John Avlon, Editor-in-Chief of *The Daily Beast*, *The Sunday Times*, 7 May 2017

Case insight 7.4 Strava

Monetising a smartphone app

Strava is a fitness app, conceived as a 'virtual locker room' by Mark Gainey and Michael Horvath and launched in 2008. It is used in 195 countries. Based in San Francisco, it has offices in the UK and Germany. The app works on iPhone and Android devices and, using GPS tracking, allows cyclists, runners and skiers to track their routes, record and post times and performance statistics, and compete against each other. It also allows them to share their location in real time and develop 'heat maps' and trails. Indeed, Strava obtained some unwanted publicity when it emerged that US troops were using these 'heat maps' and inadvertently giving away their secret location in Syria. The company subsequently changed its privacy settings. Stava has also become a social network for amateur athletes encouraging the development of a community where they can exchange information, knowledge and gossip, providing a certain camaraderie and team spirit. It is claimed that some 15 million completed activities and 4 million photos are uploaded each week.

The basic app is free but there are three upgrade packs – training, safety and data analysis –that are offered initially on a free trial and then on a subscription basis. Income is also derived from companies who sponsor a 'challenge' based upon the sponsor's target market (e.g. run 30 miles in a month or ride 10 hours a week). The challenge can be global or targeted on participants based on their location, gender or sport type. It is used to build awareness and loyalty for a brand. Participants receive a badge for their digital trophy case and often the sponsor might offer additional prizes or product discounts. They are encouraged to join the sponsor's 'club' – which acts as a social network for members – and the company is then able to communicate with them, advertise and sell merchandise – and organise more 'challenges'. Athletes can enhance their posted activities with content from the sponsor. For example, Le Col is a UK manufacturer of premium cycling wear. Starting with a challenge on Strava that attracted over 87,000 participants, Le Col developed its Strava club, which now has almost 100,000 members and more than four times as many followers as any other platform that the company uses.

Strava has raised $42 million from investors, including the venture capital giant Sequoia. Despite its diversified income generation model, it has yet to make a profit.

Access the *Digital Links* booklet to visit the company website and watch a video explaining how Strava works.

Questions:

1. What do you think of Strava's business model? Could it be improved?
2. Why are investors willing to put money into a company that has yet to make a profit?

Many tech start-ups do not make money early in their lives, indeed some continue to make losses well after their launch and even after becoming listed on a stock exchange. The Swedish music streaming service Spotify, launched in 2006 and listed on the US stock exchange with a value of $24.2 billion, has a huge user base and 100 million paying subscribers but remains loss-making (forecast at $320 million in 2019). Tech investors tolerate these losses because they hope that the company will at some point in the future dominate the market that it has pioneered and be able to make monopoly profits. Alternatively the data it gathers on users may be of commercial value or the company may be sold to a competitor at a profit (Spotify's competitors are Apple and Google).

Data and information on customers have become as valuable as the customers themselves – something that can not only be sold, but also used to create competitive advantage. Western companies like Facebook, Alphabet, Amazon, Apple, WhatsApp, Messenger and Instagram control enormous amounts of data on their users: 'Once we searched Google, but now Google searches us. Once we thought of digital services as free, but now surveillance capitalists think of us as free' (*The Observer: The New Review*, 20 January 2019). Facebook has used the data it harvests to good effect to target precise customer segments with particular demographics. Facebook sells this targeting advertising facility to anybody who is willing to buy it and 99 per cent of its $10.3 billion turnover is derived from advertising. It can also deliver advertisements via a process of online auctions, which happen in real time whenever you click on a website. This is possible because just about every website you visit now plants a cookie on your web browser, meaning that when you go to a new website an instantaneous auction for the ads you see takes place. Eastern counterparts like Alibaba, Tencent and Baidu control just as much data but have far closer links with the Chinese government and are already using it to incentivise citizens to 'do good' using tradable credits.

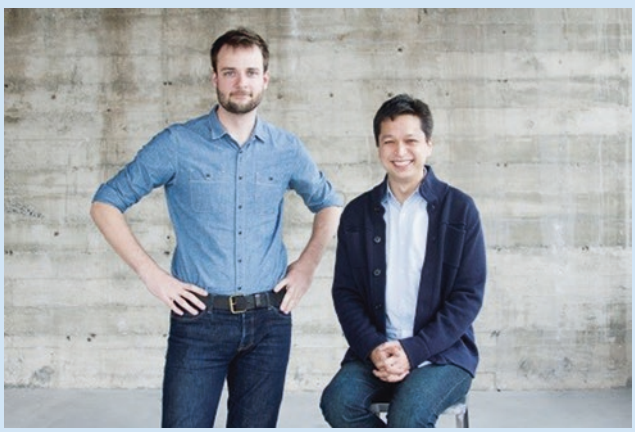
Case insight 7.5 Pinterest

A business model for a radical innovation

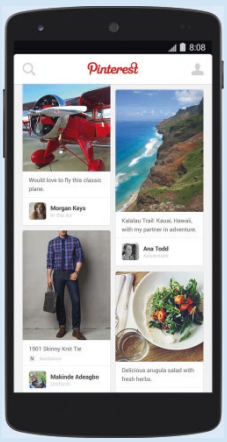
Founded in 2010 by Ben Silbermann, Paul Sciarra and Evan Sharp, Pinterest has attracted investments that value the company at $12.3 billion, despite the fact it has only just begun to generate revenue. Pinterest is a visual discovery app that helps people discover and save creative ideas. Users save (or 'pin') ideas they find on Pinterest or the web to themed digital boards – for example, fashion, photography, cooking, home or garden improvements etc. The site is highly visual, unlike many other text-heavy social networks. 'Pinners' are given recommendations for Pins and boards that interest them based on what others with similar interests have saved. There are more than 175 million monthly active users on Pinterest.

The inspiration for the idea came when Silbermann and Sciarra were working on a failed idea for a shopping app called Tote. They noticed that instead of buying through the app, users emailed pictures of products to each other. People liked pictures and they wanted to get ideas and inspiration from them. The challenge was to turn this into something that made money:

> *'There has been so much remarkable work on search – on making it so that you can find what you're looking for and you can retrieve it really quickly. But there has been little work done on helping people discover things when they may not know exactly what they are looking for ... From very early on with our investors, we were clear that the goal of the service was to help people discover things that were meaningful to them. That motivation falls closely in line with the goals of lots of businesses and advertisers.'* (The Sunday Times, *6 July 2014)*



Because Pinners have an obvious hobby interest, advertising can be highly relevant and targeted, thus commanding a premium price. Because Pinners browse Pinterest for attractive images and ideas, it has a very different feel to conventional search engines,



such as Google, that are designed to deliver specific information. Sites like Google build profiles of their users by mining the data they generate. But that means that their targeted advertising can often feel intrusive and therefore counterproductive for advertisers. People come to Pinterest to plan the things that they would like to do in the future – whether it is something they would like to buy, a recipe they would like to make, or a place they would like to go to. They just click on the pins they wish to investigate further. Therefore, it is a huge opportunity for marketers to be a part of the process in helping Pinners take action on the Pins that they find online. And, while Pinterest also has Pins promoted by companies, a Promoted Pin looks just like any other Pin in the system with the exception of a note that says 'promoted', making a Promoted Pin less obtrusive than other ads. Companies have been pinning for years, setting up their own pinboards on Pinterest to showcase their own products. In 2014 the company launched a self-serve platform that enables companies to create their own Promoted Pins that can be posted to other boards.

With more than 175 million regular users, Pinterest has caught not only the attention of investors but also the big advertisers. However, now that it has devised a revenue-generating business model, the question is: how will the search engines that it hopes to take revenue from react? In the past they have often bought up the best new ideas.

Access the *Digital Links* booklet to visit the company website and watch videos of Ben Silbermann telling the story of Pinterest and pitching the idea of the business in 2013.

Questions:

1. Which business models would you apply to Pinterest?
2. The inspiration for Pinterest came from a failed idea for an app called Tote. What are the potential effects on an entrepreneur of a failure like this?

SECURING SUSTAINABLE COMPETITIVE ADVANTAGE

Generally, the more innovative the product/service and the business model, the more likely the firm to have some form of competitive advantage, at least in the short term. And the more frequent the product/service innovation, the more likely the firm is to be successful, particularly in manufacturing and technology-based industries (Calvo, 2006). However, unlike inventions or innovations, an entrepreneur is unlikely to be able to safeguard their intellectual property around a business model. Sometimes business models do not meet the test of market reality and have to be changed (see Chapter 17). However, the more successful the business model is, the more likely it is to be copied. And often today's novel business idea can prove to be tomorrow's norm. Telephone banking gave way to internet banking and both now are the norm. So the questions are: Which business model has the highest chance of success for a start-up and for how long can the business model be sustained before it is copied?

Research gives us the answer to the first question. A strategy that emphasises something that makes the firm as unique and difficult to copy as possible and delivers as much value to the customer as possible today and, more importantly, tomorrow is the most likely to succeed (Harrison et al., 2010; Lusch et al., 2010; Newbert, 2008; Wu, 2010). For a start-up this is the niche business model. However, nothing in business is certain.

There are three major strategies to help secure sustainable competitive advantage:

1. Speed-to-market – As we saw in the last chapter, there may be a lot to be said for first-mover advantage but finding the right time to launch – that tight 'window of opportunity' – is a difficult judgement call (Figure 6.2).
2. Speed-to-market dominance – Market dominance gives market power, so it is generally better to dominate a small market than to be a small player in a big market. There is strong empirical evidence that rapid dominance of a market niche is the real key to success. There is also a strong relationship between market share and financial return.
3. Brand strength within that market – This is the marketing tool that helps carve out that market dominance – a topic we cover in the next chapter.

The prospect of market dominance leading to the ability to make monopoly profits, particularly in new rapidly growing industries or markets, can be very attractive. Companies like Alphabet (owners of Google and YouTube), Apple, Facebook and Amazon have all used these strategies to facilitate their growth and secure that market dominance. For internet-based companies there may be the opportunity to capitalise on network effects – where one user tells another and another, and so on and the value of the network is increased as more people use it (e.g. Facebook). For Amazon the network effect comes from the sheer diversity of its product offering that attracts customers and the scale of its operations that allows it to keep prices low. However, these companies have also been accused of stifling competition and wielding excessive monopoly power. The European Commission fined Google €2.4 billion in 2017 for abusing its market dominance as a search engine by giving illegal advantage to its own comparison shopping service, Google Shopping, while demoting the results of rival sites. The prospect of market dominance has also led to investors tolerating the lack of profits in disruptor companies like Uber (Case insight 17.3) and Airbnb, perhaps sensing that these companies might come to dominate new, enormous markets and generate monopoly profits in years to come.

Nohria and Joyce (2003) provide a postscript. They reported the results of a ten-year study of 160 companies and their use of some 200 different management techniques. They concluded what we all know: that it does not really matter so much which technique you apply but it matters very much more that you execute it flawlessly. They claim flawless execution is something too many management theorists have forgotten. Attention to detail is important.

The conclusions, therefore, are obvious. While nothing in this world is guaranteed, the strategy with the best chance of generating sustainable growth and the highest profits is to differentiate with the aim of dominating your market as quickly as possible, and to continue to innovate around that differential advantage. Gaining rapid market dominance is important.

Explore further 7.3

Keeping strategies simple

Access the *Digital Links* booklet to watch a short talk by Professor Donald Sull on the importance of keeping strategies simple and streamlined.

Bonus Case Monzo

Visit the companion website at www.bloomsbury.pub/burns-esb-5e to access this bonus case.

CHARACTERISTICS OF AN ATTRACTIVE BUSINESS MODEL

The commercial viability of a business idea is generally unknown until the business model, and the related financial forecasts are developed. The best business models generate high profits and involve low risk. Unfortunately, very few such opportunities exist. However, there are some characteristics of a business model that are likely to ensure commercial viability and prove attractive to potential funders. These were outlined in Table 6.1 and are expanded further here. Each will be dealt with in subsequent chapters:

1. Identified market need or gap – The idea must meet a clearly identified market need to be commercially viable. We looked at this in Chapter 4.

2. No or few existing competitors – The more innovative your product/service and markets, the fewer your competitors, and the higher the price you are normally able to charge. However, remember it is always possible that there are no competitors because there is no viable market for the product/service. We looked at this in Chapter 5.
3. New or growing market – It is always easier to launch a business into a new or growing, rather than declining, market. Of course, it may be that you are launching a business that will create a completely new market. We looked at this in Chapter 5.
4. Low funding requirements – The lower the funding requirement, particularly early on, the easier it is to start up and the less you have to lose if the idea does not work. We looked at how this might be achieved in Chapter 6.
5. Clearly identified customers and a viable business model – If you don't know who you are selling to, you won't know how to sell to them, which means you probably will not succeed. You need to go about building a business model systematically. And remember you may be selling to more than one market segment. We looked at this earlier and will continue in Chapter 8.
6. Sustainability – The business must be built on solid foundations so that it has longevity. We looked at how this might be achieved earlier in this chapter.
7. High profit margins – The more innovative the product/service and its market, the higher the margin a firm is likely to achieve. We shall look at this in Chapters 9 and 15.
8. Effective communications strategy – Once the firm knows who it is selling to, and why they should buy from it, they need to be able to communicate a persuasive message to prospective customers and start to build a loyal customer base. We shall look at this in Chapter 10.
9. Not easily copied – If it can be, intellectual property (IP) should be protected. However, often getting to the market quickly and developing a brand reputation is the best safeguard. We will go into ways to safeguard IP in Chapter 11.
10. Identifiable risks that can be monitored and mitigated – The future of a start-up is by definition uncertain. Identifying risks is the first step to understanding how they can be monitored and then mitigated. Identifying critical success factors and strategic options is important. We shall look at this in Chapters 12 and 13.
11. Low fixed costs – Low fixed costs mean lower risk, should volume reduce. It gives a firm more flexibility. A combination of high profit margin and low fixed costs (high profit, low risk) is always very attractive. We cover this in greater detail in Chapters 9 and 15.
12. Controllable – Putting in place robust operating and financial controls increases chances of survival and success and ultimately will add value to the firm. The major imperative in the early years is to monitor and manage cash flow. We cover this in greater detail in Chapters 12 and 15.
13. Management skills that can be leveraged – A founder needs to have the appropriate management skills, and if they do not they need to acquire them, or recruit or partner with others who do. We shall look at this in Chapters 14 and 16.
14. Scalability – Small-scale start-ups can usually get off the ground easily, but bigger projects can be problematic because they are just 'too big', in which case, you need to see whether the project can be broken down into smaller projects that can be implemented when the original idea is proven – scalability. The aim is to avoid as much risk as possible for as long as possible – but to make sure the window of opportunity is not missed completely. This is all a question of judgement and, with changing market conditions, the entrepreneur needs to remain flexible and think through how they might scale-up the project when it proves successful. We shall look at this in Chapters 17 and 18.
15. Financeable – If the founder does not have sufficient financial resources themselves, the business needs to be able to attract finance. We shall look at this in Chapter 19.

These characteristics can only be judged as the business model is developed. Chapter 17 shows you how a business model can be turned into a formal business plan.

Case Insight 7.6 Deliveroo, Uber Eats and Just Eat Takeaway.com

A tale of two business models

The UK meal delivery market is dominated by three firms: Deliveroo, Uber Eats and Just Eat Takeaway. In the UK the market leader is Just Eat (recently merged with Dutch Takeaway.com), with over 60% of the market, Deliveroo has about 26% and Uber Eats about 13%. Deliveroo leads the market in the USA. Uber Eats leads in France and Australia. Each company is striving for market domination. However, while each company delivers the same benefits to the end-user, each has a different business model.

Deliveroo and Uber Eats have invested billions in creating delivery networks to deliver food to customers via self-employed couriers and are expanding their service globally in a fierce battle for market domination. They are scrambling for economies of scale (and therefore cost savings) and are backed by venture capital funds. Despite charging the takeaway or restaurant 30% on each order, both companies continue to be heavily loss-making. Both vie with each other to sign deals with big-name national restaurant chains like McDonald's, Nando's and Wagamama and now mount aggressive attempts to sign up local independent restaurants.

By way of contrast, Just Eat (now Just Eat Takeaway.com) has a different business model. It acts as a middleman between the customer and the restaurant. Orders are taken online and the takeaway or restaurant delivers the food. This low-cost model allows it to charge just 14% on each order, plus £0.50. What is more, rather than targeting large national restaurant chains, Just Eat has targeted small independent takeaways or restaurants. The result is that the company has consistently reported substantial profits, largely because it does not have to fund a costly logistics network.

Both Deliveroo and Uber Eats were struggling before the coronavirus pandemic lockdown. Deliveroo recently quit the German market and Uber Eats has quit eight international markets. But when lockdown was imposed in the UK one firm benefited far more than the others because of its different business model. Lockdown closed the big chains of restaurants and, as a result, business dried up for Deliveroo and Uber Eats, while their fixed costs still had to be paid. Just Eat continued to take orders for its takeaways and even its restaurants, who delivered the food themselves. Indeed, because of the reduced competition, business boomed.

To combat the fall in revenue Deliveroo sought delivery deals with UK supermarkets such as Marks & Spencer, Morrisons and Aldi, described as a way of 'keeping its head above water'. Although Just Eat's margins have also been eroded in recent years, Jitse Groen, Just Eat's boss, sees their rivals' lack of profitability as unsustainable:

> *'They have fantastic growth, but it is not profitable. At some point you need to turn a profit ... not just pump money in.'* (The Sunday Times, *21 June, 2020)*

Deliveroo's response was to secure a further £130 million in funding from investors including Amazon and to go public in the



Source: egbank on Unsplash

UK with an IPO valuing the company at more than £5 billion. Seeing the opportunity, Just Eat has started to invest in its own courier service to operate alongside its existing service (thus offering two business models) and, when McDonalds reopened it struck a deal, ending Uber's exclusive delivery contract. Other national chains followed suit. However, Just Eat has its eye on bigger things. In 2020 it also made a $7.3 billion bid for US meal delivery service GrubHub, trumping a rival bid by Uber Eats. The combined turnover of the two companies would have been $3 billion in 2019, producing profits of $447 million – quite a difference compared to their loss-making rivals. The stakes in this war are high. If the deal goes through (it needs shareholder and regulatory approval) this will be the biggest meal delivery service outside of China with over 70 million active customers generating almost 600 orders each year – and making a profit. Just a few months later Uber Eats bought out the US food delivery service Postmates for $2.65 billion – an expensive acquisition with a 25% premium on the previously traded share price. Postmates delivers food and other products from restaurants and stores in 4,200 US cities.

Access the *Digital Links* booklet to visit the companies' websites.

Questions:

1. Why are these firms seeking to dominate markets?
2. Can these two different business model coexist? Explain.
3. Why are venture capitalists so keen to back Deliveroo and Uber Eats?
4. If the deals with GrubHub and Postmates go through, what might be the consequences?

SUMMARY

- Values and beliefs should underpin a business. They set expectations about how it will treat all its stakeholders. A mission statement is a statement of purpose for the business. The vision for the business is the mental image of what it might become. It is attractive and desirable but credible, acknowledging that there may be tension created by a realistic appraisal of the current situation. 'Strategic intent' is the term used by growth businesses to reconcile these tensions.
- 'Effectuation' is a term that refers to how entrepreneurs think: they have broad goals based on resource availability and react opportunistically to situations; they set 'affordable loss' and react quickly rather than evaluating thoroughly; they do not like traditional, formal planning; they build networks and partner with others; and they are less concerned with competition, believing they can overcome it.
- Business model frameworks allow entrepreneurs to plan in a less formal way. They provide the link between the experience of running the business and emerging strategy – a simple 'learning-by-doing' framework that can help organise what might otherwise be an unstructured and disjointed experience.
- The core competencies of a business are the resources, competencies and capabilities it has. For a start-up they reflect the skills, competencies and capabilities of the founder. They can be combined with strategic assets to create sustainable competitive advantage. The more unique these competencies are, the more difficult they are to copy and the more successful the start-up is likely to be.
- There are three well-understood business models: low-price/low-cost, high differentiation and customer focus. These combine to produce the niche business model of highly differentiated products/services offered in small volume at a relatively high price to a focused target market. These are models consistent with fundamental ways of creating sustainable competitive advantage.
- Different business models with different value propositions can exist happily side by side in the same industry, appealing to different target markets. Differentiation allows higher prices to be charged. However, the niche model is the one with the highest chance of success for a start-up because of its limited resources.
- There are many internet business models but data and information on customers have become as valuable as the customers themselves.
- Three strategies help create sustainable competitive advantage: speed-to-market; speed-to-market dominance; brand strength. Market dominance implies the ability to make monopoly profits and this can be very attractive in new, growing markets. However, it can also lead to companies using their market dominance to stifle competition.

GROUP DISCUSSION TOPICS

1. Why are values and beliefs important for a business?
2. Can the values and beliefs for a start-up be different to the values and beliefs of the founder?
3. Why are ethics important in business?
4. The law defines the extent of our ethical and social responsibility. Discuss.
5. Is it ethical to make profit out of ethical and social values?
6. Is effectual reasoning logical?
7. If entrepreneurs do not like traditional, formal planning, why should they develop a framework to explore the launch of their business?
8. What are the advantages and disadvantages of using flexible business model frameworks to explore the launch of a business?
9. What are the advantages and disadvantages of a business model relying on low cost/low price?
10. What are the advantages and disadvantages of a business model relying on differentiation?
11. In what ways can a business differentiate itself? Give some specific examples for a retailer, service business, internet business and manufacturer. How can these be safeguarded against copying?
12. What are the advantages and disadvantages of a business model relying on customer focus?
13. What are the advantages and disadvantages of the niche business model?
14. Give some examples of products/services that are niche markets. Are these niches sustainable?
15. Why are business ideas involving internet-based virtual content ('knowledge products') difficult to monetise?
16. Is it ethical for a business to use data from customers? Is it ethical to sell this data?
17. Is it ethical for a business to use its market dominance to maximise its profits by stifling competition?
18. Is it ethical to aim to dominate a market niche?
19. What are competencies and capabilities? Explain and give examples.
20. In a global marketplace, how can you ever dominate a market?

STUDENT ACTIVITIES

1. List your values and beliefs. List your ethical, social and environmental concerns. How could these be reflected in a start-up: its business model and its relationship with stakeholders?
2. Find an SME that describes itself as a niche business and analyse its business model. Do you agree that it is a niche business?

START-UP ACTIVITIES

1. List your values and beliefs. List your ethical, social and environmental concerns. How will these be reflected in your mission and vision for the business and your business model?
2. Write a mission statement for your business using Wickham's pro-forma.
3. Write a vision statement for your business.
4. Identify which of the three generic business models best fits your business idea. Jot down the implications of this.
5. On a scale of 1 (low) to 5 (high), evaluate your business idea using the 15 characteristics of a good business idea. Add up the score (maximum 75) and jot down the implications. If you have more than one idea you might want to repeat this process for each of them.

8

MARKET SEGMENTS AND VALUE PROPOSITIONS

Contents

- Identifying target customers
- Defining the value proposition
- Marketing mix
- Values and the value proposition
- Sustainable entrepreneurship and corporate social responsibility
- Differentiation through branding
- Branding the firm's values
- Brand name and logo
- Building the brand
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: Getty Images/iStockphoto/Vincent Nijhof

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Identify and describe customer segments and define the value proposition they are offered;
- Understand the difference between the features and benefits of a product/service, and how physical, psychological and emotional benefits might be combined to help differentiate it;
- Understand how values, beliefs, ethics and social responsibility can translate into psychological benefits to customers, as well as making commercial sense;
- Understand the importance of creating brand identity and how this might be achieved.

Case insights

8.1 The English Pub (1)
8.2 The Entertainer
8.3 Zound Industries
8.4 Cotton On Group

Explore further links

8.1 Service-dominant marketing logic
8.2 Values-driven marketing
8.3 Corporate social responsibility
8.4 Branding

IDENTIFYING TARGET CUSTOMERS

Constructing a business model requires a clear idea of the target customers and the value proposition offered to them – one that meets their real needs or solves real problems for them. The value proposition should be different to that offered by competitors – one that better meets the needs of the target customers. Aligning the value proposition to a target group of customers involves judgement because both can usually be adjusted to a greater or lesser degree. All customers are individuals but certain groups will have similar needs and, if these groups can be identified, this allows them to be targeted and communicated with through marketing. These are called 'market segments'. The key for a start-up is to identify and focus limited resources on just two or three clearly defined, important and sizeable market segments. As discussed in Chapter 5, this is the firm's 'Served Available Market' (SAM) which is part of a bigger 'Total Available Market' (TAM). The marketing plan can then be tailored to the needs of customers in these different segments. This involves developing, the marketing mix and a marketing communications plan. Of course customers who do not fall into these segments will not be turned away; it is just about focusing limited resources where they are likely to have the greatest return.

There are many ways of segmenting markets and there are no prescriptive approaches. Market segments match groups of customers with their product/service wants or needs – the benefits they are looking for. The segment can be any one, or a combination of, descriptive factors. The descriptive factors for private customers (B2C markets) might include personal demographics (e.g. age, gender, socioeconomic group, occupation, stage in family life etc.), geographic location (particularly important for retail start-ups), psychological characteristics (e.g. personal attributes, values, preferences etc.) and/or behaviour (e.g. existing product/service purchases, channels of distribution used, social habits, etc.). For business markets (B2B), they might include business characteristics (sector, size, location, technology used etc.), purchasing characteristics (owner-managed, where buying decisions are made etc.) and/or attitudes (loyalty to existing suppliers, early/late adopters of technology etc.).

By grouping customers, we are looking for market segments with similar needs that can be identified and described in some meaningful and useful way – and then communicated with economically. We are particularly looking for a gap in the market, where the needs of a particular segment are not being met as well as they could be. This is all a matter of creative judgement (left- and right-brain). Desk research might be a starting point (it might help identify a SAM), but it is certainly not going to yield a novel market segmentation. What is needed is a more 'bottom-up' approach, linking knowledge of the market with some creative thinking. This might be validated through field research (interviews, focus groups etc.).

A start-up might target more than one market segment (if it has the resources). This might spread the risk associated with too high a dependence on just one segment, but usually at a cost in terms of marketing expenditure. To be viable a market segment should be:

- Distinctive with significantly different needs from other segments. Without this the segment boundaries are likely to be too blurred. A firm needs to be able to paint a detailed picture of the typical customer in the segment linking their needs to the segment characteristics.
- Sufficiently large, or willing to pay a high enough price, to make the segment commercially attractive. It may be that a gap in the market exists because it is not commercially viable.
- Accessible. The gap in the market might not exist in reality because the segment cannot be reached – through communication or distribution channels.
- Defendable from competitors. If the segment is not defendable, for example because it is a copycat product/service, prices and profits will quickly reduce as competition increases.

> *Vary your markets. Think about how your product could fit into different markets.*
>
> Calypso Rose, founder of Clippykit, *The Daily Telegraph*, 6 February 2009

Market segments vary in size. The slimmer the market segment that the product/service is tailored to suit, the higher customer satisfaction is likely to be, but so, too, is cost – and therefore price. We all like personal service and the ultimate market segment comprises just one customer. However, this might not be a commercially viable segment. The trend is towards slimmer and slimmer market segments, particularly since the internet has made it easier to link customers with similar needs in different geographic areas. The danger facing firms selling to a slim market segment is their overreliance on a small customer base. If tastes change, the segment might disappear. This is the reason for possibly targeting more than one segment.

DEFINING THE VALUE PROPOSITION

The value proposition is a statement of the tangible benefits a customer gets from buying a product/service – the problem(s) it solves for them. It can differentiate a company and is why customers buy from one company rather than another. The features or characteristics of the product/service – the marketing mix – must combine to deliver those benefits to the customer, or they will not buy it. And different market segments might be looking for different benefits. The features of a car combine to provide the benefit of transport, but different customers are looking for more than just transport – which is why there are numerous types of cars (from SUVs to sports cars) and many producers (from BMW to Ford). It is also why cars might be sold, leased or rented. Products/services may appear to be the same but often have other related benefits compared to competitors such as: saving time or money, producing more of the result, undertaking the task more safely or with less risk or in a more innovative way.

It has been argued that customers essentially purchase services rather than goods, and goods should therefore be viewed as a medium for delivering or 'transmitting' services (Vargo and Lusch, 2004). Vargo and Lusch defined service as 'the application of specialised competences (knowledge and skills) through deeds, processes, and performances for the benefit of another entity or the entity itself'. In this way companies manufacturing cars are not in the business of selling cars but in the business of providing 'mobility services' through the cars that they manufacture. How this is delivered as a service to customers can be many and varied. Thus, all industries are service industries and it therefore becomes vital for firms to understand the service that consumers are seeking from them. It requires a shift in focus from the product to the consumer and an understanding of their needs and how these translate into a service that they value.

When customers buy a product/service they are looking for the benefits that it brings them – often referred to as the problem(s) it solves. These benefits can take many forms; physical, psychological, even emotional. Any product/service delivers certain core benefits (e.g. transport in the case of a motor vehicle) but it can also be designed to deliver additional forms of benefit such as conveying status, being more ethical or environmentally friendly etc. Focusing on the benefit-needs of the market segment(s) and delivering distinctive, differentiated value propositions to each of them is at the very core of developing a marketing strategy. Unfortunately, many owner-managers like to define their products in physical terms and therefore think they are selling one thing, only to find customers are buying something else.

Listing the features of a product/service can be the start of the process of understanding the benefits that the customer is seeking from them. The features can then be translated into benefits by exploring their meaning. Possibly the best example of a value proposition that has become a generic name for a type of shop is 'convenience store'. Table 8.1 lists some of the possible features of a convenience store and the benefits they translate into. Most relate to the service offered rather than the physical products it sells and the first four can be summarised by the word 'convenience'.

However, it is more convincing to start with the benefits that customers are looking for and then construct features that provide those benefits. These features are called the 'marketing mix' and we shall return to this in the next chapter. Which actually comes first – features or benefits – is a little like the chicken or the egg question. Nevertheless, once an entrepreneur starts thinking about benefits, they are starting to think like a customer.

Table 8.1 A convenience store: Features translated into benefits

FEATURE		BENEFIT
Our shop stays open later than others	*Meaning...*	You get more choice of when to shop (i.e. convenience)
Our shop is local	*Meaning...*	You do not have to travel far to shop (i.e. convenience)
Our shop sells a wide range of goods	*Meaning...*	You get more choice of what you can shop for (i.e. convenience)
Our shop takes credit cards	*Meaning...*	You can budget to suit your pocket (i.e. convenience)
Our shop is a family business	*Meaning...*	You get individual, personal attention from somebody who cares

A value proposition should therefore state four things:

1. How the product/service will solve a problem for the target customers.
2. The tangible and intangible benefits customers can expect – the problem(s) it will solve for them (as we shall see later, proof of this may have to be offered in the marketing message).
3. Why these benefits are valuable to the customers.
4. Why customers should buy this product/service rather than another from competitors.

It is important to understand precisely what the value proposition(s) of a product/service is and the target market(s) it is aiming at. Different target markets may have slightly different value propositions. The discipline of expressing this in a few, specific words is extremely valuable and one that they will be able to refer back to again and again as they develop their marketing campaign. The template below might help:

> Because our product/service has *(features and other differentiating and provable attributes)* it will *(problem solution)* for *(target customer segment)* meaning that *(customer benefits)*.

Often the value proposition forms the basis for the 'strap-lines' (short one-line sentences) you see describing what products or companies do or what they represent. For example the UK cosmetics firm Lush leaves no doubt about what it does by using the simple strap-line: 'fresh handmade cosmetics'. The computer equivalent of Post-it® notes, Evernote, is equally clear: 'Remember everything' but adding 'Inspiration strikes anywhere. Evernote lets you capture, nurture, and share your ideas across any device.' Skype uses the strap-line: 'Skype makes it easy to connect with your loved ones', but if you go to its website the front web page states very clearly what it does (helps you share, message, and call), how it does it (on phone, tablet, and desktop), and who it does it for (the whole world).

Explore further 8.1

Service-dominant marketing logic

Access the Digital Links booklet to watch a video of Professor Robert Lusch explaining his concept of service-dominant marketing.

MARKETING MIX

The benefits customers are looking for are represented in tangible form by the features of the product/service and the marketing mix is simply this bundle of features. It is often simply called the 'Five Ps':

- Product/service (functional specification, design etc.);
- Price;
- Promotion (or communication);
- Place of sale (location, channels of distribution etc.);
- People (or related service).

Elements in the marketing mix are shown in Table 8.2 in no particular order of importance, although the basic functionality of the product/service underpins everything else. The marketing mix is the vehicle for delivering customer benefits (physical, psychological and emotional). It can be tailored to meet the needs of different market segments and the marketing objectives of the company. It can be used to create brand identity or to reinforce it. However, customers buy the marketing mix as a package, and therefore each element must be mutually consistent, each reinforcing the other. So, for example, a low-price for a high-quality product/service might jeopardise sales because it sends a confused message and questions credibility – can the value proposition be trusted? A high price is

Table 8.2 Marketing mix

PRODUCT/SERVICE	PRICE	PROMOTION	PLACE	PEOPLE
* Quality and functionality	* List price	* Communications	* Distribution channels	* Relationships
* Design	* Discounts (volume, loyalty etc.)	* Advertising (incl. social media)	* Retail/wholesale	* Service support
* Specification	* Auction pricing	* Branding	* Location	* Advice
* Newness or novelty	* Negotiated price	* Word-of-mouth	* Shop layout	* Convenience of use
* Colours	* Differential or segment pricing	* Fairs and exhibitions	* Internet selling	* Partnerships
* Sizes	* Sales and special offers	* Sponsorship	* Telephone selling	
* Packaging	* Loyalty discounts	* Competitions	* Face-to-face selling	
* Customisation	* Payment terms	* Point of sale displays	* Accessibility	
		* PR	* Mail-order	

usually expected to be charged for a quality product/service, but the other elements of the marketing mix will need to be consistent with this (e.g. branding, packaging and service support). The role of the marketing plan is to pull together a unique and consistent marketing mix and to communicate the benefits it offers to the identified target market segments – called the 'unique selling proposition'.

For a start-up, which is likely to be short of money, the founding entrepreneur is central to the whole marketing mix. Of necessity, their approach to marketing will probably be very much hands-on and face to face. They might use their network of contacts to find customers and suppliers. They might develop strong, trusting personal relationships with customers to secure repeat sales. This can be a distinct competitive advantage over larger firms that adds value to the customer. Indeed, one particularly effective entrepreneurial strategy is to identify a sector in which customer relationships are weak and to create value by tightening them up. In the longer term, this relationship can evolve into a distinctive brand. Customer relationships are an important part of the marketing mix and marketing strategy.

While any individual element of the marketing mix may not be unique and can often be easily copied, elements of the mix can be combined to produce something unique and distinctive. It is the combination that is unique, not the individual elements, and this can provide a differential advantage over competitors. If the combination is sufficiently unique, it may challenge existing market paradigms. Establishing a brand that captures the elements of uniqueness can itself add value to the value proposition. And building switch costs for customers into the value proposition – costs of changing supplier – can also enhance the competitive position by discouraging them from buying from competitors. Alternatively, a company might offer additional benefits for customer loyalty.

VALUES AND THE VALUE PROPOSITION

A firm's values and vision are tools that can help create identity for it – a unique identity that should be reflected in the value proposition and the marketing mix. And if this identity is attractive to customers it can create value. At the very least, a clear *identity* for the business means that customers know what they are buying and, if they like it, facilitates a repeat purchase. But identity can do more than this. It is also about creating *trust and reputation*. As we have seen, customers buy a product/service because it provides them with a range of benefits that they value. Reputation assures customers that they can trust these will be delivered every time they purchase the product/service. It reduces their risk and is therefore of value to them.

Case insight 8.1 The English Pub* (1)

Linking value propositions, market segments and marketing mix

You might think that a pub (a bar selling alcoholic and non-alcoholic drinks and food) is a very English institution. However, it faces all of the challenges facing any retail outlet. In particular, it faces high fixed costs related to its physical location and its serving staff. These costs need to be paid even if there are no customers. To compensate for this, gross margins can be high – 60 to 70% – so the operational imperative is to attract customers throughout the day.



Source: IMAGE SOURCE

To meet this challenge, an English high-street pub chain developed a two-tier marketing strategy. One, at the corporate level, outlined how it planned to expand and grow. The second, at the pub level, was designed to help local pub managers.

Each of these pubs was located in a prime, high-street, town-centre location, close to shopping centres and offices. Each was large, with areas with different seating, lighting etc. in separated areas, allowing it to change the ambiance and target a number of different market segments. The pub chain needed to maximise

Table 8.3 Local-level marketing strategy for a pub

Segments	Shoppers	Office workers	Pensioners & unemployed	Office workers	Students	Regulars	Young, pre-clubbers
* Time * Male/female	11.00–17.00 10/90%	12.00–14.00 40/60%	14.00–17.00 90/10%	17.00–19.00 60/40%	Any time 50/50%	19.00–22.00 60/40%	21.00–24.00 60/40%
Value proposition	A comfortable, safe, value-for-money place to eat and drink	A quick, value-for-money place to eat lunch	A comfortable, value-for-money place to spend time	A lively atmosphere to meet friends after work	A relaxed, value-for-money place to meet friends	A welcoming place to meet friends for value-for-money food and drink	A fashionable, lively place to meet friends
Marketing mix							
* Main products	Coffee, tea, soft drinks and food	Food, range of drinks	Alcoholic drinks	Wide range of alcoholic drinks	Alcoholic drinks	Food, range of drinks	Wide range of alcoholic drinks
* Service	Friendly	Fast	Low priority	Friendly	Low priority	Friendly	Fast
* Price	Value for money	Competitive	Low-price beers	Attractive 'happy hour'	Value for money	Value for money	Low priority
* Ambiance	Safe, clean and comfortable	Clean and comfortable	Warm, TV, newspapers	Up-beat, lively	Relaxed, safe	Friendly, home away from home	Lively, up-beat with music and promotions
* Importance of location	High	High	Low	High	Moderate	Moderate	High
Critical success factors	Safe, clean and comfortable environment	Rapid service. Value-for-money food	Low-price beers	Up-beat, lively ambiance with 'happy hour'	Relaxed, safe environment with other students	Friendly service and ambiance. Value-for-money food. Recognition as 'regulars'	Lively, up-beat ambiance with music and promotions

the number of customers it attracted throughout the day – spreading its high fixed costs as far as they might profitably go. That meant targeting different market segments at different times of the day.

The local pub strategy is summarised in Table 8.3, as it appeared originally on one page of A4 paper. It highlighted the value proposition for each segment at different times of the day and the main elements of the marketing mix needed to deliver

Questions:

1. What is the marketing plan in Table 8.3 designed to do? Does it convey the key activities needed to deliver the marketing mix effectively? Why is this important? Outline any details you think might have been omitted. that proposition.

   Finally it told the pub manager the critical factors they need to get right at each of these times.
2. Why is the location and size of the pub important for this marketing strategy to work?

*The English Pub is a real company, but the name is fictitious.

However, benefits can be psychological as well as physical. For example, a successful sole trader might offer a reliable, personal and friendly service that differentiates them effectively from the competition. The personal *relationship* they establish with their customers epitomises the reliability and friendliness of the service they deliver. And this relationship is based on trust, usually built over time, and it underpins the customer loyalty that is generated. The challenge is to extend it beyond the single-person business. Establishing a reputable name – or brand – for a product/service (and the firm that provides it) involves three things:

1. Establishing an *identity*;
2. Helping build *trust and reputation*;
3. Helping develop a *relationship*.

The development of a relationship with customers reflects a move away from seeing the customer as someone with whom to have an arm's-length transaction – just somebody to sell to. It is part of the development called 'values-driven marketing' that seeks to actively engage with customers and use them to help sell existing products/services and develop new ones. This is based upon establishing a good relationship with customers – one that is underpinned by mutual self-interest, where there is something in it for both the customer and the company with each helping the other in certain ways. Relationships are built on good communication – a topic we shall return to in the next chapter – and technology has made this easier on a mass basis. Indeed, the development of the internet and social media has made it possible and affordable on a global scale.

Piercy (2000, 2001) was one of the first academics to observe that, as customers become increasingly sophisticated, marketing will move away from just relationships to values-driven strategies that reflect customer priorities and needs:

> Achieving customer loyalty with sophisticated customers is the new challenge and we are only just beginning to realize what this means. It will mean transparency. It will mean integrity and trustworthiness. It will mean innovative ways of doing business. It will mean a focus on value in customers' terms, not ours. It will require new types of organization and technology to deliver value.

Piercy characterises marketing strategy and the search for customer loyalty as progress from transactional and brand approaches to relationship and values-based strategies. Values-driven marketing aims to combine relationship marketing with brand-based marketing – encapsulating certain values in the brand that are attractive to and involve the customer. These are illustrated in Figure 8.1.

Values-driven marketing (also called marketing 3.0) has been characterised as a holistic approach to marketing based upon combinations of segmentation approaches. It places a *participative* customer at its centre – a customer who is not only king, but also market research head, R&D chief and product development manager – for example through open source innovation. Customers are actively

> *You and your rival have access to virtually all the same resources. Only by constantly thinking of new ways to reorganize these factors can you differentiate yourself. It's like poker. Everyone has the same number of cards. It's how you play your hand that matters.*
>
> Zhang Ruimin, CEO of Haier Group, *Strategy + Business*, Issue 77, Winter 2014

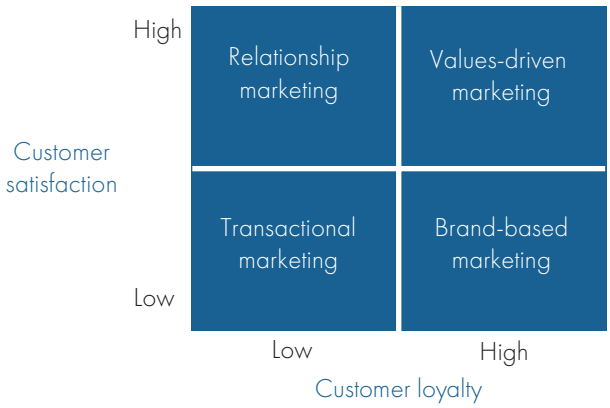


Figure 8.1 Values-driven marketing

involved as advocates of the product/service – for example through social network sites. In this way the customers' involvement is leveraged far beyond simple purchase of the product/service. This only happens if the organisation is continually engaged in dialogue with customers through as many media as possible.

Piercy suggested that the sources for this values-driven strategy were:

» Management vision – Clarity in direction and purpose, effectively communicated through a wide range of communication media.

» Market sensing and organisational learning – Understanding and responding to the external world using all possible networks and channels of communication.

» Differentiating capabilities – Using core competencies to build differential advantage.

» Relationship strategy – Managing the network of relationships and channels of communication used for market sensing to achieve superior performance.

» Reinventing the organisation – Changing the organisation's form and processes to sustain and renew this strategy.

Kotler et al. (2010) are keen advocates of values-driven marketing. Rather than seeing values as an 'add-on', they envisage marketing and values as being integrated, without separation. They say companies need to focus on creating products/services and entire organisational cultures, which are driven by the values of customers at a more multi dimensional, fundamental level – starting with the vision, mission and values of the company. Customers are looking for products/services that not only satisfy their consumer needs, but also address their spiritual needs, appealing to their head, their heart and their spirit. The key to this is customer participation and involvement, using all the channels of communication created by internet-based social media. They argue that to thrive in this interlinked world companies must collaborate with each other, with their shareholders, channel partners, employees and customers.

A firm's values should, if possible, be reflected in its value proposition to customers. They are part of its identity, upon which it hopes to base a trusting relationship with its customers. To do this the entrepreneur therefore needs to answer four questions:

1. What are the values they wish their business to embody? (see Chapter 7)
2. Which of these values differentiate them from competitors?
3. Which values are attractive and of value to their customers (i.e. they might find attractive *and* be willing to pay for)?
4. Can these values be incorporated into the value proposition? If so, how?

Explore further 8.2

Values-driven marketing

Access the Digital Links booklet to watch:

- A short clip from a lecture by Professor Philip Kotler on values-driven marketing.
- A Harvard Business Review interview with Professor Michael Porter on the importance of shared values in creating economic value.

SUSTAINABLE ENTREPRENEURSHIP AND CORPORATE SOCIAL RESPONSIBILITY

There is a long history of socially motivated entrepreneurs – from the chocolate maker J. Cadbury & Sons with its Quaker values, to the jam maker Wilkin & Sons. More recently companies like Lush (Case insight 11.5) and Timberland (Case insight 20.4) have managed to combine business and social values successfully – and in the process enhance their brand image and make substantial profits. Another approach to this issue in recent years has been the emergence of what has become known as 'sustainable entrepreneurship'. This is where issues of what is widely called 'corporate social responsibility' (CSR) – ethics, environmental sustainability and good corporate governance – are at the core of the commercial enterprise. It is said to be about meeting the needs of today through profit without prejudicing the future. Entrepreneurship that emphasises only economic and ecological value creation has been called 'environmental entrepreneurship', 'eco-entrepreneurship' and 'eco-preneurship'. In all cases the prime objective is to develop a profitable business that adheres to certain principles, usually emphasising them as part of its branding.

Social, environmental and ethical values are something that many individuals will identify with – whether entrepreneurs or customers. These can be reflected in the culture of a firm as well as its strategies and actions and ultimately translate into a distinctive and attractive brand identity. And they can even translate into profit. Firms may practise CSR for many reasons. Figure 8.2 depicts a hierarchy of virtue. At its base is CSR that delivers profit to the company. Next is CSR that comes through compliance with the law. Finally, there is CSR that is discretionary, based upon ethical norms and a desire to do the best thing for the community and society as a whole. Fortunately, this hierarchy is not always contradictory and CSR can make both sound commercial as well as ethical sense, particularly for companies selling directly to the public.

> *Any business model that orients only toward financial performance is neither sustainable nor desirable.*
>
> Frank Mars, Chair of Mars Inc., https://www.mars.com/about/mars-compass



Figure 8.2 Hierarchy of virtue

> *I think every business needs a leader that does not forget the massive impact business can have on the world ... What I see is demand from our people to be a business that is good, makes a profit, but also does something for the planet and humanity.*
>
> Richard Branson, www.hrmagazine.co.uk,13 July 2010

> *We're really noticing people's perceptions changing. More than ever they want products that are sustainable but without sacrificing style or quality.*
>
> Heather Whittle, founder of Beyond Skin, *The Sunday Times*, 28 June 2015

> *You can be eco-aware without being boring. It is really important that small businesses consider sustainability, and doing it without compromising the end product is crucial.*
>
> Chris Holmes, founder of Woodbuds, *The Sunday Times*, 28 June 2015

Sustainable entrepreneurship can offer both commercial and social benefits, and the more a firm can benefit from CSR, the more it is likely to integrate it on a strategic decision-making level, simultaneously increasing its effectiveness in promoting its CSR causes. Looked at strategically, sustainable entrepreneurship can be used to bring both social and economic goals into alignment and to leverage capabilities and relationships in support of charitable causes. This can create additional value for both the company and the causes it supports. As well as helping to achieve altruistic aims, strong CSR policy can have three sound commercial benefits:

1. Increased sales, brand identity and customer loyalty – While any product must first satisfy the customer's key buying criteria (quality, price etc.) a strong CSR brand can increase sales and customer loyalty by helping to differentiate it. Customers are increasingly drawn to brands with a strong CSR profile and CSR has become an element in the continuous process of trying to differentiate one company from another. A strong CSR brand can even create its own market niche for an organisation. For example, the Co-operative Bank in the UK has a long history of CSR. It has set itself up as an ethical and ecological investor with an investment policy that is the most frequently cited reason that customers choose the bank. On the other hand, a bad CSR image can severely damage sales, as BP found after the 2010 oil spillage in the Gulf of Mexico.
2. Reduced operating costs and productivity gains – One aspect of sustainability is about measuring and controlling inputs, and many environmental initiatives therefore also reduce costs (e.g. reducing waste and recycling, having better control of building temperatures or reducing use of agrochemicals). Yahoo! saved 60 per cent of its electricity costs simply by opening windows where servers are located so as to let the hot air out. General Electric started a programme of becoming more sustainable ('greener') back in 2004. Within four years this initiative had yielded $100 million in cost savings. Waste-reducing cost-savings can come from looking at raw materials usage, the manufacturing process, packaging requirements, transport needs, maintenance and the use of disposal methods. Actions to improve work conditions, lessen environmental impact or increase employee involvement in decision-making can improve productivity. For example, actions to improve work conditions in the supply chain have been seen to lead to decreases in defect rates in merchandise. Many social initiatives can increase employee motivation and cut absenteeism and staff turnover. An increasing number of graduates take CSR issues into consideration when making employment decisions.
3. Improved new product development – A focus on CSR issues can lead to new product opportunities. For example, car manufacturers are striving to find alternatives to fossil fuels, while developing conventional engines that are more and more economical. Innovation linked to sustainability often has major systems-level implications, demanding a holistic and integrated approach to innovation management. As well as reducing costs, General Electric's sustainability programme yielded 80 new products and services that generated $17 million in revenues in the first four years.

Porter and Kramer (2002, 2006) believed that social and economic goals can be aligned, leveraging capabilities and relationships in support of social and philanthropic causes while adding shareholder value. Kurucz et al. (2008) believed that CSR can create 'win–win situations through synergistic value creation' – linking economic and social goals.

However, you may ask whether there is any evidence that CSR specifically creates corporate value? The quest to link corporate CSR directly to financial performance and/or share price performance spans some 40 years and the results have often been contradictory and confusing. Nevertheless, in a review and assessment of 127 empirical studies, Margolis and Walsh (2003) concluded that there was a positive relationship between CSR and financial performance, a result supported in a meta-survey by Orlitzy et al. (2003). Looking at investment portfolios, Ven de Velde et al. (2005) concluded that high-sustainability-rated portfolios (ones that integrated environmental, social and ethical issues) performed better than low-rated portfolios. What is more, an Economic Intelligence Unit survey in 2008 showed that the vast majority of US business leaders and their boards of directors now accept a clear relationship between CSR and financial performance (Business Green, 2008).

In a review of the literature Carroll and Shabana (2010) concluded that on the whole a positive relationship exists between CSR and financial performance, 'but inconsistencies linger'. This is because

financial performance is affected by many other internal and external variables, not all controlled by the firm. In addition, 'the benefits of CSR are not homogeneous, and effective CSR initiatives are not generic'. They concluded that CSR activities need to be part of a coherent and consistent strategy that is directed at improving both stakeholder relationships and social welfare. They talked about 'a convergence between economic and social goals' – where social good is crafted into creating economic value. This requires CSR to be embedded into the business model for a product/service.

> *One of the most important aspects of any business is its ethical code, a statement of the principles governing the way it operates and its employees behave.*
>
> Duncan Bannatyne, serial entrepreneur, *Daily Telegraph*, 5 August 2009

Explore further 8.3

Corporate social responsibility

Access the Digital Links booklet to watch:

- A short talk by Professor Paul Burns on how CSR can be commercially beneficial.
- An animation that makes the business case for sustainability.

You can also explore the following web links:

- Planet Mark is a mark that assures customers that the organisation it is purchasing from is active in improving its environmental and social performance. Established in 2013 by the Eden Project and the sustainability consultancy Planet First, businesses achieving the mark are then helped to monitor their environmental impact and lessen it, as well as encouraging their employees, customers and stakeholders to take action.
- The Institute of Corporate Responsibility and Sustainability (ICRS) is a not-for-profit professional membership body established in 2014 by a number of leading companies to help promote CSR and sustainability through seminars and other events.

DIFFERENTIATION THROUGH BRANDING

The next challenge facing the entrepreneur is communicating this 'values-enhanced' value proposition that differentiates their product/service from that of competitors in the eyes of customers and consumers. And, unless they are face to face with customers, this can be complicated. Differentiation means setting out to be unique in the industry along some dimensions that are widely valued by customers. These can be based upon the product/service and can be tangible (observable product/service characteristics such as function, quality, design, performance or technology etc.) and/or intangible (customer needs such as status, exclusivity, ethical, social or environmental concerns etc.). Both elements can be reflected in the product/service identity and reputation – part of the business model. Often differentiation is more sustainable when based not just on tangible factors, which can often be easily copied, but also on intangible factors, which are not. So, for example, Mercedes-Benz cars and Dom Pérignon champagne differentiate themselves through product quality and status in their respective sectors. The UK retailer Lush differentiates itself through its bright, fun, shopping environment, novel products and its ethical values (case insight 10.5).



Source: Trung Do Bao on Unsplash

Case insight 8.2 The Entertainer

Family values

The Entertainer is the largest independent toy retailer in the UK, with over 170 stores and an online store called TheToyShop.com. It was founded by Gary and Catherine Grant in 1981 after Gary was made unemployed. It remains a family business with Gary as executive chairman and Catherine as a non-executive director; joined now by two of their four children, Duncan and Stuart. Duncan, who initially trained and worked as an accountant in London, joined the family firm in 2006 and is now deputy chairman:

> *'After a year working there [in the family business], I quickly realised that I couldn't really imagine working anywhere else … I think what I brought to the business is a sense of how you create processes and structures, in turn allowing the business to grow and expand.'**

His brother Stuart was involved with the business from the start and, having initially joined in a junior role, has worked his way up through the buying department to become global sourcing director. However, key roles are not just reserved for members of the family:

> *'On a regular basis we will question, are we the best owners for the business? Are we the right people with the right skills? … We have, over the years, changed our roles and brought in people where we feel it's the best decision for the business … We don't care so much what someone's surname is, the important thing is that we've got great people that run the business.'*

Preserving the founding values of the firm is important to the family – values such as honesty, integrity and kindness. The family has strong Christian beliefs and as a consequence the stores remain closed on Sundays – unusual in the UK. It also does not sell products deemed to have a connection to the occult, which led it not to stock Harry Potter merchandise. In line with its religious beliefs, the company also donates 10% of its profits to charities, including its own Grant Foundation and The Toybox Charity. It also encourages charitable giving by staff, who can donate to their selected charities through deductions from pay – matched by the company. In addition it encourages customers to round up the cost of their purchases made by credit or debit card and donate the additional sum to charity, an initiative called 'Pennies'.

The company's long-term orientation is shown by its consistent incremental growth which required investment and patience to see the returns. However, the retail toy business also needs to keep a sharp eye on short-term fashions, trends and development:

> *'When you're around people in the family that support you and you don't have to explain as much of what you're doing, you have that longer-term patience to see things through. Often changes in business take 5–10 years to come through…'*

However, Duncan also points out: 'If you don't think about the short term as well, then you don't stay in business long enough to worry about the long term.'

The firm also believes in developing lasting relationships with important stakeholders such as customers and staff. Staff long service and loyalty are rewarded:

> *'Long service really does get recognised … We have a ten-year club where we celebrate staff who have been in the business more than ten years, and that's about thanking them for giving their time and career to The Entertainer and to the Grant family.'*

Access the Digital Links booklet to visit the company website and to watch a video telling the story of Gary Grant, The Entertainer, and how, eventually, it developed values.

Questions:

1. How important are the religious beliefs of the Grant family to this business?
2. Why do you think the company does not use these beliefs and its charitable giving more as a way of differentiating itself?
3. If the company were to pass out of family ownership, could/should these beliefs continue to direct the actions of the business?
4. This is a private company. Could a publicly owned company operate in this way?

*Source:*All quotes are from Duncan Grant in IFB Research Foundation Working Paper: Clinton et al. (2019).*

Even companies competing primarily on price attempt to differentiate themselves not just through brand recognition. Dell may no longer have differentiated products but it attempts to differentiate itself on speed of delivery, uniqueness of personal systems configuration and other elements of service, while still maintaining a competitive price. McDonald's has a very recognisable brand associated with value-for-money meals but also tries to differentiate itself, in part, through consistency and quality of service (speed, cleanliness and so on). A business can differentiate itself therefore by 'bundling' these things in different ways – so long as the customer values the 'bundle' and cannot create the 'bundle' easily themselves. This bundle of features is often called the marketing mix and translates into customer benefits (Chapter 9).

One way of shortcutting the process is to develop a brand – with an identity and reputation – that encapsulates the value proposition and everything the entrepreneur and their company stand for. In this way the customer's script is written for them and articulation is easier. It is what companies like Apple have achieved with their brand identity. Apple is a lifestyle brand that stands for design excellence, simplicity and ease of use. It identifies the owner of its products as part of the exclusive Apple 'tribe' and therefore builds a relationship of loyalty with them. Its advertising reflects not only the product value proposition but also the company's identity. Values-based marketing involves having a strong brand identity which includes good customer relationships. It uses these things to the mutual advantage of both customer and company. The advantages of branding to both customers/consumers and product/service providers are shown in Table 8.4.

> *Customers relate to brands and the values it stands for more than the tangible aspects of a product.*
>
> Richard Branson, founder of Virgin Group, *The Guardian Media Planet*, May 2015

Michael Eisner, CEO of Disney, said that 'a brand is a living entity – and it is enriched or undermined cumulatively over time, the product of a thousand small gestures'. It should be the embodiment of the product or service value proposition to customers. Not only should it tell you what you are buying (the physical product or service) but also what you want from the purchase (the psychological benefits). So, for example, the Mercedes-Benz, Jaguar and BMW brands tell you that you are buying a car but, more importantly, all convey quality and status. Virgin is the embodiment of Richard Branson: brash, entrepreneurial, different, anti-establishment. Effective brands, therefore, are emotional, appealing to the heart as much as the head. However, many so-called 'brands' fall far short of this instant recognition of values and virtues, being little more than expensive logos allowing recognition of the physical product or service but conveying little else. What do the Barclays, Shell or BT brands convey, other than the knowledge of what the firm sells? Do they have a reputation? Do they try to develop a relationship? Brands should be more than just logos that identify the products sold. They should represent the very identity – the persona – of the product. And, just as you are more than a head, body, two arms and legs, so too any product/service should be more than the sum of its parts. The challenge is to create that brand identity.

Table 8.4 Advantages of branding

ADVANTAGES TO CUSTOMERS/ CONSUMERS	ADVANTAGES TO PRODUCT/SERVICE PRODUCER
* Clear product/service identity	* Conveys emotional aspects of the value proposition & helps develop relationships
* Clearer communication of value proposition	* Promotes product/service loyalty
* Aids with product/service evaluation	* Helps target marketing
* Reduction in risk when purchasing (homogeneity of offering)	* Defends against competitors (creates differential advantage)
* Can create additional interest or character for the product/service	* Allows higher prices to be charged * Increases power in distribution channels

Case insight 8.3 Zound Industries

Branding and design

Zound Industries makes headphones and speakers. It was founded in 2008 by eight individuals with different backgrounds in design, product development, finance, marketing, sales and business. It has made a mark in the technology industry by bringing distinctive design to bear on headphones, merging the function of a sound-source with fashion accessories targeted at different markets. Zound is one of the fastest-growing companies in Sweden, with a turnover in 2019 of SEK 2.0 billion and some 250 employees. It has offices in Stockholm, New York, London, Paris, Hong Kong and Shenzhen, where most of the equipment is manufactured. By 2020 it had released some 70 headphone designs, branched into speakers and was working with Marshall and Adidas brands.

Many younger people identify with certain lifestyles and 'tribes' of people through the clothes and trainers they wear. Zound is about the ability of design to help customers identify the 'tribe' they belong to also by the headphones they wear. It tries to combine good functional technology with brand identity and distinctive design. Zound's mission is to 'create unique experiences in the intersection between lifestyle and tech'. Its vision is to 'create products that define our time'. To do that it makes extensive use of market research to provide customer insights and identify trends in both lifestyle and technology. It uses design to adapt sound technology to different uses and lifestyles (e.g. jogging, commuting etc.), at the same time creating a distinctive look.

Zound now has three brands of headphones and mini-speakers, each range targeted at a different market:

- Urbanears: These were the first headphones developed and produced by the company. Launched in 2009, it is the company's biggest brand. It is minimalist and fashion-orientated, at a mid-point price range. Mini-speakers were added to the range of headphones in 2017.
- Marshall: This iconic brand with a unique musical heritage was licensed from the UK amplifier company. Launched in 2010, it is a range of quality headphones and speakers that sells to the high end of the market. It mirrors the distinctive look of Marshall amps and, by working with Marshall Amplification, also mirrors the distinctive sound quality. In 2018 the licence agreement was renewed for an additional 15 years and Marshall became a shareholder in Zound, with a director on its board.
- Adidas: Adidas is one of the world's biggest sports and lifestyle brands and Zound has a licence to use the name on a range of headphones, the first of which was launched in 2019. This range is designed for activity and sports and uses light-weight components and tangle-free cords.





The company had two other product ranges that have now been discontinued or merged with the current one. Coloud (launched in 2009 alongside Urbanears) was a cheaper range of headphones targeted at the young and active, seen as the headphone equivalent of a Swatch watch. Molami (launched in 2011) was an ultra-high-end, female-focused fashion range, incorporating materials like leather and silk.

Zound set its sights on going global from its very beginning. It has developed new products (and dropped less successful ones) and new markets with relentless effectiveness. A New York office was opened in 2014 and by 2019 sales in the USA were SEK 288 billion, making it Zound's biggest single market.

Its distinctive design-led products are targeted at specific markets:

> *'From the time a product is developed to the day it is sitting on a store shelf, it has been strategically thought through how to create, market, and distribute it and which brand the product will be sold under. This way, multiple demographics are reached.'*

Brand identity is important for Zound. To support and promote its products it hosts high-profile Swegie events showcasing Swedish design, culture and creativity that coincide with fashion weeks in cities around the world, making certain they all have a 'celebrity' feel. Thousands of articles have featured the company's products, in publications such as *Vogue* (US), *Elle* (US) and *Time*.

Zound's success has also been based on its ability to partner with others. Starting at the very beginning the founders had a range of skills and experience. They described themselves as a 'collective'. It has sought additional capital systematically at different stages of its growth, starting in 2009. It has partnered with different distributors in different countries and even produced joint-branded products with the retailer H&M. In 2014 it announced a partnership with Swedish telecom operator TeliaSonera, who acquired a stake in Zound. The aim was to bundle fashion headphones, audio speakers and device accessories together with TeliaSonera's mobile telecommunications.

Access the Digital Links booklet to visit the company website and to watch a video which shows the Zound product range and demonstrates the target markets for their three brands.

Questions:

1. Why has Zound licensed the names of Marshall and Adidas for its products?
2. Describe who you think are the target market customers for each of the three brands. How are they distinctive and different? How are the emotional (right-brain) and practical (left-brain) needs of these four target groups different? What are the implications for how each brand is marketed? What is the role of brand and design in this?
3. If this is a fashion brand, is it sustainable? If so, how?

BRANDING THE FIRM'S VALUES

It is a common misconception that only large companies can have 'brands'. The name of a local tradesman is often their 'brand' and that name may stand for many things like quality of service. They will place great store on their local reputation. What is more, a good tradesman will take time to develop a personal relationship with their customers – something big companies have difficulty doing – and that relationship will be based on trust that they provide 'value for money' and respect that they will do a good job. When customers have a good relationship with a reputable tradesman they will often recommend them personally to friends. And all of this costs infinitely less than the expenditure large companies make in developing their brand – and it can be infinitely more effective.

Consumers tend to form relationships with brands in much the same way as they form relationships with people (Aaker et. al., 2004). And a recognisable brand that resonates with customers can outlive its founder and can be a vehicle for growth for the company that has real commercial value. However, differentiation of any form usually adds costs – even if it is just taking time to talk to customers – and branding can be expensive. It is therefore essential that branding not only succeeds in creating an identity for the product/service that is seen as different to that of competitors, but that the benefits to the customers are seen by them as outweighing the costs. In other words customers are willing to pay the extra costs involved in conveying the reputation and developing a relationship. The value of reputation to the customer is about risk reduction – the assurance that the product/service offering will be consistent or homogeneous. The value of the relationship is based on trust that the reputation is accurate. So, all of the promised product/service benefits (physical and psychological, including CSR) must be delivered consistently. Trust and reputation are difficult to establish but easy to lose.

> *More than ever, consumers expect brands to be environmentally aware. They want to invest financially and emotionally in a product and, at start-up, you can't ignore that.*
>
> Chris Holmes, founder of Woodbuds, *The Sunday Times*, 28 June 2015

> *Branding is valueless if consumers get home and are disappointed with the product.*
>
> Simon Smith, Head of Brand for The Saucy Fish Co., *The Observer*, 29 September 2013

BRAND NAME AND LOGO

Brand and company names need to be distinctive and easy to remember, say and even spell across different cultures and nationalities. This implies short names are best. It is important that they do not have negative associations or that names do not mean bad things in other languages. Names should be supportive of the value proposition. This is not always easy or straightforward. 'Freeserve' was a good brand name for one of the first UK internet service providers – it was free. However, in 2004 it was changed to 'Wanadoo' because the name was easier to market across Europe. In 2006 it was again changed to 'Orange' as the company's product offering was expanded to include internet and telecommunications. Because it adds value to the company, a brand name and logo can and should be trademark protected if possible (Chapter 11).

There are no hard-and-fast rules about using the company name as a product name. Sometimes this works, particularly when it is a one-product company, but there are examples of successfully using different company and product names alongside each other. 'Burger King' is a successful company brand that describes at least the major part of the company's product range. It is associative – suggesting some characteristic or benefit of the product, albeit sometimes in an indirect way. In this way 'iPhone' is another associative product brand name, but this time is used alongside the company name 'Apple', which has a different set of brand associations. This is a freestanding name that has built brand value over a number of years. Some company names have been less successful in transferring across product ranges. For example the Dyson brand name is based upon the inventor/entrepreneur James Dyson, but is still very much associated with vacuum cleaners, although the company now offers a range of electrical products.

BUILDING THE BRAND

> *The key thing is never to do anything which discredits the brand, like ripping off the public or doing something which you'd feel uncomfortable reading about.*
>
> Richard Branson, founder of Virgin Group, *The Observer*, 14 September 2014

As we have seen, in a world where products and services are often all too homogeneous, a good brand is a powerful marketing tool that must be the cornerstone of any strategy of differentiation. It also helps to cement customer loyalty. The brand must reflect the promise of the value proposition and the personality or culture of the organisation that offers it. Support for social and ethical causes can reinforce this, as well as often making good commercial sense. Building a brand takes time. It is built up through the effective use of communication media and is recognised through the company name and logo. But the brand values need to be designed into everything the company does.

At this stage a start-up may not have a recognisable brand like the ones cited, but it is never too early to start developing one. In many ways shaping the identity of a start-up is easier than trying to shape one later on. There are fewer variables to deal with. The founder can start to shape the identity of their business based upon their own values and beliefs, underpinned by what the big companies call CSR. The trick is to understand what these are and to make them explicit and clear. The founder can then find partners and recruit employees who share these values and beliefs (Chapter 14). Together they can ensure that they are reflected not only in what the firm does do, but also how it does things – its personality or culture. This requires strong leadership – a topic we return to in Chapter 16.

Explore further 8.4

Branding

Access the Digital Links booklet to watch a short animation on the value of branding.

Case insight 8.4 Cotton On Group

Values-driven marketing

Back in 1991 Nigel Austin was studying business at university and was short of cash, so he started selling acid-wash denim jackets from the boot of his car at the markets in Geelong, Australia. He bought the jackets from his father, a clothing wholesaler. The jackets sold well and, finding trading addictive, he decided to open a shop, also in Geelong. Today he is still selling denim jackets – as well as T-shirts, jeans, checked shirts, dresses, sweaters, bras, undies and homewares. The difference is that his Cotton On Group (COG) has grown to become Australia's largest value fashion retailer selling fashionable, everyday, leisure clothing at value-for-money prices and quality through over 1,500 stores in 18 countries around the world. Sales in 2018 were approximately AUD 2.59 billion. And yet, the company remains a privately owned family business with its Australian business operating under a series of discretionary and unit trust structures with no requirement to file statutory financials. Relatives of Nigel and his wife hold many key positions in management and its global headquarters still remain in Geelong, Australia.

COG has a multichannel strategy with brands aimed at a number of niche markets. It has a number of its own clothing brands: Cotton On, Cotton On Body, Cotton On Kids, Sunny Buddy (kids), Factorie (youth), Supre (female youth). It also has Rubi Beauty and Rubi footwear, Typo stationery, as well as a travel accessories brand Lost. It is known for its intimate knowledge of its target customers, who are mainly young and value-conscious, and its ability to keep abreast of new trends in the industry and then to move quickly to meet them. Range reviews are conducted for each brand every quarter. Products are designed by a team of designers and trend forecasters, with a turnaround time between design and manufacture of two to eight weeks, depending on the category. New products are delivered to stores daily and new ranges arrive every week.

Critical to this retail model is the timing of design and production and key to this is its supply chain and sourcing strategy, which allows COG to offer quality products at the cheapest possible prices. COG was one of the first Australian retailers to move to direct sourcing and adopt a fully vertically integrated supply model. This allows for rapid replenishment of stocks and generates a higher margin. Products are manufactured by some 560 suppliers, mainly in China and Bangladesh, and are sent by sea freight to eight distribution centres around the world. The company still uses many of the same suppliers it started out with, as Nigel explained:

> *'We're still dealing with the same factories today. The 30-piece orders they were doing at the time were probably an inconvenience for them, now they're doing significant business with average runs these days around 5000 pieces.'*

However, direct sourcing also exposed the company to supply chain and reputational risk because of the various scandals over the use of cheap labour and unsafe working conditions. Despite establishing an ethical sourcing programme some years earlier, COG was criticised for being slow to sign an international fire and building safety agreement which compelled retailers to improve fire safety conditions and pay for factory workers in Bangladesh after the clothing factory disaster in 2013. Jacqui Hennessy, COG head of risk and compliance, explained:

> *'The delay in signing the fire and safety accord was so we could do our own due diligence. We wanted to make sure if we were going to sign and commit to five years it was going to enhance our own program.'* (The Sydney Morning Herald, *2 April 2015)*

Also important in keeping costs low is the ability to find retail spaces that are relatively inexpensive, so that the capital investment can be kept low. However, with fixed costs still high for most retailers, stores need to be filled with as many customers as possible and part of the company's marketing strategy involves encouraging something they call 'dwell time' – the time customers stay in stores – and trying to make them 'retail theatres'. COG stores offer phone-charging stations, roomier fitting rooms, free yoga sessions, kiddies' play areas and even DJ decks and photo booths. The aim is to create 'stickiness' between customers and the COG brand.

Cotton On Foundation

After the birth of his first son in 2007, Nigel established the Cotton On Foundation. The Foundation raises money and organises charitable work through COG staff for communities in Uganda, South Africa, Thailand and Australia. Most of its work has been in Uganda where it helped provide water and sanitation, education and meals as well as meaningful employment. Its aim is to break the poverty cycle. It organises work for COG staff such as building schools or digging bore holes and raises money from events, selling cloth bags, bottled water, mints, coffee etc. in the COG shops. Photos of staff undertaking the work adorn the office walls and are displayed in stores to raise the profile with customers. By 2018 the Foundation had raised over AUD 100 million, with some 90% going directly to projects.

The Foundation's aim is to 'inspire lasting positive change with limitless possibilities'. It tries to engage participants in ethical, fun and entrepreneurial projects that build 'deep trust and mutual respect with our communities, customers, partners and team members'. Its projects are based on four pillars derived from the United Nations Millennium Development Goals: health (targeting the reduction of child mortality and HIV prevention),

education (providing primary and secondary education and school meals), sustainability (encouraging and funding community projects) and infrastructure (building schools, dams, wells, health centres etc.). They form the basis of every project undertaken by the Foundation.

Access the Digital Links booklet to visit the COG and the Foundation websites and to watch a video telling the COG story and explaining what the brand represents. There is also a video showing how the Cotton On Foundation mixes charitable and commercial objectives.

Questions:

1. What are the main elements of COG's business model?
2. What are the critical success factors and how might these change as the company expands internationally?
3. How important is the Foundation to the COG brand image?
4. Why is this concept of 'dwell time' important for a retailer?

SUMMARY

- Customers buy the benefits (solutions to problems) of a product/service. These benefits are represented in tangible form by the features of the product/service and the marketing mix is simply this bundle of features, often called the 'Five Ps'.
- The value proposition is a summarised statement of this unique mix of benefits. These benefits can be physical, psychological and even emotional and can be tailored to meet the needs of identified market segment(s). Particularly when linked with a strong brand identity, they differentiate a product/service from those of competitors.
- Branding communicates the product/service offering to the customer and is the start of developing a relationship based upon trust that mutually benefits the customer and the firm.
- Brand identity should reflect the value proposition presented to customers and be underpinned by the values of the firm, reflecting its personality or culture. This can be created by the firm based upon the founder's values and beliefs. A strong brand identity creates a trust-building reputation that a product/service will deliver its value proposition.
- Values-driven marketing aims to combine relationship marketing with brand-based marketing – encapsulating certain values in the brand that are attractive to and involve the customer. It encourages customers to become loyal advocates of a product/service by involving them in aspects of marketing and product development.
- As well as being worthwhile in its own right, CSR can be used to underpin brand identity and convey evidence of values and beliefs. It can also make sound commercial sense by cutting costs, enhancing brand identity, creating commercial opportunity and improving staff motivation.

GROUP DISCUSSION TOPICS

1. Is market segmentation an art or a science?
2. How can you group together customers in a useful way?
3. We spent most of the twentieth century creating mass markets and will spend most of the twenty-first breaking them down. Discuss.
4. Customers buy services not products. Discuss.
5. Every product or service is different. Discuss.
6. Why are values in business important? Are they ever dangerous?
7. Why are ethics in business important?
8. Can you make more money in business being ethical or unethical?
9. The law defines the extent of our ethical and social responsibility. Discuss.
10. The law says that avoiding tax is legal but evading it is illegal. Large multinationals like Starbucks, Google or Dell are therefore perfectly within their rights to move profits around the world to countries with low tax rates. Discuss.
11. SMEs cannot move profits around the world to countries with low tax rates. Companies that do this have an unfair competitive advantage. Discuss.
12. Is it ethical to make profit from ethical and social values?
13. Why is branding so important?
14. What makes a good brand?

15. Is creating a brand more or less difficult for SMEs than for a big company?
16. How can SMEs develop a brand without the resources big companies have to publicise it?
17. How can you 'communicate' a brand image?
18. Why are people willing to pay quite high prices for bottled water when it is free from the tap?

STUDENT ACTIVITIES

1. Select two products in everyday use. One a cheap commodity-type product, the other a more expensive 'luxury' product:
   a) Describe the target market segments these products sell to.
   b) List their features and translate them into benefits for these market segments.
   c) Describe the value proposition for each of the market segments the products sell to.
   d) Explain how a business model based upon this value proposition can be delivered. What are the business imperatives? What role does price play?

START-UP ACTIVITIES

1. Describe as best you can the target market segment(s) your product/service is aimed at.
2. List the features of the product/service and translate them into benefits for these market segments. Assess the relative importance of these benefits against each market segment (1 = low, 10 = high). What does this tell you?
3. Describe the value proposition for each of the market segments the product/service is aimed at. You can use the template on page 180 if this helps.
4. Write down the message you want your brand to convey – its identity. Brainstorm how this might be crafted into a simple, coherent message. Are there any images you can incorporate? Brainstorm whether there is an appropriate name and/or logo for your business that is consistent with this brand identity.
5. For the main competing product/service, repeat activity 2. What does this tell you?

9

DEVELOPING THE MARKETING MIX

Contents

- Differentiation through design
- Routes to market
- Understanding customers and consumers
- Channels of distribution
- Pricing decisions
- Pricing decisions and volumes
- Pricing decisions and contribution margins
- Pricing 'knowledge products'
- Pricing decisions and competitive reaction
- Developing the marketing plan
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: iStock.com/andresr

Learning outcomes

When you have read this chapter and undertaken the related exercises you will be able to:

- Understand how design can help reinforce a brand image and differentiate a product/service;
- Understand that there are different routes to market and be able to critically evaluate different channels of distribution and their requirements;
- Understand how costs and volumes impact on pricing decisions;
- Make pricing decisions based upon different competitive situations.

Case insights

9.1 Apple and design

9.2 Lara Scobie, ceramicist

9.3 UK Sofa-beds*

9.4 Fortnite: Battle Royal

9.5 Flying Tiger Copenhagen (1)

DIFFERENTIATION THROUGH DESIGN

Chapter 8 explained how customer benefits are represented in tangible form by the bundle of features of the product/service offering called the 'marketing mix' ('Five Ps'). The challenge is to engineer these features so as to deliver distinctive benefits that customers value, and craft them into a marketing plan. But, as we have seen, features can be many and varied, covering all the elements of the marketing mix, and combined in almost endless variations. One important weapon in the armoury of the marketing mix is design. Chapter 6 highlighted how 'design thinking' can be a different lens that is worth using in looking at a new business idea. Combined with branding, design is an extremely effective way of identifying and differentiating a product/service from those of competitors. Good design can help not only improve the functional performance of a product/service, but also make it distinctive. It can make a product/service aesthetically pleasing and can help convey emotions that functionality cannot. Studies have shown that for every £1 invested in design, businesses can expect turnover to increase by over £20 and profit by over £4 (Design Council, 2012). SMEs may not have the money to spend on design that big companies have, but, nevertheless, design is not something that can be ignored, particularly if it is part of your value proposition.

Apple has a track record of using outstanding design to create competitive advantage. The launch of its iconic iMac in 1998 created a paradigm shift in the market for desk-top computers (Case insight 9.1). Apple still combines high quality with easy-to-use product functionality and elegant design. This even extends into the packaging of Apple products. The design features of its products are promoted as part of its marketing strategy to create a fashionable, distinctive and desirable brand that allows it to charge high prices for its products. For Apple, all the elements of this marketing mix, including design, must be consistent, mutually reinforcing the brand identity and the value proposition of individual products. Design and branding add extra layers to a differentiated product – shown in Figure 9.1. The functional qualities of the product/service (appealing to the left-brain) can be enhanced through the aesthetics of design (appealing to both sides of the brain) and reinforced by the emotional values associated with the brand (appealing to the right-brain). The more points of appeal (left- and right-brain) and differentiation from competitors, the more sustainable the competitive advantage.

Good design may cost money but it is not just for large companies like Apple. Nor is it just for products. A small up-market restaurant understands that the design of its restaurants – its decor, layout and ambiance – is just as important as the quality of its food and service, making it able to charge higher prices than other restaurants. The important thing is that all the elements that contribute to the brand image are consistent and mutually reinforcing – and at the core of that is the product/service itself. If you have ever bought something because of fancy advertising or packaging and then been disappointed by the functionality of the product itself, you will realise that this can turn a customer against a brand. They feel cheated and lied to. Good design, however, can be expensive and it is therefore important that it can be seen to provide tangible benefits (to both the company and to its customers) that outweigh the additional costs.

A report by Warwick Business School and the Design Council (Micheli, 2014) highlighted how design can add value to any organisation but it would add most value when customer-centred and focused on solving customers' problems. However, design also needs to be culturally embedded within the organisation. The report made eight recommendations, aimed mainly at larger companies but with obvious implications for smaller, entrepreneurial companies:

1. Design is about making a company stand out from the competition, and is therefore valuable in any sector and for any size of company.
2. The focus should be on the needs of customers and how these might be better met in different ways rather than what is currently offered by competitors.

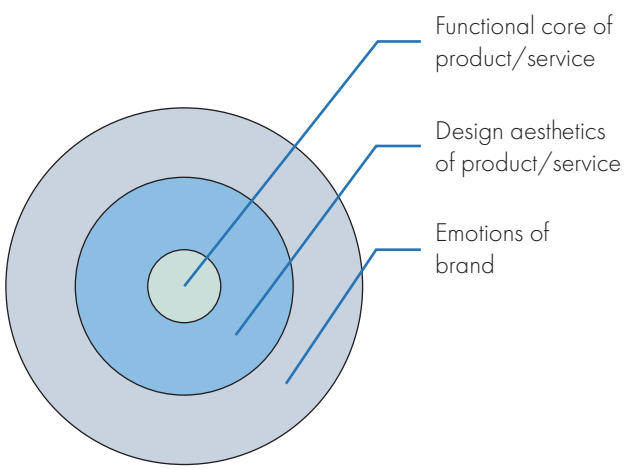


Figure 9.1 Layers of differentiation

Case insight 9.1 Apple and design

Design and competitive advantage

The original Apple iMac (G3) with its teardrop or gum-drop shape was designed by Jonathan Ive, a bathroom designer who rose to become chief design officer at Apple. It was launched by Steve Jobs in 1998 under a year after his return to Apple. It was the first Macintosh computer to have a USB port but no floppy disk, allowing other hardware manufacturers to make peripherals compatible with the Mac. But more importantly its friendly, translucent candy-colours and futuristic form made it stand out from other desk-top computers of the time. It changed how people perceived computers and created demand because of its form rather than just its function. Design was driving innovation and creating paradigm shift.

Apple has continually revolutionised the consumer electronics industry. It helped usher in the age of the personal computer in the 1980s with the sleek, affordable Macintosh; kick-started the age of digital-music with the iPod and iTunes in 2001; and laid the groundwork for the now ubiquitous smartphone with 2007's iPhone and iOS operating system. While other makers of phones and tablets buy the same off-the-shelf chips as their competitors, Apple designs its own chips, although they are manufactured largely in China. Consequently, an iPhone has a processor designed to optimise Apple's operating system, apps, display, camera and touch sensor. This attention to design detail even extends into the packaging of Apple products. The design features of Apple's products are promoted as part of its marketing strategy to create a functional but fashionable, distinctive and desirable brand that allows it to charge high prices for its products. For Apple, all the elements of this marketing mix, including design, must be consistent, mutually reinforcing the brand identity and the value proposition of individual products. The functional qualities of the product/service can be enhanced through the aesthetics of design and reinforced by the emotional values associated with the brand. The more points of differentiation from competitors there are, the more sustainable the competitive advantage.

Nevertheless, there are limits to how much customers are willing to pay for good design, even for an iconic brand like Apple. The year 2019 saw a dramatic fall in Apple's stock market valuation as turnover shrank and sales of iPhones fell, particularly in the Chinese market where competing Chinese brands offered similar or better functionality at more competitive prices. iPhones are available in China because, unlike competitors such as Google, Apple agreed to store users' data on Chinese servers and offer only 'approved' apps from its App Store. By 2015 Apple was selling more iPhones in China than in the USA. However, sales stagnated and, it is thought by analysts, started falling in 2017. While iPhones account for about half of the smartphones in the USA and UK, they now only account for 9%



Source: Daniel Fazio on Unsplash

of the Chinese market, placing it in fifth place behind domestic manufacturers Huawei, Vivo, Oppo and Xiaomi. Apple's strategy of focusing on the Chinese market and constantly raising the price of its iPhones, trying to persuade customers to replace their existing models with the latest ones, was no longer working.

To compensate for the reducing income from its hardware, Apple has turned to its software and other services, in particular its App Store. Launched in 2018 with a stock of 500 apps, by 2020 this had grown to 2 million, with Apple charging 30% commission on in-app sales. Games are the single biggest source of revenue from the App Store and Apple takes 30% not only from the sale of the game (many are free) but also from in-game purchases. Sales through the App Store often go through Apple Pay. But in 2020 the European Commission opened an anti-trust investigation into the App Store and Apple Pay because of their restrictive practices. In China many Apple services, like Apple Pay and the app Store more generally, are less widely used than in the West. In China the Android-based WeChat is the dominant messaging App and this is also used as a portal for finances, games and music because it can be used on a range of non-Apple phones. This is a double problem for Apple, which earns significant profits from sales on its App Store, since it has been estimated by analysts that up to half of App Store's revenue between 2017 and 2018 came from China where gaming apps are particularly popular.

The problem for Apple is that, despite massive investments in R&D, there appear to be few really innovative physical products to replace an ageing portfolio. Although sales of the Apple Watch and AirPod headphones seem strong, sales of iPads and Mac computers are also down. Apple is said to be working on driverless cars but is far behind Alphabet's Waymo. It has invested in augmented reality but this seems to have few immediate applications beyond gaming. The problem

with the design of physical products more generally is that it can be copied and improved upon, even with its IP protected. Increasingly, other factors need to be 'designed' into the product/market offering.

Access the *Digital Links* booklet to visit the company website and to watch a video showing how Apple use design to gain competitive advantage.

Questions:

1. Why and how did the original iMac change customers' views about home computers?
2. Why are sales of iPhones declining in China?
3. Does physical design create sustainable competitive advantage?
4. What is the relationship between virtual products and the physical product they operate on? How do you decide on pricing policies when sales of one product such as the iPhone impact on the sales of another such as the App Store?
5. What other factors might be 'designed' into product innovations?

Sources: *The Sunday Times*, 29 April 2018 and *The Sunday Telegraph*, 6 January 2019

3. Design is successful when it embodies and reinforces the brand, and speaks a language that is consistent with it.
4. Design processes need to be clearly structured, strongly led with a clear vision, but collaborative, involving all key stakeholders and functions.
5. Design innovation needs support at the highest level in the firm so as to engender trust among those involved in the process.
6. Problem-solving design needs to be embedded in a firm's culture.
7. Design should be present in the work environment, enabling collaboration, exchanges of ideas and teamwork.
8. For strategic design to work, designers have to be able to work in cross-functional teams and act as influencers who champion design. They have to be capable of using and understanding different languages and perspectives and be fully aware of commercial considerations.

ROUTES TO MARKET

It can be difficult to identify the benefits customers are looking for when they purchase a product/service. Part of the reason is that often the end-user is not the only customer. Not all products/services are sold direct to the end-user. They might be sold through various distribution channels and each link in the chain, as well as the end-user, is looking for benefits. And each link in the chain can be influenced by the marketing plan.

Let us take as an example the simple pen and look at the benefits customers might be looking for and how marketing might enhance those benefits and influence the customer. One type of pen is the cheap, disposable ballpoint, bought simply as a writing implement. Clearly, its core value proposition to end-use customers is based upon low price/cost, and the pen manufacturer needs to drive down costs and drive up volumes. Pens of this sort sell for a few pence in volumes of 100+, but for more when sold individually (although still very cheap). These pens typically have a low-cost, functional plastic shell, usually with a cap. Two end-use market segments might be private customers and organisations with employees needing pens. The characteristics of these segments and the routes to market are shown in Figure 9.2. Our pen manufacturer needs to understand the benefits these two segments are seeking. They are looking for a pen that writes satisfactorily and can be conveniently purchased, but is also cheap and therefore disposable (although doing this in an environmentally friendly way may also be important). If new technologies produce cheaper, more convenient ways of writing or passing messages, these customers may stop purchasing pens altogether – which is happening because of smartphones and computers.

Our pen manufacturer also needs to understand the routes to market, shown in the lower part of Figure 9.2. Channels of distribution are important for this product and each channel will be looking for different benefits – typically profit and product availability. If they do not get the benefits they are looking for, the end-use customers may never be offered the product, no matter how good it is.

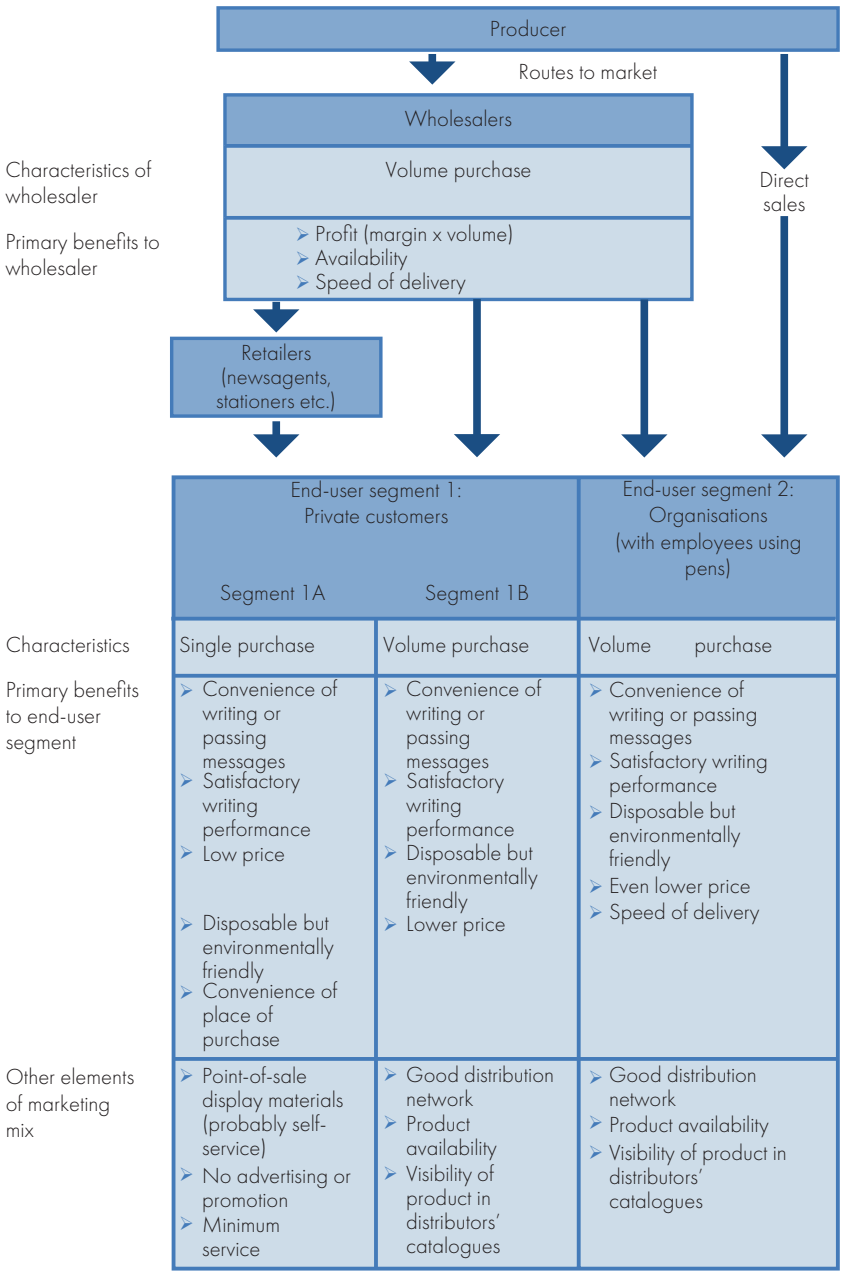


Figure 9.2 Features, benefits and marketing mix for plastic pens

Consider the route to market for the single-purchase private customer (segment 1A). Convenience of purchase is their primary consideration. No advertising or promotion is expected and service is non-existent, as pens are probably sold on a self-service basis. Other elements of the marketing mix are relatively unimportant, so there is strong price competition from manufacturers of similar pens. These customers purchase the pen through retailers like newsagents or stationers. Retailers buy in bulk through wholesalers. The benefit that retailers, like wholesalers, are looking for is profit – which means the higher the margin to them, the more attractive the product and the more prominently they are likely to display the pen. Indeed, they may be persuaded to stock only this pen rather than those of competitors (called 'supply-push'). The margin must, however, be sufficient to satisfy both wholesaler and retailer. The retailers might be encouraged to purchase the pens because of 'free' point-of-sale displays. At the same time, just-in-time deliveries, with increased delivery reliability and improved distribution times, may allow wholesalers to both decrease their inventory costs and reduce stock-outs – real benefits that help differentiate this manufacturer from others.

Private customers buying in large volumes (segment 1B) and organisations buying for their employees (segment 2) may buy these pens in bulk from wholesalers. They expect lower prices than those offered by the retailer, as well as speedy, reliable delivery. Pens selling through this distribution channel will not need point-of-sale display materials but may need different packaging. Discounts may be offered based upon volumes purchased. The wholesaler may need to invest in a catalogue, website, advertising and a direct sales force. The pen must be prominently displayed, or at least easily found, in the catalogue or website. The pen manufacturer might also decide to sell direct to these end-users, but they would have to invest in a catalogue, website, advertising and a direct sales force – things that may not be their core activities.

One way of stimulating end-user demand is to advertise directly to the end-user and persuade them to seek out the product from the distributor (called 'demand-pull'). This only works if the product they are seeking is highly differentiated (e.g. through branding), so it is unlikely to work for this sort of pen. The less differentiated the product, the less likely this strategy is to work. However, an innovative start-up may decide to bypass the established distribution channels and sell directly to the end-customer. But this is likely to involve extra costs such as advertising, distribution, delivery etc., which may not be commercially viable.

This disposable pen example underlines the fact that customers buy benefits, not features, and there is a need to understand the benefits offered to both end-use customers and distributors. The marketing mix should be tailored to meet the needs of customers and consumers at each stage in the chain. Each element of the marketing mix needs to be consistent with and reinforce the other. This is what the marketing plan should demonstrate. And the marketing plan will have implications for other elements of the business model, from the operations plan to the resources needed. It will determine costs and revenues and have implications for the risks the business will face.

UNDERSTANDING CUSTOMERS AND CONSUMERS

Not all pens are the same and not all customers are consumers of the product/service. Some pens are bought by a customer as a gift for the ultimate consumer. And, again, we need to offer benefits to both the customer and the consumer. While a gift pen must perform the basic function of writing, it is likely to look very different and to have a very different marketing strategy, with a value proposition based upon high differentiation rather than low price. Two market segments and the benefits they are looking for are shown below, in Figure 9.3. The routes to market are likely to be the same as the disposable pen, although in this case retailers are likely to be gift shops or department stores. Smaller gift shops might go through a wholesaler, while department stores might purchase direct from the manufacturer. As in the previous example, retailers and wholesalers are looking for profit, but in this case purchasing smaller volumes at a higher price, but expecting to make a higher profit per pen when they sell it on.

For both the customer and consumer, the pens must be functional and well made, high quality and elegantly designed. The other elements of the marketing mix are also important. The pen will have prestige branding with guaranteed quality performance. It will come housed in an attractive gift presentation case and is advertised and promoted at times of gift-giving as prestigious and something that values the 'worthiness' of the recipient. If sold in a shop, it will probably be kept in a glass display stand that can be accessed only with the help of a shop assistant. If the pen is sold to an organisation, the organisation will probably want the opportunity to be associated with the brand by having their name put on the pen, although they will probably still expect a discount if ordering in bulk.

The point here is that the customer wants to spend, say, £50 on a prestigious gift for the consumer – one that conveys a message to them about the feelings of 'worthiness' the customer has for them. The brand and what it conveys – reinforced by the design – are probably more important than the functionality of the pen itself. This is the benefit they are looking for. A low price is not consistent with the message and the benefit sought. And a box of 500 cheap, disposable ball point pens is not a substitute gift, even though they are likely to last longer than the expensive pen. They just do not provide the right benefits. Competition comes from other gifts costing the same that convey a similar message.

Putting together a bundle of benefits through a consistent marketing mix for each target market segment is the key to an effective marketing strategy. It is not easy. There is no blueprint to work from since most products/services and their markets are different. And, while studying an industry can

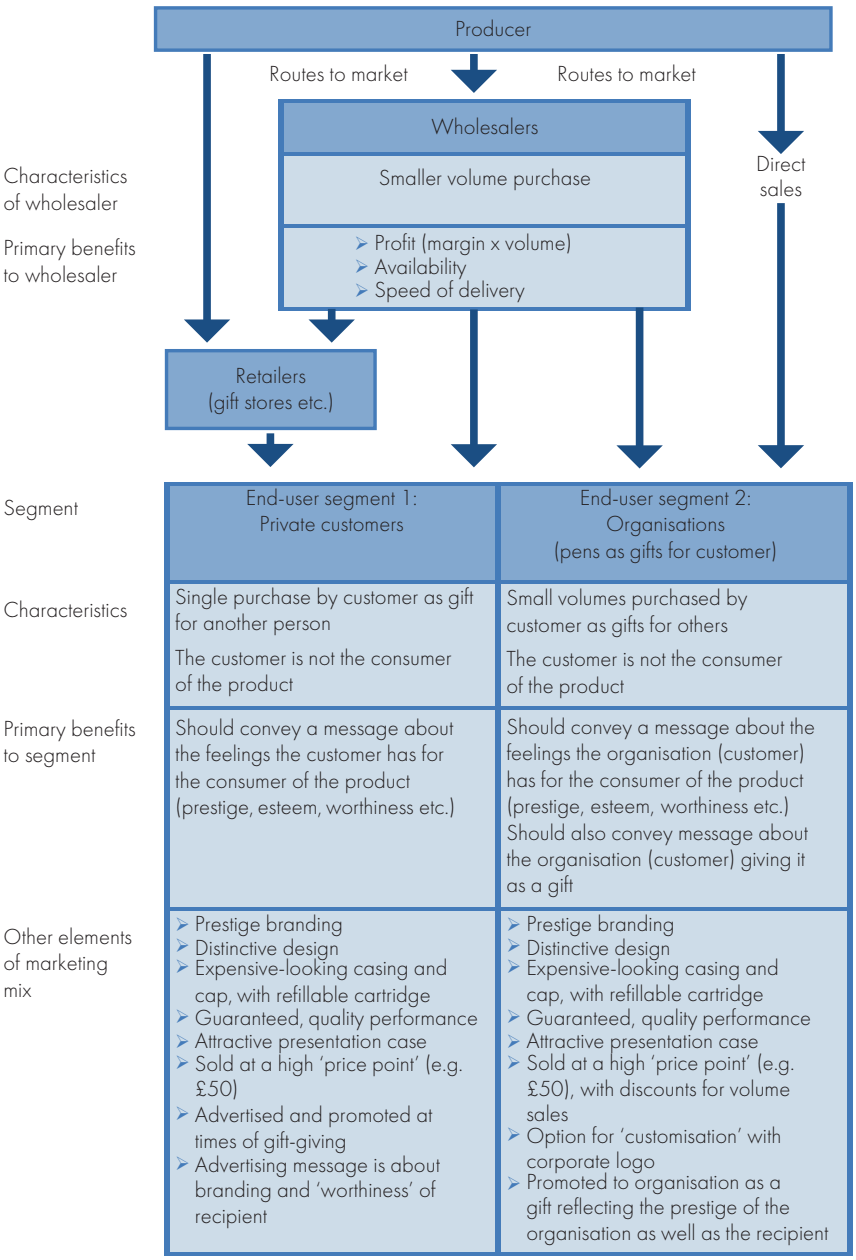


Figure 9.3 Features, benefits and marketing mix for gift pens

tell you how competitors currently do things, this is no guarantee for the future. Indeed, daring to do things differently can be very profitable.

CHANNELS OF DISTRIBUTION

Channels of distribution need careful consideration whatever a firm is selling. Using retailers, wholesalers or agents for physical goods or app stores and referrals for virtual goods may extend market reach, but each link in the chain is important and is looking for benefits, of which profit is probably the most important element. A firm does not control its distribution channels directly, it influences them, usually with money – and this eats into profits. On the other hand, if it decides to sell directly to customers, its revenues may be higher but so too are its costs. For a physical product selling direct to customers, direct sales costs might include a direct sales force, costs of developing a website, online and/or telephone sales team or agency, advertising and mail/delivery costs. Figure 9.4 shows the typical channels of distribution for a physical, consumer and business-to-business product.

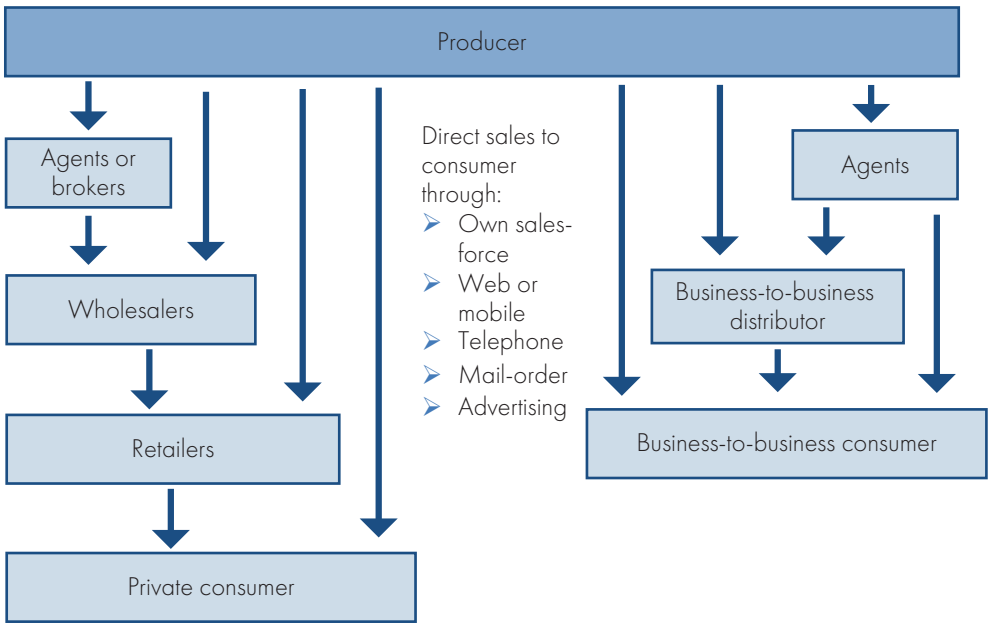


Figure 9.4 Typical distribution channels – physical product sold through physical channels

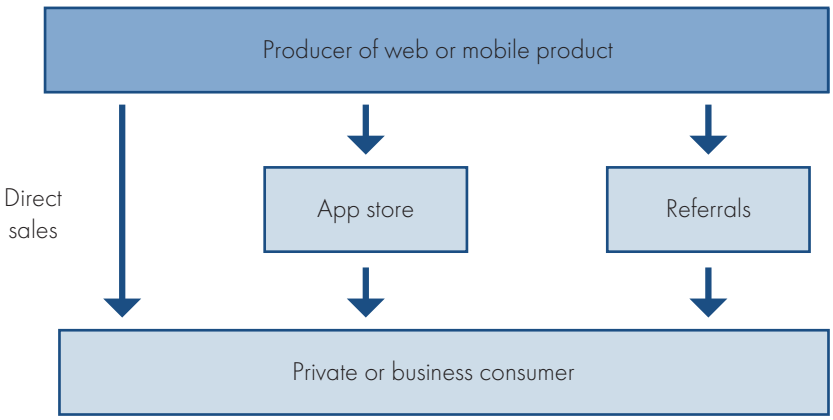


Figure 9.5 Distribution channels – web or mobile products sold through web or mobile channels

For a web or mobile product sold through web or mobile channels of distribution, sales may come from the firm's own website either directly or by referral or through an app store, with a cost attached to the last two sources. Remember that many products sell through a number of different distribution channels, each with a different profit margin. This is called a 'multi-sided market'. Although multi-sided markets might get a product/service in front of more customers, there is a cost and every link in the channel will typically add costs to your business model, which needs to be weighed against the increase in sales revenue. Figure 9.5 shows the distribution channels for a typical web or mobile product sold through web or mobile channels.

Selling through a distribution channels such as shops, agents, distributors or web channels eats into profit margins but allows a start-up to expand the market it is able to reach, benefiting from distributors' strengths. Getting end-use customers to buy a product/service means incentivising each stage of the distribution chain. While an entrepreneur might be able to contact distributors directly to create awareness of their product/service, they will need an incentive to stock it. And that usually means an adequate profit margin. They will be interested in the uniqueness of the product/service –

Table 9.1 Advantages and disadvantages of using distribution channels and a supply-push strategy

ADVANTAGES	DISADVANTAGES
* Fewer buyers to communicate with: • time with buyer important; • relationships with buyer important.	* High-value, infrequent purchases by buyers are high-risk: • need for detailed information about buyer; • need for accurate identification of buyer incentives (product characteristics, point-of-sales displays, frequency of delivery, financial incentives etc.).
* Less capital needed to invest in direct consumer communication, distribution etc.	* Lack of direct influence and control over end-consumer.
* Potential to leverage market in line with distribution channels, gaining wider market coverage quicker than otherwise.	* Buyer may have dominant negotiating position regarding price.
	* May de-emphasise brand and not cement product loyalty with consumer.

that will attract customers – and will also react to whether customers are already seeking it out because of some sort of advertising or promotion campaign ('demand-pull'). 'Demand-pull' communication strategies focus on the end-use customer, using the communication media covered later in this chapter. They can create awareness and demand for the product/service and pull it through the distribution chain. However, they can be prohibitively expensive for many start-ups and therefore restrict the available market.

Distribution channels are primarily interested in profit, so they might be persuaded to stock a product/service simply because of the high profit margin offered, particularly if initially it is offered on a sale-or-return basis. Indeed, they might help promote it themselves if an extra initial discount or bonus is offered ('supply-push'). With supply-push the launch strategy will need to influence each link in the distribution chain. However, unless accompanied by other promotional activity, such as point-of-sale displays etc., this can leave decisions about promotion activity entirely with the distributor. This can lead to unintended consequences, such as distributors entering into local price promotions that are not consistent with other elements of the marketing mix of the product/service. This underlines the important point that the launch strategy – which we shall discuss later in this chapter – must be consistent with the overall marketing strategy and should seek to coordinate 'push' and 'pull' incentives. The advantages and disadvantages of using distribution channels and a supply-push strategy are summarised in Table 9.1.

There is no 'best' way to distribute a physical or virtual product/service. Both demand-pull and supply-push strategies can work with distribution channels. However, not using distribution channels and going direct to the customer can also have merit, if the money saved can be used more effectively and you can keep competitors from copying you for a sufficient length of time. Low-cost airlines such as easyJet changed the way passengers bought their air tickets by insisting they could only book their flights online or by telephone, thus cutting out any intermediaries and the margin they might expect. This was a key part of their business model. Of course, other airlines have now copied this direct route to market.

PRICING DECISIONS

Pricing is also an important weapon in the armoury of a marketing mix. The more valued the brand to customers and consumers, the higher the price a product/service is able to command. Setting prices is a crucial element of the marketing strategy, but it is an art rather than a science. A firm may have one list price for its product/service or different prices for different market segments. Alternatively, it may operate an auction or negotiate the price of its product/service. It may offer discounts for loyalty, the volume purchased, even prompt payment. There may be special offers at sale times.

The underlying principle is that the price charged for a product/service ought to reflect the value-to-customer of the package of benefits. The value can be different to different customers and in different circumstances. Take, for example, the price charged for emergency, compared to routine,

plumbing work. A premium price reflects the benefit to the customer of preventing the house being flooded. However, the features of that emergency service, as reflected in the marketing mix, must provide the customer with the benefits they are looking for; for example, ease of telephone call-out, 24-hour fast and efficient service, clear-up, facilitation of insurance claims and so on. Similarly, a low-cost airline like easyJet is able to charge a range of different prices for what is essentially the same service, transportation from one place to another, for example by offering early booking or off-peak fares. However, there is usually a going rate charged by competing firms for a similar product/service.



Source: Vlad Hilitanu on Unsplash

One factor in the pricing decision is the costs you face. Many people use what is called cost+ or full-cost pricing. This takes the total cost of producing a product or delivering a service and divides it by the predicted number of units to be sold, to arrive at the average cost, to which a target mark-up is then added. Some costs, often called overheads, are fixed, and do not change with volume (e.g. depreciation of equipment, rent and some salaries). So what happens if predicted sales volumes are not achieved? The same fixed costs have to be spread over smaller volumes; implying that a higher price will need to be charged to recover the overheads – a strategy that itself is likely to lead to falling sales. The reverse is true if volumes are greater than predicted.

Another benchmark is the variable cost of the product/service – the cost of producing one additional unit (e.g. the costs of materials or components and piece work labour). The price of a product/service must be higher than its variable cost otherwise the firm is not recovering those fixed overhead costs. If the price is lower than the variable cost there is no incentive to produce, because each additional unit sold would incur an additional loss. However, if the firm wanted to charge a range of prices to different market segments, these can be as low as the variable cost, so long as the average price it charges is above its full-cost (thereby covering those fixed overhead costs). The lower the variable cost, the greater discretion the firm has in pricing. This is why off-peak tickets on low-cost airlines can be so much lower than peak fares. The extra variable cost of taking a passenger off-peak, when the plane is not full, is very low.

However, determining full cost is a problem. Table 9.2 gives an example of how fixed costs affect profit. Suppose you are selling a box of Lego figures at a car boot sale. You buy each box of figures for $1 – this is your variable cost. You decide to sell each box for $3 and the profit (or 'contribution') of $2 a box therefore looks attractive. This contribution is often expressed as a percentage of selling

Table 9.2 Fixed cost and profit example

BOXES SOLD	1	2	3	4	5	6	7	8	9	10
Income	$3	$6	$9	$12	$15	$18	$21	$24	$27	$30
Cost of boxes	$1	$2	$3	$4	$5	$6	$7	$8	$9	$10
Profit	$2	$4	$6	$8	$10	$12	$14	$16	$18	$20
Pitch cost	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10
Net profit/(loss)	$(8)	$(6)	$(4)	$(2)	$nil	$2	$4	$6	$8	$10
Full cost per box	$11	$6	$4.3	$3.5	$3	$2.7	$2.4	$2.25	$2.1	$2

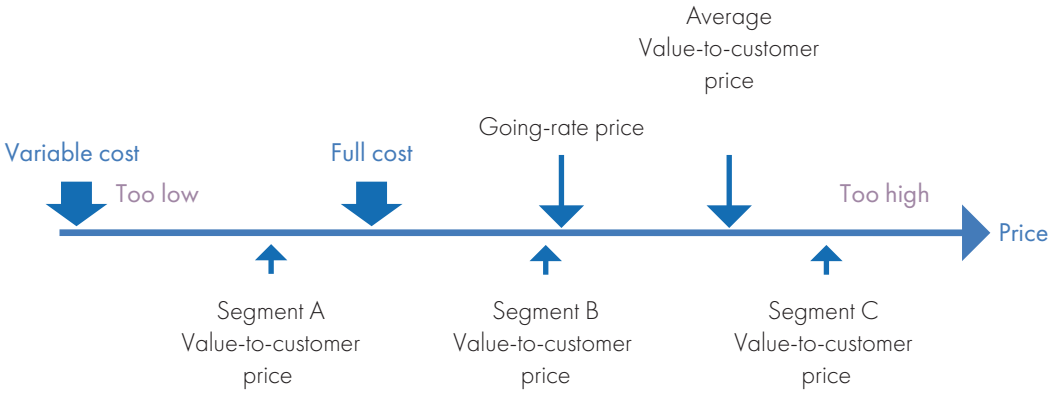


Figure 9.6 The pricing range

price and is called the contribution margin ($2 ÷ $3 = 0.67 or 67%). The cost of the pitch at the car boot sale is $10 – this is your fixed cost or overhead. Every box you sell 'contributes' $2 towards these fixed costs.

Table 9.2 shows that if you sell only one box you make a loss of $8. This is because it cost $10 for the pitch, making the full cost of each box $11 ($10 + $1) – assuming you do not sell any more. This loss decreases until you sell 5 boxes, at which point you are at a breakeven point, making neither a profit nor a loss, although the full-cost of each box sold is now $3 ($10 + $5 ÷ 5). If you sell 10 boxes the full-cost of each box comes down to $2 and you make a profit of $10 (33%). Full cost continues to decrease as you sell more boxes and spread the fixed cost of the pitch over increasing sales. Full-cost therefore depends on how many boxes you sell (and produce) – not a great help.

Pricing is therefore a question of judgement. Figure 9.6 shows the pricing range. Minimum short-term price is set by the variable cost – $1 in the previous example. This is the only firm benchmark available. Long-term viability is set by the full cost price, but determining this involves making a judgement about how many units will be produced and sold. To make a profit, the average value-to-customer price needs to be above this full cost. The problem is that value-to-customer is not always obvious and can vary according to circumstances. What is more, it can be made up of a range of prices charged in different market segments, some of which might be below full cost (segments A, B and C).

The important point is that it is not *necessarily* linked to costs. Nevertheless, most consumers, including business consumers, associate high price with high quality (Anderson, 2010). So, it is important not to under price the product/service, as many start-ups are tempted to do. Charging too low a price can mean that customers associate the product/service with low quality. It sets assumptions and expectations about quality and price that may be difficult to change in the future.

Price undoubtedly plays an important part in the buying decision. Deciding on the price depends, in part, on whether the product/service is a big- or small-ticket item. If a big-ticket product/service (high price, infrequent purchase) is unique or fashionably desirable the firm may be lucky enough to be able to charge a premium price at its launch. Demand may outstrip supply. This is often the case with new technologies (e.g. at the launch of 5K HD televisions). This creates a certain status associated with ownership of the product/service. The price can then be reduced as competitors enter the market. More features can then be added to the product/service while the ticket price is kept the same – effectively lowering the price but maintaining its 'premium' status. This is the strategy used by Apple, with new versions of its products carrying new and better features. With this sort of product a firm can also afford to be selective about distribution, going into new channels as the product ages. So, for example, a film is shown first in cinemas, then on pay-to-view channels, and finally it becomes available on video or through download, usually with the price reducing progressively over time.

Case insight 9.2 Lara Scobie, ceramicist

Pricing ceramic art pieces

Lara Scobie is an award-winning ceramics artist working from her studio at The Adam Pottery in Edinburgh, Scotland. Three of her pieces are featured on the cover of this book. Each piece is unique, individually made in fine Parian clay and hand decorated using a combination of inlay and sgraffito (Italian for 'scratched') drawing. Scobie studied ceramics at Camberwell College of Art in London and holds a postgraduate diploma from Edinburgh College of Art. She has exhibited internationally since 2011 at venues including the Saatchi Gallery in London and the Tansey Contemporary in Chicago and Los Angeles and in selected exhibitions such as the British Ceramic Biennial in London and the Triennale de Porcelaine, in Nyon, Switzerland. Her awards include Premier winner of The Fletcher Challenge in New Zealand and Honourable Mention at Mino Ceramics, Japan. She is a fellow of the Craft Potters Association of Great Britain and a professional member of Contemporary Applied Arts, London.

Scobie was a part-time lecturer at Duncan of Jordanstone College of Art in Dundee until 2015, at which point she decided to devote all her time to her ceramics work. She had been feeling that she needed to do this for some time and when the college offered voluntary redundancies she accepted the payment as a way of funding her first year or so of full self-employment. Her uncle was an artist and her two brothers are both self-employed, so self-employment as an artist was something she understood. Devoting only 50% of her time to ceramics, she felt that she would come to regret not devoting all her time to the thing she loved best and since then her work has developed, become more recognised and sold more pieces. Scobie has found that she enjoys being completely in control of her work, particularly her ceramics. She never became an artist to become wealthy. She enjoys the lifestyle and has no regrets about the move, although she says she would like more help with marketing.

Scobie makes extensive use of pictures on Instagram to promote her work. She sells her pieces through galleries, ceramic fairs and exhibitions as well as online through her own website (although she only added a sale facility to it in 2019). The prices vary according to size and complexity – from £100 to £1,000. There is no prescriptive formula that she can follow for pricing, since many costs are shared (e.g. firing the kiln), sometimes she makes multiple copies of the same piece and sometimes a ceramic will crack in the kiln. It is almost impossible to cost any individual piece accurately. She charges what she thinks she can get. While she now covers her material costs and overheads, she does believe she under prices her time, particularly if she does not produce a larger volume of the piece. As an example, those designs on the cover of this book are priced at around £100. If they are sold from her website or at a fair, she takes the full amount. However, if she sells through a gallery she gets only 50%. The price is the same from the gallery or the website. She has found that once a customer buys from a gallery they will usually return to purchase another piece through her website and estimates that some 40% of customers are repeat buyers. She regards galleries as another way of promoting her work and is happy to take the reduced margin. She is also seeing an increase in commissioned work as she becomes better known.



Source: Lara Scobie

Scobie took the GET2 test (see Explore further link 3.2) and scored 91%, meaning she was described as 'highly enterprising' with 'a tendency to start up and manage innovative projects'. Her scores are shown below in Figure 9.7. She was not surprised by the results.

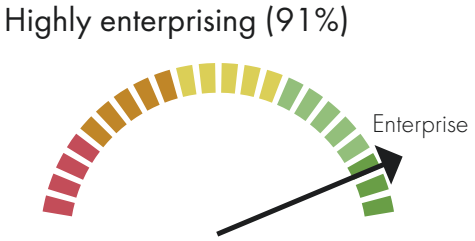


Figure 9.7a Overall GET2 result

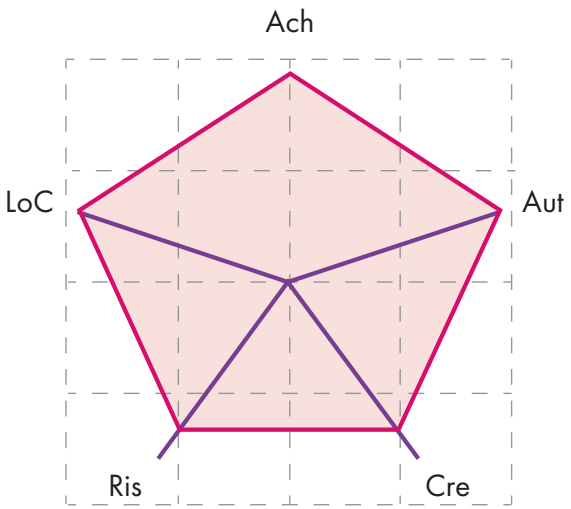
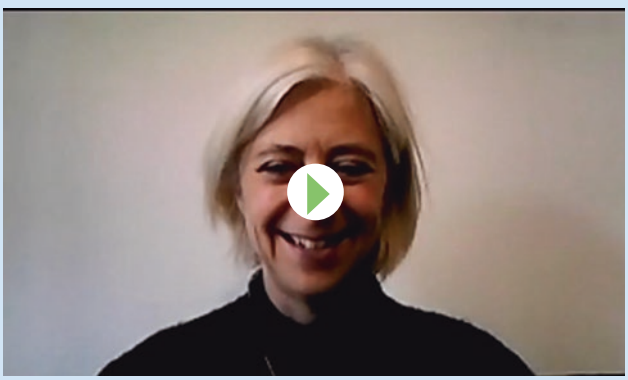


Figure 9.7b GET2



Figure 9.7c Detail GET2



Get into the entrepreneurial mindset. Access the *Digital Links* booklet to visit Lara Scobie's website, meet her and to watch an interview with her exploring her mindset and reactions to the GET2 results.

Questions:

1. Are there tensions between being an artist and being self-employed? Explain.
2. What do you learn about pricing products/services from Scobie's experience?
3. Were you surprised by Scobie's GET2 test results?

By way of contrast, it may take some pricing encouragement to persuade customers to switch supplier and make an initial trial purchase of a small-ticket item that is less unique (low price, frequent purchase). In these circumstances free samples/trials or special 'introductory offers' to encourage a trial purchase may be part of the launch strategy. These offers might take the form of discount vouchers or coupons, including e-coupons. Rather than setting a low price, these offers allow the firm to re-establish its value-to-customer price more easily after introduction. Customers will accept the removal of a discount far more easily than an increase in price. Since repeat purchase is important for small-ticket items, offers might also include discount or loyalty vouchers that encourage this – helping the firm gain market share quickly, albeit at a cost in lost profit. However, if a product/service proves attractive to customers, competitors may start to price more aggressively and the firm may be forced to do the same.

It is always easier to lower price than to raise it, therefore in trying to establish the value-to-customer price of a product/service, the principle is never to start too low. If this can be done on a customer-by-customer basis, it should help establish the actual value to customer. When any discount is removed the effect on demand can be reappraised. As we shall see in the next section, this all depends on how customer demand reacts to changes in price. For most products/services, the lower the price the higher the sales are likely to be. The question is whether that will lead to higher profit – and that is not always the case.

PRICING DECISIONS AND VOLUMES

How demand reacts to changes in price is determined by the 'cross elasticity of demand'. The more the product or service is a commodity, the more price will be elastic – sales volumes will be affected by price changes. The more differentiated the product/service, the more price-inelastic is demand – the volume sold does not vary greatly with changes in price. Price elasticity may sound a highly theoretical concept, but the practical applications of it are important.

Table 9.3 shows the increase in sales volume required to maintain the same level of profitability as a result of a price reduction. This depends on the contribution margin (sales price minus variable cost, expressed as a percentage of the sales price) before the price cut. If the contribution margin is only 20% and the price of the product/service was cut by 15%, a firm would have to quadruple sales volumes (×4) – just to maintain the same profits as before. The higher the margin, the less the effect, but even at 40% margin, the firm would still have to increase sales by ×1.6 or 60%.

Table 9.3 Volume sales increase needed to maintain profits[1]

		CONTRIBUTION MARGIN		
		20%	30%	40%
PRICE REDUCTION	–5%	×1.33	×1.2	×1.14
	–10%	×2	×1.5	×1.33
	–15%	×4	×2	×1.6

In contrast, Table 9.4 shows the decrease in sales volume that could sustain the same level of profitability in the face of a price increase. With a 20% margin, if prices were to be increased by 15% the firm could afford to see volume sales reduce to 57% of their previous level and still generate the same level of profit as before (a 43% reduction). Of course the effect is less the higher the margin, but even with a 40% margin, the firm could afford to see volume sales reduce to 73% of

1 The calculation is: (Contribution margin %/Contribution margin % ±change in price %). All % are expressed as decimals (e.g. 10% = 0.10). If the price decrease % exceeds the contribution margin % then no increase in volumes will allow profits to be maintained. Calculations are rounded up.

their previous level and still generate the same level of profit as before (a 27% reduction). However, if it were to cut overhead costs at the same time (why maintain the same level of staff with less work?) it should see profits actually increase. Alternatively, it might decide to improve the level of service offered by redirecting these overheads so as to justify the higher price. Either way, lower volumes might mean that stocks/inventories as well as other capital expenditures can be reduced – an important consideration if cash is scarce.

Table 9.4 Volume sales decrease allowable to maintain profits

		CONTRIBUTION MARGIN		
		20%	30%	40%
PRICE INCREASE	+5%	×0.80	×0.86	×0.89
	+10%	×0.67	×0.75	×0.80
	+15%	×0.57	×0.67	×0.73

As you can see from these tables, if you are working on slim margins, lowering prices may well lead to increased sales volumes, but it may also lead to lower profits. On the other hand, increasing prices may lead to increased profits, despite lower sales volumes. They show that the lower the contribution margin, the more vulnerable a firm is to price competition because it is less able to reduce price. In contrast, the higher the contribution margin, the greater the firm's discretion in terms of offering discounted prices because a smaller increase in volume is needed to justify the price reduction. This can make differential pricing particularly attractive for high-margin businesses (segments A, B and C in Figure 9.6). These calculations underline the importance of understanding the costs related to a business. They affect the business model, the risks it faces and the funding it may need.

PRICING DECISIONS AND CONTRIBUTION MARGINS

The contribution margin a product/service typically commands varies enormously from product to product, market to market, sector to sector. This is not just because of market demand, but also because of the high fixed overhead costs that some businesses need to cover in order to make a profit. Contribution margins in the bricks-and-mortar retail or leisure sector are likely to be high because of the high fixed overhead costs they face in staffing and running their buildings. Just think of the fixed costs a firm faces to lease and run a prime-site, high-street store before they even make a single sale. As a result, many non-food retailers try to operate with high contribution margins of over 60 per cent in order to cover these fixed costs. Because of these high margins they have considerable price flexibility, allowing them to hold regular promotions and store 'sales'.

Businesses with high fixed costs face the risk that these costs might not be met by the income generated from sales. As explained in Chapter 13, they have a high breakeven point. Consequently, there is an increasing trend to try to 'share out' these fixed overhead costs as far as possible by partnering with other businesses such as suppliers, for example having just-in-time supplies which cut down stock-holding costs. Using established channels of distribution can often help keep fixed costs to a minimum but will reduce the price a producer is able to charge (and consequently their contribution margin). While it is unlikely that customers would agree to share costs, they might be willing to guarantee a certain volume of purchases in return for that lower price. This is why suppliers will often offer lower prices to the large supermarkets and retailers in exchange for volume guarantees and why subscription-based business models might be attractive.

Case insight 9.3 UK Sofa-beds*

Pricing decisions and distribution channels

Price plays a big part in decisions involving distribution channels. Supplying goods to wholesalers and retailers, rather than directly to the end-customer, may gain a wider market but each link in the chain is looking for a margin. And that means the original supplier must charge a lower price than they will be able to obtain from the end-customer. Let us take the example of a small sofa-bed manufacturer called UK Sofa-beds. It had been selling its sofa-beds to a large national retail chain for many years. Many were sold in the shops under the retailer's own label. The typical selling price to the retailer is £250 and the variable costs are £200 (frame, upholstery, materials, shipping and piece-work labour etc.). It therefore makes a profit of £50 per unit, or a 20% contribution margin (typical for the industry in the UK). UK Sofa-beds operates from a small industrial unit and the fixed overheads are low.

The retailer on the other hand faces high fixed costs (lease costs on the retail premises, store staff, advertising, heat and light etc.). It also has more buying power and can squeeze the margins of the smaller manufacturer in what is already a highly competitive industry. Consequently it hopes to make a high profit by selling each unit at £750, giving it a profit of £500 and a high contribution margin of 66% (again typical for the UK industry, although rarely achieved because of fierce discounting). These figures are set out in Table 9.5.

Table 9.5 Original levels of profitability before scenario planning

LOW-MARGIN SOFA-BED MANUFACTURER		HIGH-MARGIN SOFA-BED RETAILER	
Sale price:	£250	Sale price:	£750
Cost:	£200	Cost:	£250
Profit:	£ 50 (20%)	Profit:	£500 (66%)

The owner of UK sofa-beds decided to set up a number of scenarios – 'what-if?' situations – to help him decide on his pricing decisions and business model. He asked his accountant to calculate the financial consequences. Since the industry was so competitive, he first decided to investigate whether he could increase his sales (and hence profit) by discounting his price. Scenario 1 (Table 9.6) sets out the increase in sales volumes each business needs to achieve in order to maintain the original level of profitability after a 10% decrease in selling price.



Source: Toa Heftiba

Table 9.6 Scenario 1 – 10% decrease in sale price

LOW-MARGIN SOFA-BED MANUFACTURER		HIGH-MARGIN SOFA-BED RETAILER	
Sale price:	£225	Sale price:	£675
Cost:	£200	Cost:	£250
Profit:	£ 25	Profit:	£425
Sales *increase*:	100%	Sales *increase*:	18%

The results shocked him. The 100% increase in sales would almost certainly be impossible to achieve. On the other hand, the high-margin retailer seemed to have far more pricing discretion. Achieving an 18% increase in sales turnover if the shop offered customers a 10% sale discount seemed achievable.

He next looked at the effect of an increase in costs for the two businesses. In scenario 2 (Table 9.7) each business faces a 10% increase in costs.

Table 9.7 Scenario 2 – 10% increase in costs

LOW-MARGIN SOFA-BED MANUFACTURER		HIGH-MARGIN SOFA-BED RETAILER	
Sale price:	£250	Sale price:	£750
Cost:	£220	Cost:	£275
Profit:	£ 30	Profit:	£475
Sales *increase*:	167%	Sales *increase*:	6%

Again he was shocked. In the face of a 10% cost increase he needed to increase sales by a massive 167% to maintain his original level of profitability. The accountant had already advised him that cost control was important, but these results drove this advice home. What worried him was that he did not control some of these costs, for example the steel bed mechanism was imported and the cost varied with changes in

the exchange rate. He was also surprised that the high-margin retailer only had to increase sales by 6% to maintain profitability. He realised that this could mean that they might be willing to accept a price increase, particularly if it was linked to an improvement in quality that was attractive to customers which might result in increasing sales for both parties. The problem was that he did not really know how price-sensitive customers were because he had only ever dealt with the retailer.

He therefore decided to look at the effect of an increase in price for both businesses. Scenario 3 (Table 9.8) shows the effects of a 10% increase in selling price.

Table 9.8 Scenario 3 – 10% increase in sale price

LOW-MARGIN SOFA-BED MANUFACTURER		HIGH-MARGIN SOFA-BED RETAILER	
Sale price:	£275	Sale price:	£875
Cost:	£200	Cost:	£250
Profit:	£ 75	Profit:	£575
Sales *decrease*:	33%	Sales *decrease*:	13%

He was surprised to see that both businesses could afford to see a reduction in sales and still maintain their original level of profitability. But what really shocked him was the effect on his business. He could afford to see a massive reduction of 33% in sales and still maintain his original level of profitability. It got him thinking whether he should change his business model. Perhaps a higher price could be combined with changes in other elements of the marketing mix. How much would an increase in the quality of some of the materials used cost him, and could this be passed on in terms of a higher price? Certainly he would be less stressed.

The results tempted him to consider a radically different business model – selling direct to the public rather than going through the retailer. He asked his accountant to work out one final set of scenarios. Scenario 4 (Table 9.9) sets out the results of charging a sales price of £400 (4a) and £500 (4b). Both selling prices would be well below that charged by the retailer. In both scenarios he could maintain his original level of profitability despite a massive decrease in sales volumes (75% and 83% respectively).

Table 9.9 Scenario 4 – Changing the business model

SCENARIO 4A: SELLING DIRECT TO PUBLIC @ £400 PER UNIT		SCENARIO 4B: SELLING DIRECT TO PUBLIC @ £500 PER UNIT	
Selling price:	£400	Selling price:	£500
Cost:	£200	Cost:	£200
Profit:	£200	Profit:	£300
Sales *decrease*:	75%	Sales *decrease*:	83%

This caused the owner to think hard. His costs would increase if he sold direct to the public – particularly the fixed costs involved in marketing. The problem was that he did not know much about the customers the retailer sold to, and they certainly would not recognise his brand since many had been sold under the label of the national retailer. Should he change his existing business model?



Access the *Digital Links* booklet to watch a short video showing how these sofa-beds work.

Questions:

1. What lessons do you learn from this case?
2. If the owner continues to sell to the retail chain, what factors should he consider in deciding on the price? If you want to change the price, how might this be done?
3. What are the pros and cons of selling direct to the public? What should the owner do before embarking on this strategy?
4. Are selling to the retail chain and selling direct to the public mutually exclusive strategies? How could they be undertaken together?
5. What would you advise the owner to do?

* This is a real company but the name is fictitious.

PRICING 'KNOWLEDGE PRODUCTS'

'Zero-cost' products – offering almost a 100 per cent contribution margin – are becoming increasingly common. These are most likely to be 'knowledge products', often internet-based – like software, other web or mobile products like apps, recorded music or videos – where almost no additional variable cost is incurred by producing one additional unit. Once developed (incurring a fixed cost) the content can be downloaded again and again, at virtually zero (variable) cost. However, the fixed costs for development could be high and still need to be recouped and reflected in the price. We looked at some typical business models for these products in Chapter 7, but how can the price for this sort of product be set? If it is set too high, sales might not be as expected and the total contribution might not even meet the fixed

overhead costs, let alone generate a profit. There may be the added problem that the product itself can be easily copied (e.g. recorded music), so that if the price is high there is a strong incentive to copy it.

The first thing to do, unless the firm wishes to offer its product as 'open source' (e.g. like Wikipedia or Linux), is to ensure that it has secured the intellectual property (IP) rights on the product (see Chapter 11). If the firm needs to charge a high price for its product in order to recoup high fixed development costs it is then in a much better position to do so. For example, new drugs cost huge amounts to develop but relatively little then to manufacture and distribute. The IP on the invention is protected through a patent, in effect giving a monopoly on the sale of the product for up to 20 years. This allows the drug to be sold at higher prices, allowing the fixed costs of development to be recouped over the 20-year period.

However, even owning the IP on a product does not guarantee that it will not be copied, albeit illegally. Generally, firms selling zero-cost products need to have a clear idea about the volume of sales they can reasonably expect. If they do not expect volume sales to be high but fixed costs are high, the only way to make a profit is by charging a relatively *high price*. Whether this can be done depends on the benefits derived by the customer. For example, a firm might charge a large corporate client a high price for software or consultancy that saves them a lot of money by streamlining their processes. They might go on to sell similar software or consultancy to another corporate client at an equally high price, despite the fact that the additional costs involved in modifying the software or consultancy are low. This is an example of differential pricing. The fact the firm is selling a complex product to a few clients means that clients or customers are unlikely to copy it and they can more easily assert their IP rights since they know precisely who it has been sold to.

If a firm expects to sell high volumes of the product they can afford to charge a *low price*. The total contribution must then cover all the fixed costs and make a profit. Sales volume is the key to success, so the firm must have good channels of distribution – probably through referrals and app stores. For example, recorded music is a zero-cost product – once a song is recorded, the cost of downloading it is zero (although there is the fixed cost of the distribution network). Apple sells its iTunes globally for just a few cents through its iPod and iPhone networks. Apple makes a profit from selling both the music and the device. If your business idea involves smartphone apps or music then selling it through the Apple and/or Google networks may be a good strategy. However, there still remains the problem of copying. Apple's approach is to make purchase so cheap and easy that the customer will not be tempted to illegally copy the material, with all the extra time and risk involved.

Whether a firm sells in low or high volumes, it may still be able to price differently for different target customers, markets (e.g. different countries). This is what many of the business models outlined in Chapter 7 do (e.g. the freemium model). Similarly, the 'brand' is likely to be an important influence on price since this guarantees a certain quality (e.g. subscription model in Chapter 7). 'Brand' means not just the name of the organisation producing the product/service (this could be a consultancy, a software house or even a band), but also the values behind it that enable customers to trust in it.

Another option is to offer your product *free* and instead generate income indirectly. For example, a free-to-use website might show related advertising or offer related products/services to purchase on a click-through basis (the advertising model in Chapter 7). With this model there is no incentive for consumers to copy the product and the major effort the firm needs to make is directed towards generating the alternative revenues that build profit. This means having a two-sided marketing strategy. Firstly, attracting a large volume of users together with views per page, click-throughs etc. Secondly, signing up sufficient advertisers and retailers for the website at rates that generate adequate income. Often successful websites have multiple income streams – one subsidising another – using a number of the internet business models outlined (the multi-sided market model in Chapter 7).

For some start-ups, there may be a tension here between short-term profitability (and survival) and long-term market dominance (and higher profits). Low prices are likely to attract more customers. Long-run market dominance, although not always associated with price competition, is likely to lead to high and more sustainable profits and can be particularly important in newly emerging markets. We have seen this with start-ups like Airbnb and Uber which launched on the stock market very successfully without having made any profits. As with many things in business, pricing is an art not a science and requires good judgement.

Case insight 9.4 Fortnite: Battle Royal

Monetising a free-to-play computer game

The free-to-play computer/smartphone game Fortnite became a cultural and financial phenomenon in 2018 with some 125 million people reported to have played it that year, generating an estimated revenue of $2.4 billion in the calendar year. The game was developed by Tim Sweeney and his company Epic which he founded based in his parents' house in Maryland, USA in 1991. His first hit game was Gears of War. In 2012, while Fortnite was in development, the Chinese technology conglomerate Tencent purchased a 48% stake in the company for $330 million. Fortnite went live in 2017. In 2020 it secured a further $750 million from a funding round, valuing the company at $17 billion.

The business model for free-to-play computer games is simple. You offer the game for free and attract a wide player base but sell in-game powers, abilities, clothes etc. for a few dollars. There are costs to this. For example, Apple charges not only for placement in its App Store but also charges a commission of 30% for all in-game sales. Nevertheless, the more players Fortnite has, the more the add-on sales it achieves – and these can add up to $millions. Fortnite drops 100 players onto an island and lets them build forts, scavenge for supplies and weapons and fight to the death. They can play individually or in teams. By mixing elements like the strategy of building forts for defence as well as just shooting opponents, it seems to attract a diverse range of players: young and old, professional and amateurs. The building element encourages problem-solving and the game encourages learning through experimentation. Players say it is great fun. Income is derived from buying trivial things like 'skins' (costumes for the characters) or 'emotes' (expressions of emotion like a victory dance) rather than gaming advantage. Dances such as the 'floss' have become real-world crazes. These are expensive, some three or four times the normal price in games. And the company creates demand – some skins are only made available for a limited time. Fortnite accounts with the rarest skins have been resold on eBay for some $3,000. Epic feeds this enthusiasm. In 2018 it announced that it would give out $100 million in tournament prizes in 2019 – the most ever offered by a computer gaming company.

Fortnite has 350 million players – less than Minecraft or Call of Duty, but it commands a lot more of players' attention, with players online for 3.2 billion hours compared to 2 billion for Minecraft and 2.4 billion for Call of Duty. It is also finding ways to generate additional income by hosting events. In 2019 it hosted a live event to publicise a new Star Wars film and in 2020 Fortnite hosted its first virtual concert with Tavis Scott (a US rapper). It now offers a range of services to game developers, from publishing their work and collecting fees to managing multi-player online games. By 2020 it was estimated to be generating some $2 billion in revenues. And more were promised through its 'Unreal Engine' – a toolkit widely used already by developers to build games with life-like digital characters and worlds. Disney has already used the tool for background images and it is also starting to be used by architects and town planners.



Source: Vlad Gorshkov on Unsplash

Serious players train regularly and many of the better known Fortnite players offer their services as coaches using Skype. Ali Hassan, aka SypherPK, a 22-year-old from Austin, Texas earns some $150,000 a month from playing, coaching and live-streaming his Fortnite games on Twitch, an Amazon-owned broadcast channel that streams live video games (*The Sunday Times Magazine*, 21 October, 2018). The channel is free but some fans pay $5–$25 a month to form allegiances with their favourite players. Twitch keeps 30–50%. Hassan now has some 17,000 Twitch subscribers, plus 1.5 million followers, not to mention 1 million on YouTube.

Access the *Digital Links* booklet to visit Epic's website and explore the Fortnite game.

Questions:

1. How many income streams are there connected with Fortnite?
2. What are the keys to generating this income for Epic?

PRICING DECISIONS AND COMPETITIVE REACTION

An understanding of contribution margins can also help in making decisions about changing the price of a product/service (e.g. in the face of strong competition). Suppose that the product/service sells at $20 wholesale and a competitor starts price-cutting, selling a similar product/service at just $16

wholesale. The question is to decide whether to match the price reduction or to seek a more profitable alternative strategy. Look at the calculation in Table 9.10. Column 2 shows the effect on profits if prices are maintained with the result that there is a one-third fall in sales. Column 3 shows the effect on profits if prices are reduced in order to maintain the level of sales.

As we see from column 3, the business will actually lose money ($4,000 per month) if it follows the price lead of the competitor. If it maintains its prices, the position is rather better, although it will still not make a profit (column 2). However, there may also be the opportunity in this situation to reduce fixed overhead costs to reflect the lower sales, or even to spend more on advertising to persuade customers that this product/service is better and worth more than $20. Of course this all depends on the price elasticity of demand – will sales drop by a third to 2,000 units per month if the price is held? But then will sales be maintained at 3,000 units despite a price drop in the face of competition? These are all judgements. However, despite the evidence that an analysis of this kind can reveal, many start-ups automatically cut prices as a 'knee-jerk' reaction to competitive pressures, without evaluating the alternatives.

Table 9.10 Effect on profit of changing price

	1 CURRENT POSITION	2 COMPETITOR LOWERS PRICE: FIRM HOLDS PRICE	3 COMPETITOR LOWERS PRICE: FIRM ALSO LOWERS PRICE
Price per unit	$20	$20	$16
Variable cost per unit	$12	$12	$12
Contribution per unit	$8	$8	$4
Sales volume per month (units)	3,000	2,000	3,000
Total contribution	$24,000	$16,000	$12,000
Fixed costs per month	$16,000	$16,000	$16,000
Profit/(loss) per month	$8,000	nil	$(4,000)



Bonus Case Xtreme SnoBoards (1)



Visit the companion website to access this four-part bonus case that covers pricing, the preparation and evaluation of financial forecasts and an estimated company valuation.

DEVELOPING THE MARKETING PLAN

A strategy is just a high-level plan connecting a series of actions aimed at achieving certain long-term objectives. Marketing strategy is made up of elements of the marketing mix as they relate to the customer segments they are targeted at. It delivers the value proposition to these target market segments. As part of the business model it explains the logic behind decisions regarding the marketing mix. It should demonstrate that the marketing mix is consistent, with each element reinforcing the other, and show how a distinctive brand image can therefore be created.

The next stage in the process of developing a marketing plan is to show how this marketing strategy is translated into a sales and marketing communications campaign that persuades customers to purchase the product/service and then become loyal, repeat customers. We cover this in the next chapter. Together, the marketing strategy and communications campaign form the marketing plan. The marketing plan will, in turn, require certain actions and activities to be put in place as part of the operations plan. Some of these actions and activities might be critical to the success of the venture, for example securing low-cost resources is likely to be critical for a company with a low-price business model. Developing the operations plan and highlighting these critical success factors are covered in Chapter 12.

Case insight 9.5 Flying Tiger Copenhagen (1)

Price-point retail business model

The price-point retail model was invented in the USA. Typically it is a model operated by variety stores, selling a range of inexpensive household goods. Single price point means that goods sell at one price, for example one dollar, pound or euro. And the name of the store then often reflects its value offering. The UK's Poundland claims to have introduced the concept to Europe in 1990 and is still the largest single-price discount retailer. Value and discount retailers have seen a boom in sales since the recession of 2008.

Lennart Lajboschitz opened the first Flying Tiger store in Copenhagen in 1995. The story is that he left his brother's girlfriend in charge and she could not find the prices so he told her to sell everything for 10 kroner (about £1). By 2019 the company had grown to some 909 stores in 27 countries, employing more than 6,000 people with sales of DKK 5,226 million.

Flying Tiger Copenhagen is a Danish version of price-point retail concept. It sells a quirky, ever-changing range of products like toys, stationery, hobby and craft goods like knitting needles and glitter glue. The products are own-branded, simple and colourful and most retail at less than £5. Global best selling lines include low-value items like popping candy, pencil sets and soap bubbles but the store also sells odd items at higher prices, like a record player at £100. Flying Tiger taps into seasonal occasions like Christmas or Halloween. For example, in 2016 it offered an inflatable Santa suit. It also taps into lifestyle trends. For example, when the trend for crafting took off it started offering knitting needles and brightly coloured wool.

Flying Tiger stresses its Scandinavian, functional but aesthetic design. Some 50% of new products are now designed, or have quirky design elements like packaging added, in-house. Flying Tiger recently received a Red Dot award for its pink and green food containers. The store itself is light, colourful and fun – laid out to be appealing to passers-by and to encourage impulse buys once inside as shoppers negotiate their way through the maze of stalls. It has been likened to an IKEA marketplace. In the UK, Flying Tiger has been called the 'posh-Poundland'; however, whereas you might go to Poundland for necessities, you would go to Flying Tiger for 'affordable indulgences'.

> *'When we opened our first store in Basingstoke in 2005, some press called us a cool Scandi company. We hadn't seen ourselves like that. We were just a Danish store selling cheap items.' (Tina Schwarz, Brand Director, The Observer, 18 December 2016)*

The price-point retail model is basically a low-cost/low-price one, enhanced by other elements like location. Flying Tiger's website says that its business model is based on four elements: value proposition, assortment, store experience and customer experience:

- *Value proposition:* 'To deliver everyday magic by providing a unique and playful experience in our stores, where customers discover a world of products that we carefully select and design. Flying Tiger Copenhagen stores are designed and curated to give our customers creative, fun and useful products. Our mission is to engage with people's lives, to help them live out their values and ideas and connect to the people that matter to them. While our products are offered at affordable round price points, it is a key objective that the quality should meet or exceed the customer's expectations as well as Zebra's [the name of Flying Tiger's holding company] corporate social responsibility requirements.'
- *Assortment:* Flying Tiger's value-for-money products are continually changing. Up to 300 new products can be introduced in any month. They are primarily proprietary 'inspired by Danish heritage' often with a quirky twist.
- *Store experience:* Stores are located in high-footfall locations on high streets and in popular shopping malls. Store size is between 150 and 250m². The clean Scandinavian decor is a differentiating characteristic. The maze-like floor layout leads customers through pallet tables displaying products with discreet price signs. The warm lighting creates stylish but unpretentious product presentations.
- *Customer experience:* Flying Tiger wants to provide a 'fun' customer experience derived partly from the shop and its products (which often just make you smile) but also from the attitude of the shop workers.

We shall return to Flying Tiger in Case insight 11.4 to look at its growth model and in Case insight 13.6 to look at its operations model.

Access the *Digital Links* booklet to visit the company website and to watch a video that takes you on a tour of a typical Flying Tiger store.

Questions:

1. Using either the New Venture Creation Framework or the Business Model Canvas (Chapter 6), sketch out as many elements of the business model for Flying Tiger as you can.
2. Is the marketing mix consistent, with each element reinforcing the other? Does it reflect the firm's value proposition?

SUMMARY

- The marketing mix underpins the value proposition of a product/service. It defines the features that create benefits for customers and differentiates it from competitors. All the elements of the marketing mix need to be consistent and reinforce each other to form a coherent marketing strategy.
- There are many routes to market. Rather than selling direct to the end-user, selling through distribution channels is likely to reach a wider market. However, each link in the chain is looking for benefits – usually profit. Nevertheless, they can be influenced by marketing strategy. 'Supply-push' creates incentives to intermediaries in the distribution channels to sell the product/service (usually profit). 'Demand-pull' creates incentives directly with end-use customers who then 'pull' the product/service through the distribution channels.
- Customers may not always be the consumers or end-users of a product/service and both are looking for different benefits.
- Pricing decisions are difficult judgements. Price should reflect value-to-customers, not costs. The more unique the product/service, the higher the price it is likely to command. Price should never be below variable cost.
- Differential pricing involves charging different prices to different target markets so as to maximise the volume of sales. The higher the contribution margin, the greater the ability to discount and therefore price differentially.
- Price incentives can be effective in stimulating trial purchases of small-ticket, repeat-purchase products/services, particularly when there are few differentiating features from competitors.
- Knowledge of contribution margin is essential in deciding which products/services to push the sales of, how to react to competitive price-cutting and where to allocate scarce resources.
- Marketing strategy is made up of elements of the marketing mix as they relate to the customer segments they are targeted at. It delivers the value proposition to these target market segments. The marketing plan provides details of the marketing strategy and the marketing communications campaign to support it.

GROUP DISCUSSION TOPICS

1. Every product is a service. Discuss.
2. Why is it important to have a consistent marketing mix?
3. Why are routes to market important?
4. Should a business model have only one route to market?
5. What are the advantages and disadvantages of having a number of different routes to market?
6. How might you influence or control distributors?
7. As an SME, what are the advantages and disadvantages of dealing with a small compared to a large distributor?
8. Which strategy is best – 'supply-push' or 'demand-pull'?
9. What is the difference between the marketing mix, the value proposition and the business model?
10. Costs determine price. Discuss.
11. How important is the price charged for a product/service? Explain.
12. Customers always want the cheapest product/service. Discuss.
13. Is there any limit to the price you can pay for a product/service?
14. Can you really sell less and make more profit? Explain.
15. In what circumstances can you charge different prices for the same product/service? Give examples.

STUDENT ACTIVITIES

1. Select a physical and a virtual product/service and analyse their routes to market. Are there alternatives?
2. Select a railway or airline route and find out how many ticket prices are offered and the basis for these different prices.

START-UP ACTIVITIES

1. Estimate the fixed and variable costs of producing your product/service. Compare these to the price you think you will be able to charge for your product/service in different market segments. Calculate the contribution margin. Estimate the volumes you can sell at this price. Calculate the effect on volumes of +/– 5% price change, then of +/– 10% price change.
2. As in Case insight 8.1, construct a table similar to Table 8.3 for your business:
   a) List the customer segments you intend to sell to.

b) Against each segment, describe in as few words as possible the value proposition.

c) Against each segment, describe each of the main elements of the marketing mix that supports the value proposition.

d) Against each segment, highlight the critical success factors for marketing – the things you need to get right to ensure you deliver the value proposition.

e) Assign to each critical success factor a score reflecting its importance to each customer segment (1 = low, 5 = high).

f) Evaluate your ability to deliver this compared to your nearest competitor(s).

Evaluate this analysis. How does your product/service compare to that of competitors? Are there any market segments that you should focus more on or change the marketing mix for?

10

SALES AND MARKETING COMMUNICATIONS

Contents

- The customer journey
- Using communications media
- Social networks and media
- Guerrilla marketing
- Publicity and public relations (PR)
- Advertising
- Identifying prospects
- Radical innovations: Prospect characteristics
- Radical innovation: Messages
- Incremental innovation: Messages
- Developing selling skills
- Developing a communications campaign
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: iStock.com/D3Damon

Learning outcomes

When you have read this chapter and undertaken the related exercises you will be able to:

- Understand the customer journey from prospect to advocate of the product/service;
- Understand how different media with appropriate messages can be used as part of a marketing communications campaign to move customers through this journey;
- Practise and develop face-to-face selling skills;
- Write a press release;
- Draw up a marketing communications campaign for a start-up.

Case insights

10.1 Curtis Waters and TikTok
10.2 Instant Pot
10.3 Avi Shiffmann
10.4 Influencers
10.5 Lush

Explore further links

10.1 Social media
10.2 Guerrilla marketing
10.3 Advertising

THE CUSTOMER JOURNEY

A good business idea and a persuasive value proposition do not guarantee commercial success on their own. Customers will not queue up at the door of a start-up if they are unaware of its existence. Indeed, even if they are aware, they still might take some persuading to try a new, unproved product/service. As a newcomer to the market, a start-up will have little or no credibility or reputation. Even if it has created a brand, customers will not initially recognise it. And then it will still need to persuade them to purchase the product/service again, and again. A strong brand image should help them do this but building the relationship that underpins a strong brand will take time. A start-up needs to attract the customer segments they are targeting and persuade them to start the journey to become valuable loyal customers. It is not easy or straightforward, even with the best product/service in the world. To do this the entrepreneur will have to use all the tools in their marketing armoury – all the elements of the marketing mix – but in different ways, at different times and in different circumstances. How to go about this all depends on who the target customers are. Remember that it may be possible to adopt different strategies (including differential pricing) for different market segments.

The journey taken to become a regular, loyal customer can be broken down into the process shown in Figure 10.1. The objective is to move the customer up the loyalty chain from someone who buys the product/service regularly to someone who becomes a supporter and ultimately to an advocate of it. This is a customer who is so loyal that they are willing to recommend the product/service to others and even bring in new customers. As we shall see later, recommendations from friends are probably the most effective form of marketing. Customers who are this loyal might even help with product/service development. However, even at this stage their loyalty cannot be taken for granted. It must be encouraged and maintained. To get customers to this level an effective brand identity is vital.

Stage 1: Launch

The objective at this stage is to encourage the customer to try the product/service. Once the prospective customer becomes aware of the product/service they will evaluate the value proposition it offers. They need to be made aware and encouraged to make that all-important first trial purchase. This is easier for a small- rather than a big-ticket product/service. Characterised as a buyer-behaviour model, this was broken down into a three-stage process: firstly, the cognitive stage, where the customer needs to be made aware of the product/service; secondly, the affective stage, where they need to have their interest stimulated and a desire to purchase generated; and, finally, the behaviour stage, where action to buy needs to be triggered.

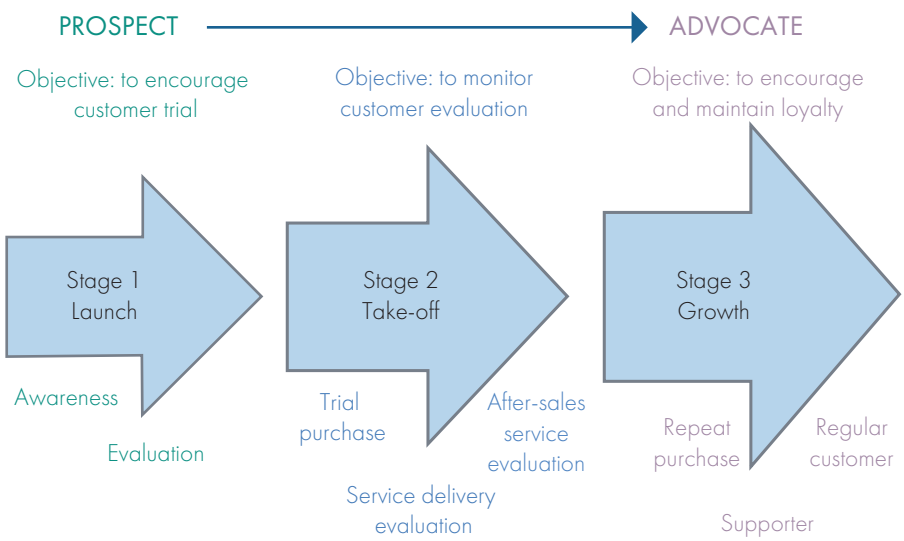


Figure 10.1 Customer journey – the buying process and loyalty chain

Stage 2: Take-off

The objective at this stage is to monitor customer evaluation of the product/service and then, if possible, alter any elements of the value proposition that they are unhappy with. Once they have purchased the product/service, customers will naturally evaluate whether it has delivered the promised value proposition before deciding whether they might purchase it again. They will evaluate the whole marketing mix, not just the product/service itself, including service delivery and after-sales service, all at the price charged.

Stage 3: Growth

If the value proposition that is delivered meets their expectations, then customers may be persuaded to buy the product/service again if it is a small-ticket item and/or to become a supporter who thinks positively about it and starts to recommend it to friends. If they think sufficiently highly of the product/service they become regular customers who will go out of their way to buy it. Again, they will need some encouragement to become regular and loyal customers and not try a competitor's product/service. This is where branding can be particularly important. If the product/service is a big-ticket item and customers are unlikely to make a repeat purchase in the foreseeable future, they need to be encouraged to become advocates straight away.

As already emphasised, it is important that a firm tries to build a relationship with customers, one based on shared values and that encourages the customer to believe they can trust the firm to deliver the promised value proposition again and again. To achieve this, the firm needs to enter into a dialogue with customers – communicating different messages at different stages and at the same time listening to what customers have to say. The nature of that dialogue will be different, depending on where customers are on the journey. An effective communications strategy can help customers on this journey – creating awareness, stimulating need, creating brand awareness and loyalty and facilitating dialogue.

Ideally, relationships are based upon one-to-one and face-to-face interaction, but they can also be influenced by various media. The questions are which media to use and how to use them? In today's interconnected, knowledge-based society an entrepreneur can use a wide range of mass communications media to initiate, develop and maintain these relationships. And mass media becomes vitally important in communicating with mass markets, where the logistics of communicating face to face are problematic.

> *In order to sell a product or service, a company must establish a relationship with the customer. It must build trust and support the customer's needs, and it must deliver a product that delivers the promised benefits.*
>
> Jay Conrad Levinson, (1984), *Guerrilla Marketing*, London: Piatkus Books

CHAPTER 10

USING COMMUNICATIONS MEDIA

This section will look at the range of media SMEs can use to communicate with prospective (and new or existing) customers. The most basic of these, one practised by most SMEs, is word-of-mouth recommendation. This is spread through the entrepreneur's relationships and networks and can be a very effective way of promoting a local start-up. It is a low-cost option that involves personal time and effort. It is extremely effective because, essentially, advocates are being used to promote the business. Family and friends might be able to help initially but, once established, unpaid customer recommendation is very powerful.

Research indicates that most customers make their buying decision based on perceived value and not on the information a company chooses to present to them. They are influenced more by recommendations from networks of family, friends and even 'outside' networks rather than mass media (Dahlen et al., 2010). This is particularly the case when 'outside' networks involve 'opinion formers' (experts) or 'opinion leaders' (innovators and early adopters in Figure 10.2). Therefore, the ability to use an 'outside-in' approach (getting outsiders to promote the product/service) and to portray a consistent brand image to target customers can be a critical success factor in competitive, information-rich markets (Jin, 2003/2004). However, word-of-mouth even through networks of family, friends and satisfied customers has a limited reach, and the ability to leverage this using social media can be an extremely valuable tool – one that we shall return to shortly.

> *I believe that one of the most important things is to spread the word in your personal network. Get your personal network working for you. A personal recommendation is so much more valuable than any kind of advertisement you can make.*
>
> Raoul Shah, founder of Exposure, *The Observer*, 29 September 2013

Table 10.1 Communication tools and media

WORD-OF-MOUTH	NEWSPAPER ADVERTISING	POSTERS
Relationships and networks	Radio advertising	Flyers
Social networks and media	TV advertising	Hoardings/billboards
Blogging	Internet advertising	Direct mail
Guerrilla marketing	Sponsorship	Email
Publicity and public relations	Telephone calling	Texting/tweeting

> *Personal recommendation still counts for a lot. As my first boss told me: 'Make one person happy and they'll tell four others. Make one person unhappy and they'll tell seven others.' Never underestimate the power of word of mouth.*
>
> Dieter Burmester, founder of Burmester, *BBC News*, 23 February 2012

Table 10.1 sets out a wide range of communications tools and media. Each has its pros and cons. What media to use depends on the target market and product/service – which will have the widest reach of the target market at a cost that is affordable. Some media are more appropriate to particular stages in the customer journey than others. For example, if your target market is young males, digital new media, using the internet and smartphones, can be very effective and good value, particularly for a novel product/service at the awareness stage (1). However, if your target market does not use the internet or consume online content, this media will not work for any stage of the customer journey. Sometimes old-fashioned media such as flyers and posters can be more effective, particularly for local markets.

SOCIAL NETWORKS AND MEDIA

> *Even if you have all the money in the world to spend, the best way to market your business and get eyes on your product is to establish a social media presence.*
>
> Richard Branson, founder of Virgin Group, *https://www.virgin.com/entrepreneur/richard-branson-making-most-social-media-entrepreneur*

Where word-of-mouth works well within a limited geographic location, social networks and media can take over to spread the word to a wider audience. This is a term that covers any communication hosted on the internet or on smartphones, such as texting, tweeting or blogging. It includes social networking sites such as Facebook, Instagram, Twitter and YouTube. Social media can spread word-of-mouth recommendations very cheaply. It is extremely fast and can 'go viral' – reach enormous audiences very quickly. For consumer goods, word-of-mouth promotion using web-based social media networks – viral marketing – has been found to be more effective in developing brand identity through what is sometimes referred to as 'shared values', 'tribal identity' or 'emotional dialogue' (appealing to the emotional right-brain) rather than traditional mass-market advertising that focuses on product/service characteristics (appealing to the left-brain). It is therefore a powerful tool for any start-up – relatively cheap and effective.

Social media sites can be used in a number of ways, for example by establishing a presence and creating a community around the product/service. Usually linked to the company's website, it can be used to establish a dialogue with customers, solicit feedback from them, build brand awareness and even generate sales leads. If used effectively, it can help harness the 'advocate effect'. The firm can generate interest by constantly providing new topics for discussion, useful information or by organising events or contests. The key to success is getting people to 'talk about' the website or share resources on it such as information and videos. With the cost of making a video having dropped significantly, many SMEs now have videos on YouTube and drive web traffic towards them.

> *The reason we have a community is because we are constantly interacting with each other.*
>
> Mark Gainey, Chairman and founder of Strava, *The Sunday Times*, 8 September 2019

Blogging is one way to familiarise people with a product/service and build an emotional bond with them. Anyone can set up a blog free through Wordpress.com. For it to work, a blog must be constantly refreshed with new content. It must be interesting, informative and fun. It must deal with more than just one company's product/service and reach out to address other lifestyle or industry issues of more general interest and usefulness. It is unlikely to work if used as a medium for straightforward advertising. Instagram and Twitter can also be cheap ways of developing relationships with customers. An entrepreneur might even email friends and family and ask them to promote their business. Many larger organisations now expend considerable resources on developing an internet presence through blogging and other social networking sites, generating artificial excitement and web traffic around their message.

Another approach to using social media to promote a product/service is to offer a free phone app that is useful or entertaining. This might be offered on a trial basis, after which the app can be purchased or subscribed to, or it can be offered as part of a freemium business model (see Chapter 7). If an app is something the firm's target market uses this can be extremely effective because it will be shared and talked about. It might even generate some recommendations. Consider the example of Volkswagen's US launch of its new Golf GTI in 2010. It decided to use exclusively a mobile platform, targeting young males and offered a free gaming app for featuring the car. Within five days the app had been downloaded 800,000 times and had become the number one free app download on Apple's iTunes App Store in 36 countries.



Source: E+/wundervisuals

Explore further 10.1

Social media

Access the *Digital Links* booklet to watch a short video clip about the importance of social media to the Virgin Group.

Case insight 10.1 Curtis Waters and TikTok

Using social media to promote a person

Curtis Waters' (born Abhinav Bastakoti) family came from Nepal, through India, Germany, Canada finally to settle in North Carolina, USA. He went into the 2020 Covid-19 lockdown as a 20-year-old student with a part-time job making smoothies. He came out three months later as a pop star through his use of the video-sharing app TikTok to promote himself. Waters uploaded a 15-second video clip onto TikTok featuring himself dancing with his 16-year-old brother, Albert, to an extract from a single he had recorded at home called 'Stunnin'. Underneath it he posted: 'dancing to my song every day until it goes viral tbh'. Waters subsequently uploaded a number of other TikTok posts with different dance routines filmed in different locations but all using the same section of music.

> *'I think we only did TikTok because I wasn't at work and there wasn't anything else to do. Otherwise I wouldn't have had the time to do silly-dance videos every day.' (*The Observer Magazine, *19 July 2020)*

The Chinese-owned TikTok is used primarily by under 25s. Users can livestream and create short clips, usually set to music or film dialogue. Video clips can be altered using the soundtrack and dance routines from another clip and then shared with others. TikTok encourages users to interact and it focuses on novelty and what is trending. In contrast, Instagram encourages browsing through chosen accounts by loyal followers. 'Stunnin'' was used and shared hundreds of thousands of times and music industry executives started to notice. Within three months Waters' video racked up over 20 million streams on Spotify. Offered recording contracts, he decided to sign up with the management company MMG and negotiated a licensing contract on his own terms. His first album was released in 2020. After ten years the master tapes from his music albums will revert to him.

Questions:

1. Why was Waters' promotional campaign so successful on TikTok?
2. What sort of product/services are best suited to promotion on TikTok? Explain.

GUERRILLA MARKETING

Guerrilla marketing is a term that refers to any low-cost approach to creating awareness of a product/service using any of the media in Table 10.1. It relies on time, ingenuity and novelty, rather than cash, to get the message taken up and passed on. It might adopt unconventional ways to do this, such as publicity stunts, graffiti, flashmobs etc. For example, BMW became notorious for attaching a styrofoam Mini Cooper to the side of a skyscraper in central Houston, Texas, as part of a guerrilla marketing campaign. It stopped traffic. Restaurants and shops in locations with high footfall have the opportunity to create some visually compelling centre-piece outside their premises. This might be changed regularly. Similarly they might organise 'events' designed to get people to notice them, (e.g. a 'flashmob' event).

The idea is to get noticed and to create a 'buzz' around the business or the product/service so that potential customers want to find out more. They are eager to enter the shop or restaurant or to search out where the product/service can be seen or purchased. Encouraging onlookers to take pictures or videos on their smartphones and then share them with friends is exactly what the 'outside-in' approach to promotion is about. The more extraordinary the stunt the more likely people are to do this and there is just the possibility it might also be picked up by the mainstream media. This approach has proved particularly successful

Case insight 10.2 Instant Pot

Using social media to promote a product

Instant Pot is a multi-cooker that does the job of a slow cooker, electric pressure cooker, rice cooker, steamer, yogurt maker, sauté/browning pan, and warming pot that has attracted a cult following, selling through social media and word-of-mouth rather than the more traditional forms of advertising and promotion. Developed through brainstorming sessions for business ideas by Robert Wang and his friend Yi Qiin in 2008, the first version was finally launched in 2010. They saw it as a way to cook healthy family meals quickly and affordably.

> *'We have tried to automate cooking as much as possible and tried to simplify the cooker. One press of the button can cook the meal for the family.'*

Initially they thought the product was so good that customers would flock to buy it. Promotion was typically low-key, through word-of-mouth. But the Pot suffered from an image problem of being seen as old fashioned because of its function as a pressure cooker and one early challenge was designing a foolproof product and persuading customers that it was safe. However, the pair remained convinced that if they could get people to try their Instant Pot, they would love it. Sales were steady but unspectacular until 2013 when they started to sell the Pot on Amazon. At that time the product started to get noticed by food bloggers who wrote enthusiastically about it and started sharing recipes with their followers. Realising the effect this was having on sales, the company started to give Pots to bloggers and launched its own Facebook page, encouraging the development of an Instant Pot community that shares recipes, photos and tips online – tips for making anything from soups, stews and chilli, to poached eggs, popcorn and cheesecake in the appliance. They recognised that cooking was a social and emotional activity that created relationships and people liked to talk about it. All they needed was the spur to do so and a medium to communicate through. As Robert Wang explains:

> *'If you look at the Amazon reviews, one common word is "love". Americans are very open with their emotions. Love is all over the place. Another one is that "Instant Pot changed my life".' (BBC News Business, 6 March 2017)*

In 2016 Instant Pot featured on Amazon Prime Day, the online retailer's global 24-hour annual sales event, and became an instant bestseller, selling 215,000 in the USA alone. Instant Pot's website carries help videos, blogs and recipes and Instant Pot now has over 400,000 followers on Facebook – who often share their 'like' for the Pot with a friend. There are also a number of versions of the Pot, with development often having been initiated by feedback and ideas submitted by users. The latest Pot can even be operated via a mobile phone app. The company launched by Robert Wang and Yi Qiin remains a small business with just 25 employees. It contracts out the manufacture of its Pots to a factory in China.

Access the *Digital Links* booklet to visit the company website and to watch a short review of Instant Pot.

Questions:

1. What do you learn about the use of social media from Instant Pot?
2. What sort of products are best demonstrated on video?

for the UK cosmetics retailer Lush, as it promotes its social and ethical values (Case insight 10.5). One promotion for its unwrapped, or 'naked', cosmetics featured staff wearing little other than an apron.

One online approach to guerrilla marketing is to link people using online chat rooms who are interested in a particular topic back to a website (see Case insight 10.3). Alternatively a campaign might use social networks and mobile technologies to encourage the spreading of a rumour related to a product/service, encouraging it to be spread between friends and 'going viral'. You only have to look at Donald Trump's tweets to see how effective this can be. To be effective the rumours must be exciting, different, something people will find interesting and unusual enough to pass onto friends. The whole idea is to involve prospective customers in promoting the product/service, at the same time building a relationship with them.

Explore further 10.2

Guerrilla marketing

Access the *Digital Links* booklet to watch a video clip showing a range of guerrilla marketing initiatives designed to grab people's attention.

PUBLICITY AND PUBLIC RELATIONS (PR)

PR involves getting media to recognise what the entrepreneur and their firm are doing and write news articles or record radio or TV features about it. It is therefore likely to reach a wider audience than their personal network of relationships. The key is to find something that is newsworthy or interesting. An entrepreneur using this tool must prepare press releases and be prepared to give interviews. A major advantage is that PR is free, and because the message comes from an 'outsider' these articles or programmes will have greater credibility than advertising which is often seen as self-serving and simply trying to increase sales (Smith, 2009). However, the problem is that the entrepreneur does not control the content of the article or feature, and prospective customers may be left interested in the product/service but not know how to purchase it or contact the firm. Worse still, there is a danger that the published article or feature might be negative or critical. And sometimes the entrepreneur's story will not be run because other, more newsworthy events have happened on that day. A professional PR company can help find communications outlets and manage message, but can be expensive.

People are usually interested most in the human interest story associated with a start-up, rather than product/service details, but offering something novel and unique in a particular location might also be of interest. The combination of an interesting personality and a 'David and Goliath' story of taking on larger competitors can be irresistible. Richard Branson has been particularly good at this, ever since he launched his first magazine – *Student* – at the age of 18. He has used PR to establish the Virgin brand. Branson's exuberant personality and newsworthy publicity stunts mean that he often grabs press attention. He launched Virgin Atlantic, identifying himself with the brand and positioning himself as the entrepreneur competing against the established competitor British Airways – a 'national carrier' that had government backing and a near monopoly on transatlantic air travel at the time. Another approach is to have a celebrity launch the product/service or open new premises. Sending a free sample of the product (e.g. a hi-fi product) or offering a service (e.g. dinner) free to specialist media can result in them writing a review of the product/service. Apple uses PR by getting respected computer and technology experts to review its new products prior to launch.

ADVERTISING

While having a presence on social media these days may seem essential, there is still a role for more traditional forms of advertising – even if it is on the internet. Advertising a new product/service launch can be through a range of media such as the internet, particularly the search engines like Google, as well as newspapers, magazines (print and virtual), radio, TV, flyers, posters, hoardings, direct mail,

emails etc. Some advertising media such as radio and TV might guarantee a wide audience but they can be expensive. However, if they can be focused in a small geographic area, for example with a local newspaper or radio station, these can be very effective for local shops or restaurants. Low-cost advertising such as posters and flyers – delivered to homes or placed under car windscreen wipers – can also be extremely effective for locally based businesses. They can create product/service awareness and tell customers where a firm is located and, if combined with a message or discount coupon that encourages a trial purchase, can quickly stimulate sales.

For retailers with shops in high-footfall areas, the shop window offers geographically focused, prime-space advertising at zero extra cost. For traders on the internet their home page is their shop window and search engine optimisation can drive customers to it (see Chapter 12). For businesses using trucks or vans, these are all opportunities to advertise without charge – and yet white vans remain the norm. For local trades people undertaking work in a location, the time taken to put up an advertising sign or post a few flyers through adjacent letterboxes might be minimal.

Some social media sites also take advertising, which can be a useful way of reaching particular target markets. For example, Facebook allows start-ups to deliver targeted advertisements based upon key words in personal profiles and geographic location. Similar paid-for advertising is available on Google, Reddit, Twitter, LinkedIn and StumbleUpon. There is no minimum spend and campaigns can be put together without an advertising agency; however, the danger is confusing volume of reach with producing effective campaigns that generate genuinely interested customers. And while Facebook may provide data on reach, this is often opaque.

> *Facebook makes it as easy as possible for you to spend money with them. It is a brilliant business model ... [but] you need to have some skill and knowledge about what you are doing.*
>
> Seb Dovey, founder of Scorpio Partnership, *The Sunday Times*, 9 February 2020

Advertising analysts say that social media advertising is generally more effective for e-commerce platforms that take customers direct to the vendor. This allows effectiveness to be measured directly. Highly focused advertising allows a firm to target its message more precisely and can be cost-effective, for example using trade press (B2B), themed magazines (B2B and B2C) or the pay-by-click advertising offered by Google and Bing. Pay-by-click allows a firm to advertise on the screen only when certain search words are used. It also allows a firm to place adverts on other people's websites – where they offer related products/services. With pay-by-click the firm only pays when its advertisement is clicked on. However, any firm using the internet to promote its business must remember that it needs to have an attractive website and one that customers can navigate around easily.

An entrepreneur might also consider sponsoring an event if the target audience coincides with the target market for the product/service. Not only might this give them the opportunity to advertise, it might also give them an opportunity to offer free samples or discount coupons that encourage people to try their product/service. Another approach is to produce short videos which can be placed on YouTube and the firm's website and then encouraging people to share them with friends. In fact, sponsored events can be the backdrop to a firm's video. Retailers like Jack Wills used this to great effect to promote their 'preppy' clothing brand.

Finally, it might be worth considering collaboration with other organisations targeting similar markets but not selling competing products/services, so that media costs can be shared. There are many examples. The World Wide Fund for Nature persuaded Whiskas cat food to support its global Tigers Alive protection programme. The genealogy website Findmypast collaborated with Grant's Whisky to give consumers the opportunity to research their own family history. Onesie designer OnePiece collaborated with Virgin Atlantic to trial a limited edition OnePiece onesie for Upper Class passengers. Finding partners in different sectors to collaborate with can involve some lateral thinking. They must have a mutual but non-competitive consumer interest. However, it can work well in any form of media for the mutual advantage of the partners.

Explore further 10.3

Advertising

Access the *Digital Links* booklet to watch a video clip showing the power of advertising in projecting a brand image for Virgin.

Case insight 10.3 Avi Schiffmann

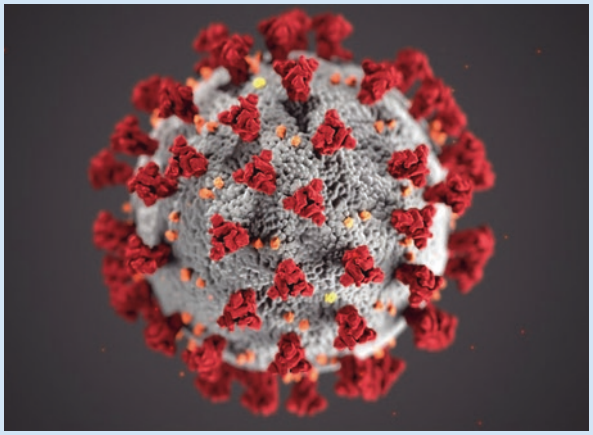
Social media and website development

Avi Schiffmann is a 17-year-old founder of the world's most popular coronavirus-tracking website called nCoV2019.live. He started tracking the virus in December 2019, noticing that it was hard to find information, and launched the website in January 2020. At first most of the traffic came to the site from his 'guerrilla marketing' tactics, linking anyone in online chat rooms looking for information about coronavirus back to his site. In March a journalist wrote a story about the site and at that point interest exploded. By April it was getting 30 million hits a day.

The website shows a dashboard of information about the virus such as infections, deaths, recoveries, and rates of change. It shows infections on a world map, and has pages with some basic information about the virus, including symptoms and tips for hand hygiene. It is updated every day with data 'scraped' from other websites such as the World Health Organization, the US Centers for Disease Control and other government agencies around the world. Schiffmann lives in Washington, USA, and started coding when he was seven years old, teaching himself from video tutorials on YouTube. Since then he has developed some 30 other websites. He turned down $8 million to put ads on his site. Instead, he cares more about the connections he's made from the project.

In an interview with the *MIT Technology Review**, Schiffmann reflected on what he had learned from ten years of website development. His advice was:

1. Learn from small projects, do not be afraid to make mistakes and continue to learn – He started with a 'terrible' (his word) school sports website and improved each new one. He uses 'web scraping' to get his data for the Covid-19 website but to do this he needs to access other servers and he had to teach himself to use Linux, which he did in a weekend. He believes you can learn anything online, with the help of others. He asked for help with the Covid-19 site on coding websites and received dozens of offers of help worldwide.
2. Use your own experience to identify a problem – The coronavirus tracker started because it was a topic that interested him and he thought it would interest others. However, he had difficulty finding out what was happening and could not find a 'nice-looking' dashboard tracker.



Source: CDC on Unsplash

3. Be first but be patient – His was the first website to track the virus but he believes it took time to become popular. However, now there are others, his remains the most popular.
4. Keep costs low – He works from home, gets free help from other people and 'bootstraps' resources (see Chapter 19). Cloudfare (the US web-infrastructure and website-security company) host his sites free because he spoke positively about them in an interview.
5. Be aware of your role and responsibilities – Once the website became popular he realised how important it was to keep it up to date and he works on it night and day.
6. Passion counts for a lot – He may not have been a good student but that was because he could not be passionate about what he was doing.

Access the *Digital Links* booklet to visit Avi Schiffmann's website and to watch an interview with him at the hight of the website's popularity.

Questions:

1. What do you learn from Avi Schiffmann's experience?
2. How relevant is his advice to other commercial start-ups?
3. Should he have accepted advertisements onto his website? Explain.

*Source:*Based on an interview by Tanya Basu in* MIT Technology Review, *12 June 2020. Available at: https://www.technologyreview.com/2020/06/12/1002838/avi-schiffmann-17-year-old-guide-building-pandemic-protest-tracker/*

Case insight 10.4 Influencers

Influencing using social media and monetisation

A digital 'influencer' on social media – a YouTuber, Instagrammer, blogger, vlogger etc. – can these days earn tens of thousands of pounds sterling from brands in exchange for product endorsements. The industry should be worth about £8 billion in 2020. For example, the cosmetics firm Estée Lauder revealed that 75% of its marketing budget in 2019 was spent on influencers. But while many celebrities have moved into this business (e.g. US actor Will Smith has his own YouTube channel and UK actor David Tennant has a podcast), it is still an area where start-ups can flourish. The skill is to find a niche area and then develop a loyal following by being entertaining and informative, growing a trusting relationship with followers by sharing personal details of your life, bringing them into 'your gang'. For example influencer Patricia Bright (see below, 'Beauty') applies lipstick while chatting about her personal life. A successful influencer knows their followers – what interests them at any time and what media they respond to (e.g. there are dozens of interior design communities on Instagram). They engage with followers offering advice, responding to questions. Followers tell influencers what kinds of videos or posts they would like to see, and influencers respond regularly and frequently.

Some influencers do not set out to earn money, instead they aim to inform and/or influence (see Case insight 10.3). For example, Greta Thornburg and Finn Harris are climate change activists, and Alice Aedy focuses on the plight of refugees. However, many influencers have monetised the platforms they have popularised. Generally the more followers an influencer has, the larger the income they are able to command and, as a result, some influencers have bought thousands of fake followers by generating fake accounts or by using automated bots. Income-generating influencers promote brands to their followers for a fee. Since followers trust their influencer, they are more likely to take any recommendation from them seriously. This can be dangerous territory and in 2019 the UK Competition and Markets Authority introduced guidelines for influencers which state they must say when items they are promoting have been loaned to them or are part of 'paid partnerships'. They must also reveal if they have previously had a commercial relationship with any brand featured in their content, signified by #spon (for sponsored). Influencers might also sell merchandise such as hoodies or T-shirts or offer online courses – the more followers the greater the opportunities.

Perhaps unsurprising given the diversity, gaming is probably the most popular sector for influencers (see Case insight 9.4). Some of the sectors influencers operate in are shown below, along with UK examples:

- Adventure (e.g. Anthony Middleton, online name 'antmiddleton')
- Beauty (e.g. Patricia Bright, online name 'Patricia Bright')
- Cars (e.g. Adnan Ebrahim, online name 'Car Throttle')
- Comedy (e.g. Michael Dapaah, online name 'Michael Dapaah')
- Entertainment (e.g. Josh Pieters, online name 'Josh Pieters')
- Family (e.g. The Saccone Jolys online name 'SACCONE JOLYS')
- Fashion (e.g. Lorna Andrews, online name 'lornaluxe')
- Fitness (e.g. Joe Wicks, online name 'thebodycoach')
- Food (e.g. Nadiya Hussain, online name 'nadiajhussain')
- Football (e.g. Theo Baker, online name 'Theo Baker')
- Gaming (e.g. Felix Kjellberg, online name 'PewDiePie')
- Lifestyle (e.g. Saffron Baker, online name 'Saffron Baker')
- Parenting (e.g. Sarah Turner, online name 'theunmumsymum')
- Sport (e.g. Nile Wilson, online name 'Nile Wilson')
- Tech (e.g. Safwan Turner, online name 'SuperSaf')
- Travel (e.g. Jack Morris, online name 'doyoutravel')

Questions:

1. Is monetising the role of influencer on social media ethical?
2. What are the pros and cons of becoming an influencer?
3. What are the pros and cons of using an influencer?

IDENTIFYING PROSPECTS

Identifying prospective buyers and giving them a reason to try a product/service may seem straightforward enough, even if the scale of it may sound daunting. Many entrepreneurs use their network of contacts to seek out introductions to prospective customers (including family and friends). This can short-circuit the problem a start-up has about credibility – trust has already been established. However, for most start-ups finding those first prospective customers depends on the nature of the

product/service and understanding who the prospective customers (a profile of the target market customer) are and how they can be contacted.

Finding prospects that meet a marketing segmentation profile can be extremely time-consuming. Of course it may be possible to buy in lists of prospects and contact them directly – by phone, email, text or visits. Lists may need to be 'qualified' – assessed for their real potential – before too much time is committed to trying to sell to them. It may also be possible to obtain referrals, recommendations or 'click-ons' from social media connections. This can be particularly valuable once a firm is established and satisfied customers are willing to help. With a good list of prospects face-to-face selling is often the best way for the entrepreneur to find their first paying customers – and this needs a particular set of skills that we explain later.

It is often easier and less resource intensive to deal with prospects that are geographically local – whether they are to be contacted using appropriate real or virtual media, including face-to-face visits. Indeed, even if the product/service has a far greater geographic potential, local roll-out of any marketing communications campaign alongside distribution can make a lot of sense so long as there is no first-mover advantage to be lost – which may be the case with radical innovation. However, the internet does open up global markets, and platforms like Amazon, eBay, Alibaba and Tencent allow firms to have a global shop window, although having that window does not guarantee people will visit it, let alone purchase anything. There are hundreds of thousands of similar products/services on these sites, many almost identical and often selling simply on price. Questions about creating awareness and convincing customers to make a trial purchase do not go away. These are simply virtual sales and distribution channels.

Trying to make the whole world aware of a new product/service is a daunting task. However, having a niche product/service offering (Chapter 7) can mean that selling globally from launch makes good sense and using these platforms may then be more attractive, although it still means that customer traffic needs be driven to the relevant website. One way of doing this is by 'search engine optimisation' – a topic we deal with in Chapter 12.

RADICAL INNOVATION: PROSPECT CHARACTERISTICS

While all start-ups need to create awareness, how to approach this will depend on the type of product/service. Refer back to the start-up typologies in Figure 4.1. Identifying prospective customers for a radically different or innovative product/service can be particularly difficult. It presents the added problem that prospects may not understand what the product/service does, let alone the benefits it might offer them. This has to be explained – or the entrepreneur must make a leap of faith that they believe in this product/service and know better than prospective customers. Remember, neither Steve Jobs nor Henry Ford had any faith in market research into the market for their original products.

The diffusion of an innovation through a market takes time and is not steady, as different types of customers adopt it at different stages. Rogers (2003) argued that this follows channels of communication within society, led by the 'opinion leaders' identified earlier, and can be represented by the curve shown in Figure 10.2. He argued that successive groups with distinguishing characteristics adopt innovations sequentially as they communicate its proven benefits. Adoption begins slowly, accelerates to a peak rate of growth and then slows. Eventually the market share of the innovation will reach saturation level as it nears the end of its life. He classified customers into five groups.

Innovators (2.5%)

These are risk takers, typically with high social and financial status, who are interested and understand the innovation (therefore not needing to have its use and benefits explained). They are willing to experiment and are better able to cope financially if the experiment with the product/service is not successful. They like novelty and try new things and playing to these desires is likely to be most effective for this group. However, they typically constitute a small part of the market.

Early adopters (13.5%)

These are opinion leaders, typically again with high social and financial status, who are sufficiently well connected and educated to learn about and understand the benefits of the innovation. However, they choose new products/services carefully. They adopt successful products/services, making them acceptable and respectable and they can be very influential, particularly if encouraged to share their opinions, for example through social media. Promoting an innovative product/service by playing to these desires and using these media is likely to be the most effective for this group. So, deciding on the promotion strategy – the message and the media – depends not only on who the target customer segment is, but also their motivations for buying early in a product/service life cycle. For a start-up with an innovative product/service this is a key group to influence. If they do not react favourably, the start-up may fail.

Early majority (34%)

These form the majority of customers with average social and financial status. They have contact with early adopters and are likely to be influenced by them. This is the tipping point where demand for the product/service suddenly takes off with explosive growth, as the early adopters give way to the early majority. This is greatest when there are strong network effects – where the value of the product/service is increased as more people in the network use it. At this point investment in capacity and distribution is particularly required and the entrepreneur will probably need to find additional funding.

Late majority (34%)

These adopt the innovation after the average person, approaching any innovation with scepticism. Typically they have below-average social and financial status.

Laggards (16%)

These are the last to adopt an innovation. They are traditionalists who dislike change. Typically they are older, with limited contacts outside their close network and also have below-average social and financial status.

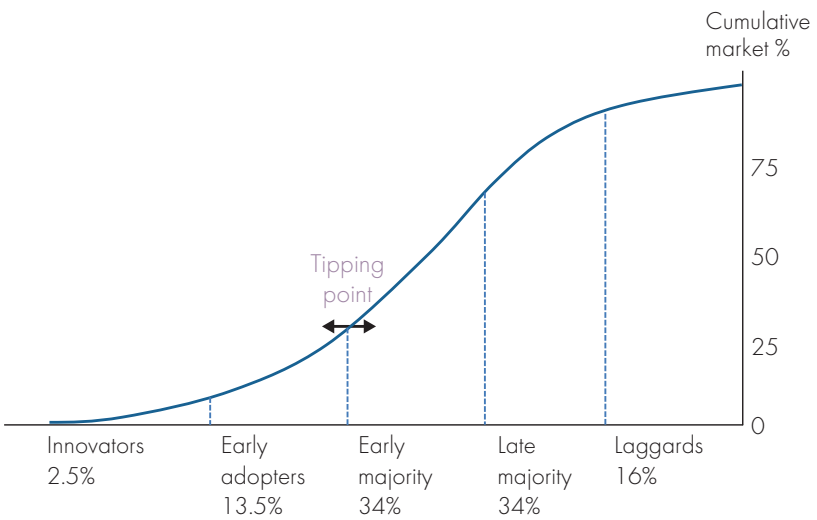


Figure 10.2 Diffusion of innovation

RADICAL INNOVATION: MESSAGES

The more radical the product/service innovation, the more likely it is to create its own genuine public interest and this is where PR can often be most successful. Interest does not automatically translate into a wish to purchase the product/service. Customers may need to understand what an entirely new product/service actually does – and then understand its value proposition; the problem it solves and benefits it offers (not to mention where it can be purchased). PR is also likely to work better where a firm is introducing a product/service that exists elsewhere into a new market where it is not currently available. Such developments are newsworthy in their own right. But even here, few companies would trust the public to beat a path to their door on the back of a news story. There is no guarantee that the story will be accurate, nor is there any guarantee that it will explain to potential customers where they can buy the product/service. So it is important to provide the media with information on what the product/service is, why it is newsworthy and where it can be obtained. This involves producing and distributing a press release and possibly organising a press conference or launch event. This can be supported by a range of other activities that utilise as many of the communication media as time and money permit.

Few product launches enjoy the same level of anticipation and pre-ordering as Apple products. Apple plans these launches meticulously. Even before the launch of a new product Apple ensures that there is promotion of the product, normally through a mix of free PR (pre-launch feature leaks, pre-launch product reviews etc.) and a theatrical launch event supported by media advertising. But then Apple has a brand recognised for design and innovation that has an established band of loyal customers and advocates – something that takes time to create and is not an option for most start-ups. So creativity is called for in organising such events and motivating customers and press to attend. Nevertheless, the lesson is clear; even successful firms need to create awareness of their product/service before the customer will even consider purchasing it and they do not leave this to chance.

INCREMENTAL INNOVATION: MESSAGES

Selling a product/service where any innovation is more incremental does not face the same barriers. Customers already understand what it can do. They need to be convinced that this product/service is better in some way than the competitor's that they are probably already purchasing. They need to be made aware of the product/service and given a reason to make a trial purchase. This creates different problems. The job of creating awareness can be more difficult because the launch is less newsworthy and this means PR is less likely to bear results. As a result the firm might focus more on the other communications media. However, it still has some PR options that might get results. Some businesses are lucky enough to be able to have a celebrity launch their product/service – sometimes free and often found through their network of contacts. Celebrity launches can be extremely effective, particularly for shops because they attract potential shoppers. However, they can also be videoed and used for promotion. A celebrity might also be persuaded to endorse the product/service, but do remember that they are putting their reputation on the line. Alternatively, never underestimate the newsworthiness of the entrepreneurial story, particularly in a local area. Many newspapers run regular small business pages and are looking for inspiring stories to fill them.

Companies selling directly to end-users (business-to-consumers) in a geographically local area might use the time-honoured approach of prospecting and selling on a face-to-face basis in a local market that traditionally attracts shoppers for certain types of products. Face-to-face selling is what market traders do all the time. They attract customers by shouting out their value proposition – from cheapest to best-quality products. They convert the prospect with a range of selling skills, possibly honed over many years. Some use an auction approach to sell their goods, other stunts that mirror guerrilla marketing techniques. At the end of a long day some might discount prices in order to sell unsold produce.

However, it becomes more and more difficult to use face-to-face techniques as the market size for a product/service gets bigger and this is where even companies selling to geographically local markets might find a range of communications media effective – from flyers to local advertising, mail drops to

guerrilla marketing. Social media can also have an important role to play locally and more widely. As we have seen, it can be a very cheap way of generating interest in a new product/service or business, but, as with all media, there needs to be a 'hook' to get people interested. If the campaign aims send a message direct to prospective customers there is the challenge of finding email or other addresses to send the message to. If the intention is for recipients to pass on the message to others with the hope that it goes viral then it is best linked to some form of virtual guerrilla marketing campaign.

Another 'hook' might be the offer of free or discounted samples or trials. This short-circuits the awareness stage and gets customers to jump straight to the evaluation or trial 'purchase' stage. This is only appropriate for small-ticket products/services that are only incrementally different to those offered by existing competitors and are likely to generate repeat sales. It works well when linked to a 'supply-push' distribution strategy as it gives distributors an incentive to stock the product/service. It also has the advantage of not compromising the price point the product/service is intended to be placed at – the value-to-customer price.

Selling to another business (business-to-business) is in many ways easier because it often involves face-to-face selling. For example, selling into a distribution network starts by identifying who specifically in the company is the buyer of the product/service – their name and how to contact them. Just making an appointment requires a degree of 'selling' because these are busy people with established suppliers. They need a good reason for the meeting. And then the entrepreneur needs to master some basic selling skills to turn these prospects into customers.

DEVELOPING SELLING SKILLS

> *All selling starts by talking to strangers – overcoming your fear of rejection, and persuading someone to buy something from you.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 4 August 2019

While marketing involves understanding customers and their needs, selling skills involve tailoring them to specific customers, communicating them effectively and being able to address their specific concerns. Most entrepreneurs will have to sell face to face at some stage – either to other businesses or to consumers. This might be at a trade fair or in a real sales situation. Ideally, to sell face to face an entrepreneur needs to identify the prospective customer by name and then be able to meet with them. This is easy to say but usually more difficult to arrange. Corporate buyers have busy schedules and established suppliers. Personal buyers often try to avoid salespeople. They need a reason for the meeting – a hook that offers them something that they need.

It sounds obvious, but the first thing is to thoroughly understand the value proposition for the product/service and make certain the benefits this specific customer is looking for have been identified. A face-to-face meeting provides the opportunity to tailor benefits to the *specific* needs of this customer. This requires some basic research on the prospect and, if relevant, the company they represent. The larger the potential sale, the more important the research and the longer should be spent on it.

If this is a chance meeting, for example at a trade fair, the entrepreneur may need to ask questions to find out who the prospect is and make judgements about what their specific needs might be. If the entrepreneur is visiting a prospect, they should send them information about their company and the product/service in advance if possible. A brochure can be very useful. At the meeting the entrepreneur should aim to build a relationship. Knowing a few personal details about the prospect and sometimes spending a little time on 'small-talk' can help break down barriers quickly. But a professional relationship is based on mutual self-interest – both parties want something – and trust that both parties can deliver what they promise – the value proposition and a cash payment for it. The entrepreneur needs to establish what the prospect really wants – the 'problem' they have – and how their product/service can solve it for the prospect. The entrepreneur needs to be able to:

- Ask questions and listen to the answers;
- Be clear about how their product/service will solve the prospect's specific 'problem' and be able to demonstrate its features either directly or with the help of photographs or brochures;
- Back up the claims they make about the value proposition with proof, for example by providing references or testimonials from satisfied customers;
- Handle objections and concerns;
- Close the sale.



Source: Xandra Luijks from Pixabay

Buyers are unlikely to eagerly buy a product/service on just the say-so of the seller. They will have doubts. How will the product/service really perform? Why should they trust what the seller claims? Ultimately this will boil down to a question of trust. And the bigger the expenditure they are asked to make, the greater this barrier will be. However, there are techniques that can help the seller deal with 'objections' and persuade customers to buy and try their product/service.

Some objections are fundamental – the customer does not want or need the product/service. But some are just raising other problems that the seller might be able to solve. There are six other types of sales objection or concerns, which a salesperson may be able to overcome by following these steps:

1. **Feature objection** – Some of the features do not meet the prospect's approval. This might be overcome by emphasising the positive reasons for these features.
2. **Information-seeking objection** – The prospect wants more information about the product/service, often about proving your claims for it. This gives the seller the opportunity to provide that information.
3. **Price objection** – This might be fundamental or a buying signal and the start of negotiations. If the prospect is seeking a lower price, the seller could try stressing the product/service benefits compared to those of a competitor and its value for money. If this does not work, they could try offering a discount only in exchange for something else like a larger order.
4. **Delay objection** – The prospect wants to put off making a decision. This is difficult if the delay is genuine and the seller needs to find out the reason. If necessary, a return visit can be arranged.
5. **Loyalty objection** – The prospect may have an established relationship with a competitor. The seller should stress the benefits of their product/service without 'knocking' the competitor. They can also try to find reasons why the prospect should change supplier, for example because they are not receiving the service they ought to. The seller should always keep in contact as it may just take time to convince the prospect to try them.
6. **Hidden objection** – The prospect prevaricates for no obvious reason. It is important to get to the unstated objection and deal with it, so the seller should probe and ask questions.

Even if the entrepreneur overcomes these 'objections', some people have problems recognising 'buying signals' from prospects and can continue relentlessly through a sales meeting long after the prospect actually wanted to buy the product/service. They just need an invitation to do so. Buying signals can be many and various: the customer becoming interested and animated, positive body language such as leaning forward or wanting to pick up or try the product. If interest is confirmed by asking a few questions, the whole process can be short-circuited and the seller can go to the most important stage of all – closing the sale. There are six well-known techniques that can help close a sale without appearing too 'pushy' or impolite:

1. **Trial close** – The seller can try this one immediately when they see a buying signal. This close uses the opportunity of an expression of interest to ask a further question which implicitly assumes a sale. For example, 'It is the quality of the product that has convinced you, hasn't it?' The trial close ends with a question, and if the answer is positive then the seller can proceed straight to close the sale.
2. **Alternative close** – This forces the prospect to make a decision between options. For example, 'Do you want an initial order of 1,000 or 2,000?' or 'Can we deliver next month or would you prefer next week?'
3. **Summary close** – This is useful if the prospect is uncertain about the next step. It summarises what has been said and sets out the next steps. For example, 'So those are the advantages our service offers

over the one you are using at the moment, and I think you would agree we are better in every respect. Do you agree?'

4. **Concession close** – Concessions are usually on price. They may secure orders but should not be given away too early, only at the end of the meeting when the seller judges it necessary to tip the balance in their favour. Always try to get something in exchange for a price concession. For example, 'And if you place an order this month, there is a special 5 per cent discount.'
5. **Quotation close** – Often a seller will have to provide a formal quote at the end of the sales interview. If this is the case, then it should be followed up with another visit to the prospect to clarify the main points, answer any queries and secure the sale.
6. **Direct close** – Sometimes it is actually necessary to ask for the order directly – and then remain silent and listen to the answer. If the answer is 'no', a follow-up question should illicit some objections that you might be able to overcome.

Selling to well-informed prospects can be particularly difficult. They may have sought out online reviews or gathered expert advice from independent sources rather than relying on what the seller might tell them. They may come to a sales meeting with a decision already half made and, after clarifying a few points that confirm they want to buy the product/service, often try to go straight to a price negotiation. The approach to take here is called 'insight selling' and involves trying to disrupt these pre-meeting decisions. Firstly, it involves trying to establish a relationship with the prospect well ahead of the sales meeting in their 'learning' phase so that the seller is seen as an expert consultant with valuable knowledge. Secondly, it involves using this position to disrupt and 'reset' the prospect's thinking by challenging their assumptions, perhaps by identifying undisclosed problems they might face. In this way, the buying decision is a joint one, with the seller adding value by their role as an expert consultant in the process.

DEVELOPING A COMMUNICATIONS CAMPAIGN

A marketing communications campaign should integrate with the overall marketing strategy of the firm. One of the dangers in using different media is that inconsistent or contradictory messages might be communicated on each platform. Integrated marketing communication (IMC) is a common-sense approach to marketing communication developed by Schultz et al. (1993). It was defined by the American Marketing Association as 'a planning process designed to assure that all brand contacts received by a customer or prospect for a product, service, or organisation are relevant to that person and consistent over time'. It aims to ensure that all forms of communications and messages to prospects, customers, consumers and other target audiences are consistent and carefully linked. It starts by focusing on the customer – their preferences, buying patterns, media exposure, etc. – and then offering a product/service that meets their needs, and promoting this through a mix of communication methods that the customer finds credible and attractive – the 'outside-in' approach. This all requires a good knowledge of prospective and/or existing customers. Ultimately IMC seeks to develop a relationship with target customers by promoting a consistent brand message at all contact points so that the brand becomes more credible and appealing to them. Other claimed benefits of IMC are greater consistency among the various communication messages and functions, cost savings and a better use of media and promotional mix (Pickton and Broderick, 2005).

Developing a marketing communications campaign involves six steps:

1. Identifying the target market(s) for the product/service.
2. Identifying the appropriate media to reaches the target market(s) (coverage vs cost).
3. Defining the communications objectives. These can be aimed at end-use customers (and varied according to the stage they are at in their customer journey – see below) as well as distribution channels.
4. Developing and refining the communications message – words and images.

5. Setting a budget (money and other resources). Decide whether the media that reaches the target market(s) is appropriate for the message and is affordable. If unsure about the effectiveness of different media, set a limited budget, test effectiveness and evaluate results after a set time – the same approach as 'affordable loss' (Chapter 6). If unsure about the message, test it out in the same way or through focus groups before using it.
6. Preparing a communications plan by deciding on media, dates, times etc.

A communications campaign should be integrated within a firm's overall marketing strategy. It should aim to move customers through the stages of the customer journey shown in Figure 10.1 – from prospect to loyal advocate of the product/service – while recognising that they all might not be at the same point at the same time. However, the short-term objectives appropriate for each stage of this journey must be balanced with the longer term objective which is to develop sustainable and close customer relationships based on shared values, underpinned by a strong brand identity. It must both deliver and receive communications with customers, but ultimately it should be designed to open up a dialogue. Listening to customers is important at all stages. Once a campaign is completed it should be evaluated against the objectives set in step 3.

Communication objectives should therefore reflect the stages in the customer journey.

Stage 1 (launch)

This is the stage where creating awareness of the product/service and persuading customers to make a trial purchase are important. Customers are being asked to try something that is unknown to them. Why should they try it? This is particularly the case if the firm is counting on the prospects contacting them rather than the other way round. Customers need to understand what the product/service does for them – the problem is solves and benefits it offers – and create a desire to at least try it. At this stage the firm will not have been able to build a trusting relationship with customers. It is about:

- Creating brand awareness – getting customers to recognise that this brand (possibly among others) meets their needs and should be considered;
- Stimulating brand purchase – persuading customers to buy this brand and try it because, in some way, it offers a better value proposition than competitors' brands;
- Encouraging brand evaluation – persuading customers to make a positive evaluation of the brand compared to that of competitors and start building trust in the brand.

Stage 2 (take-off)

This is the stage when the firm should be continuing to persuade more customers to try the product/service and, at the same time, persuade those who have tried it to repeat purchase. Stages 1 and 2 should typically target the 'innovators' and 'early adopters' shown in Figure 10.2. It is about:

- Creating brand attitude – getting customers to recognise how this brand is different to and better than others (e.g. through service delivery) and then encouraging them to share this experience with others;
- Monitoring customer evaluation of the brand – and if possible altering any elements of the value proposition that they are unhappy with;
- Facilitating/encouraging brand repurchase – having decided to buy the brand, the customer needs to know where the product/service can be purchased again and at what price.

This is the stage where customer feedback is important. Are the value propositions advertised real? Does the product/service meet customer expectations? Is the service delivery at each point in the distribution chain appropriate? Without a programme of evaluation the firm will never know at what point customers find problems. Remember they may decide not to repeat-buy if just one element of the marketing mix – however small – does not meet their expectations in some way. If a firm does not ask for feedback they may never know where there is a problem, until it is too late. A firm might try face-to-

face trials, evaluation questionnaires or feedback sheets using the market research techniques outlined in Chapter 5. It can offer incentives for feedback (e.g. discount vouchers). If it can get a customer contact address, it can inform them when a weakness is corrected, perhaps offering a free trial or replacement. It is often said that correcting a mistake for a customer can lead to forming a relationship with them and

Case insight 10.5 Lush

Business model

Lush is a retailer that sells own-brand, handmade cosmetics using only vegetarian recipes – soaps, shampoos, shower gels, lotions, bubble bath and fragrances. It was founded by Mark Constantine and Liz Weir in 1994. Today it remains privately owned but has become a multinational retail chain and the founders have become multi-millionaires. With a turnover in excess of $1 billion, it had grown to over 1,000 stores in more than 50 countries but the coronavirus pandemic is certain to cause that number to drop.

Lush shops are located in high-footfall, high-street locations. They are very distinctive with simple, bright window displays. Some products, like 'bath bombs', are stacked like fruit and others such as soap are sold like cheese, wedges stacked on shelves and sold by weight wrapped in greaseproof paper. These attractive, bright displays give Lush shops the feel of old-fashioned market stalls or sweet shops. But it is the distinctive smell of a Lush shop that first announces its presence. This is caused by the lack of packaging on its products and Lush offers a free cosmetic face mask to customers returning five or more of their product containers. The aim is to have 100% of their packaging recyclable, compostable or biodegradable. The company also sells its products online.

The shops are fun places, often with promotions and campaigns going on inside and outside. It supports many campaigns around animal welfare, environmental conservation, human rights and climate change. The shops are staffed by enthusiastic young people who are trained not to 'sell' but to help people select products by providing comprehensive product information, which includes who at Lush made the product. It targets younger, predominantly female customers who are ethically and environmentally aware.

Lush products are made in small batches (based upon shop orders) from fresh, organic fruit and vegetables, essential oils and safe synthetic ingredients. They are 100% vegetarian, 83% vegan and 60% preservative free. In addition to not using animal fats in its products, Lush is also against animal testing and tests its products solely with human volunteers. Moreover, Lush does not buy from companies that carry out, fund or commission any animal testing. Its products are not cheap, but not priced as high as most branded cosmetics.

The company has never advertised and its growth has been organic, although it owns its overseas businesses in various joint ventures (USA, Japan and Australia).

The founders of Lush have some strong ethical beliefs that are reflected in their lifestyles and the values of the company. Lush donates around 2% of its profits to charity, supporting many direct action groups such as Plane Stupid, a group against the expansion of UK airports, and Sea Shepherd, a group that takes action against Japanese whaling ships. The shops host regular campaigns around animal welfare, environmental conservation, human rights and climate change. Often, Lush launches products specifically to support these groups. It has its own employee benefit trust which is designed to give employees a stake in the business in the future. It is listed regularly in *The Sunday Times* 100 Best Companies to Work For.

The business is based in Poole, Dorset, and run from a small office above the first shop. It is still a family-run business. Mark Constantine's wife designs cosmetics, one son is head perfumer and another is in charge of online marketing. His daughter works for the charity Reprieve, to which Lush donates. The Constantines have lived in the same house for 25 years. Mark does not hold a driving licence and has never owned a car. He often cycles to work. His hobby is bird songs and he has published a book on the subject.

Access the *Digital Links* booklet to visit the company website and one that highlights the campaigns it is involved in. Also watch a Financial Times video of Mark Constantine recounting his often turbulent, entrepreneurial journey.

Questions:

1. Using either the New Venture Creation Framework or the Business Model Canvas (Chapter 6), sketch out at as many elements of the Lush business model as you can. Is this a consistent marketing mix and do they reflect the shop's value proposition?
2. What are the advantages and disadvantages of having such a strong set of values?

turning them into a satisfied customer, a loyal supporter and an advocate. If there are no weaknesses, then these are prospective repeat-buy customers and there is still the opportunity to form a relationship with them.

Stage 3 (growth)

At this stage the company is selling to the early and late adopters. It is about continuing to facilitate brand repurchase and restating brand identity – reinforcing the value proposition so that regular customers are convinced that they are making the right purchase decision. At this stage the strategy is about cementing the relationship with the customer, encouraging them to become brand advocates. However, it is also about penetrating the market and persuading more of the early and late majority of customers to purchase the product/service. We shall return to this challenge in Chapter 18.

Together, the marketing strategy and marketing communications campaign form the marketing plan. As highlighted in the previous chapter, this will require certain actions and activities to be put in place as part of the operations plan, some of which might be critical to the success of the venture, for example securing a list of prospective customers for the communications campaign. The operations plan and critical success factors are covered in Chapter 12.

SUMMARY

- The customer journey involves them moving from prospect to being persuaded to buy the product/service through to becoming a regular repeat customer and an advocate. It involves monitoring their evaluation of the product/service and trying to build a relationship with them. Each stage in the journey may require different marketing messages and use of different media.
- You must make a prospective customer aware of the product/service and then persuade them to purchase it. Once they have purchased the product/service they will evaluate whether it has delivered your value proposition. They may then be persuaded to repeat purchase and become regular customers, supporters and advocates of the brand.
- Marketing communications can involve face-to-face selling and/or the use of physical and virtual media. The appropriate media strategy – which media and nature of the message – depends on the product/service and the target customers.
- Face-to-face selling means selling the benefits of the product/service to the specific needs of this customer: being clear about how it will solve their specific 'problem' and being able to demonstrate its features; being able to back up claims about the value proposition with proof; being able to handle objections and concerns; and, finally, being able to close the sale.
- The marketing communications campaign involves identifying target market(s); identifying appropriate media (coverage vs cost); defining the communications objectives; developing the communications message; setting a budget; and preparing a communications plan.

GROUP DISCUSSION TOPICS

1. Marketing is just about selling. Discuss.
2. What is the difference between marketing and selling?
3. Relationships are based on trust. How do you build trust with customers?
4. How do you get a customer to become an advocate of your product or service?
5. Is social media the most cost-effective way of promoting your product or service?
6. You can build trust by using social media. Discuss.
7. Advertising is the most expensive way of one person talking to another. Discuss.
8. Advertising is all about gimmicks – getting noticed. Discuss.
9. PR is free and influential. Discuss.
10. Would you pay a reporter or newspaper to give you PR?
11. What is the role of pricing in persuading customers to make a trial purchase?

12. Compare and contrast the communication strategy for a high-priced technology-based product/service with that for a low-priced consumable.
13. How can you have one communications strategy if you have a number of different products or different market segments that you are selling to?
14. What methods of selling would you consider unethical?
15. If sales are important, salespeople should be remunerated based on the sales they generate. Discuss.
16. Business is all about sales, nothing else matters. Discuss.
17. A complaint is a complaint. Can how a business handles complaints ever be a positive influence on reputation?
18. What are the problems associated with finding prospective customers for a radically innovative new product/service?
19. How does the marketing mix fit with the marketing communications strategy?
20. How does the communications strategy fit in with the overall marketing plan?

STUDENT ACTIVITIES

1. List as many novel ideas for making prospective customers aware of a business of your own choice. Alternatively select one of the following:
   a) an app
   b) a design consultancy
   c) a shop.
2. Based upon the business selected for activity 1:
   a) List the ways you would persuade customers to make a trial purchase
   b) List the ways you would persuade them to become loyal advocates.
3. Based upon the business selected for activity 1, write a press release announcing the launch of the product/service.
4. Team up with two other students: one to act as a buyer (end-use customer or distributor) and one as an observer. Conduct a role-playing sales meeting lasting five minutes:
   - Seller: Provide the buyer in advance of the meeting with a one-page summary of your product/service and its value proposition. Plan your meeting using the outline in this chapter. Try to close the sale.
   - Buyer: Make certain you understand your role. Remember you have been identified as a prospect and therefore you are interested the product/service; however, prepare some objections that the seller will have to counter.
   - Observer: Observe the sales meeting and give feedback on what worked or did not work and how it might be improved.

START-UP ACTIVITIES

1. Develop a staged promotion strategy for your product/service at launch and for the first 12 months.
2. Building on this, develop a marketing communications campaign (messages and media) and draw up a communications plan (media, dates etc.), including an estimated budget. Ensure that this is consistent with and integrated in your overall marketing plan.

11

SETTING THE LEGAL FOUNDATIONS

Contents

- Safeguarding a business idea
- Intellectual property (IP) law
- Legal forms of business
- Partnerships, strategic alliances and joint ventures
- Franchising
- Legal forms of social enterprise in the UK
- Private or social enterprise?
- Corporate governance
- Taxation
- Summary
- Group discussion topics
- Start-up activities



Source: iStock.com/BrianAJackson

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Safeguard a business idea;
- Decide on the appropriate legal form for a business or social enterprise;
- Understand the responsibilities of the board of directors of a company;
- Understand the advantages and disadvantages of partnerships, strategic alliances and joint ventures and the appropriateness of each in different circumstances;
- Understand the advantages and disadvantages of franchising and what is involved in establishing one (either as a franchisee or a franchisor).

Case insights

11.1 Xmi
11.2 Trunki
11.3 Specsavers (1)
11.4 Flying Tiger Copenhagen (2)
11.5 Examples of social enterprise

Explore further links

11.1 The problem of counterfeiting
11.2 Advice on safeguarding IP
11.3 Internet domain names
11.4 Advice on forms of business
11.5 Franchising
11.6 Advice on social enterprise
11.7 Advice on taxation

SAFEGUARDING A BUSINESS IDEA

One of the important things an entrepreneur needs to think about is whether they can safeguard the 'intellectual property' (IP) of their business idea. There are a number of ways they can do this: patents, trademarks, copyrights, industrial design rights and, in some countries, trade secrets. The justification of these rights is that they encourage the creation of IP and pay for associated research and development. It is claimed that there are substantial benefits in terms of economic growth for countries that encourage IP protection, whether or not it is a form of monopoly. A report by Shapiro and Pham (2007) observes that, while economists trace 30–40 per cent of all US gains in productivity and growth over the course of the twentieth century to economic innovation in its various forms, today, some two-thirds of the value of America's large businesses can be traced to the intangible assets that embody ideas, especially the IP of patents and trademarks. They claim that 'IP-intensive industries produce 72 per cent more value added per employee than non-IP-intensive industries and create jobs at a rate 140 per cent higher than non-IP-intensive industries, excluding computers/electronics'. The authors go on to say that 'promoting and protecting new IP should be a high priority for US policymakers'.

However, some critics characterise these rights as intellectual protectionism or monopoly and argue that public interest is harmed by protectionist legislation (Levine and Boldrin, 2008). Contrary to Shapiro and Pham's study, Dosi et al. (2006) observed that, despite the doubling of patent registrations and a tripling of related legal costs of enforcement in the USA in the 1990s, there was no observable step-change in the levels of innovation or profitability. From a managerial rather than a policy perspective, strong intellectual property rights (IPR) can also have some significant disadvantages. In particular, they can inhibit collaborative working on innovation because collaborators want to safeguard their own IPR, despite the possibility that collaboration might generate far greater value. Indeed, one study concluded that the use of IPR has a *negative* effect on a strategy of long-term value creation, the positive influences being lead time, secrecy and the tacit nature of knowledge (Hurmelinna-Laukkanen and Puumalainen, 2007). Tidd and Bessant (2013) conclude: 'Firms need to balance the desire to protect their knowledge with the need to share aspects of knowledge to promote innovation … Theoretical arguments and empirical research suggest that from both a policy and management perspective, *only a limited level of IPR* is desirable to encourage risk taking and innovation.'

So, the message for an existing business is that they should not rely too much on IPR, and certainly not let it get in the way of networking or collaborative working where external knowledge is an important part of their systematic innovation. Secrecy may be just as strong a tool as IPR. Indeed, sometimes, if they can be maintained, trade secrets, such as the formula for Coca-Cola, are more effective than any form of legal safeguard since, by definition, if you register a 'secret', it is no longer secret. Only if the product can be 'reverse-engineered' in some way to expose its 'secret' is registration probably the best option.

However, for a start-up, the IP the founders have on their business idea may be one of the few real assets available to them, and in seeking finance they will have to expose it to many people, some of whom may be less scrupulous than others. In this case they would be well advised to seek the maximum IPR they can find. Nevertheless, being first to market is sometimes more effective in creating competitive advantage than the IPR on an idea that has missed its window of commercial opportunity.

Modern use of the term IP goes back at least as far as 1888, with the founding in Berne of the Swiss Federal Office for Intellectual Property, but the origins of patents for invention go back even further. No one country can claim to have been the first in the field with a patent system, although Britain does have the longest continuous patent tradition in the world. Its origins date from the fifteenth century, when the Crown started making specific grants of privilege to manufacturers and traders. They were given open letters marked with the King's Great Seal called 'Letters Patent'. Henry VI granted the earliest known patent to Flemish-born John of Utynam in 1449, giving him a 20-year monopoly on a method of making stained glass.

Explore further 11.1

The problem of counterfeiting

Access the *Digital Links* booklet to watch a short video explaining the extent of the counterfeiting problem.

INTELLECTUAL PROPERTY (IP) LAW

IP law varies from country to country. It is complex and usually comprises a multiplicity of individual pieces of legislation generated over a number of years. Because of this, if an entrepreneur thinks IP is important to their business, they should take legal advice. With the exception of copyright, if they want to protect their IP in other countries they will generally need to apply for protection in that country. The World Intellectual Property Organization, an agency of the United Nations, produces the *Guide to Intellectual Property Worldwide*. In the UK, information on regulations and laws can be obtained from the Intellectual Property Office (IPO). Detailed UK legislation can be viewed on this site, as well as practical help with searches and registering IP.

Four fundamental methods of protection are offered in most countries: patents, trademarks, industrial design rights and copyright. A simplified guide to these is given below, but details may vary from country to country.

Explore further 11.2

Advice on safeguarding IP

Access the *Digital Links* booklet for web links to the UK government (IP website), the UK Intellectual Property Office and the World Intellectual Property Organization.

Patent

A patent is intended to protect new inventions. It covers how they work, what they do, how they do it, what they are made of and how they are made. It gives the owner the right to prevent others from copying, making, using, importing or selling the invention without permission. The existence of a patent may be enough on its own to prevent others from trying to exploit the invention. However, should they persist in trying to do so, it gives the inventor the right to take legal action to stop them exploiting the invention and to claim damages. And herein lies the problem for cash-strapped start-ups. Can they really afford the legal fees involved in pursuing such a claim? Nevertheless, the patent allows them to sell the invention and all the IP rights, license it to someone else but retain all the IP rights, or discuss the invention with others in order to set up a business based on the invention.

The IPO says that for the invention to be eligible for patenting it must be *new*, have an *inventive step* that is not obvious to someone with knowledge and experience in the subject and be capable of being *made* or *used* in some kind of industry. If a patent is granted, it lasts for 20 years but must, in the UK, be renewed every year after the fifth year. Patents are published by the IPO online after 18 months, which makes people aware of patents that they will eventually be able to use freely once the patent protection ceases. This can also be seen as a disadvantage of patents. In fact there is no legal requirement to file a patent; the inventor can always decide just to keep their invention secret. This is undoubtedly cheaper, but if the invention then enters the public domain they may lose their rights to it. One thing they can do when dealing with individuals regarding an unpatented invention (such as prospective partners, suppliers or financial backers) is to ask them to sign a confidentiality agreement (also known as a 'non-disclosure agreement') which legally binds them not to disclose company secrets. They can also require employees to sign such an agreement.

The IPO lists some things for which a patent cannot be granted such as:

- A scientific or mathematical discovery, theory or method;
- A literary, dramatic, musical or artistic work;
- A way of performing a mental act, playing a game or doing business;
- The presentation of information, or some computer programs;
- An animal or plant variety;
- A method of medical treatment or diagnosis;
- Anything that is against public policy or morality.

Trademark™

A trademark is a sign – made up of words or a logo or both – which distinguishes goods and services from those of competitors. The IPO says that a trademark must be *distinctive for the goods and services provided*. In other words, it can be recognised as a sign that *differentiates* particular goods or service from someone else's. Once registered, a trademark provides the exclusive right to use the mark for the goods and/or services that it covers in the country in which it is registered. The® or™ symbol can be placed next to it to warn others against using it. In the USA, the™ symbol can be used without a registration process, but it limits the 'exclusivity' to a 'local market'. To get national exclusivity for specific categories, formal registration ® is required and proof that a formal transaction has taken place within six months of registration must be provided. In all cases, trademark registration must be renewed every ten years and cannot be maintained if it is not being used on a continuous commercial basis.

As with a patent, a registered trademark may put people off using the trademark without permission and legal action can be taken against anyone who uses it without permission. However, in the UK a trademark also allows trading standards officers or the police to bring criminal charges against counterfeiters illegally using it. As with a patent, a trademark can be sold, or other people granted a licence that allows them to use it. In the UK, even if you don't register a trademark, you may still be able to take action if someone uses it without permission, using the lengthier and onerous common law action of 'passing off'.

It is worth mentioning that just because a company has its name registered does not mean that that name is a registered trademark – company law is different from trademark law. Similarly, being the owner of a registered trademark does not automatically entitle the owner to use that mark as an internet domain name, and vice versa. This is because the same trademark can be registered for different goods or services and by different proprietors. Also, someone may have already registered the domain name, perhaps with its use being connected with unregistered goods or services.

Explore further 11.3

Internet domain names

Access the *Digital Links* booklet for the web link to the Internet Corporation for Assigned Names and Numbers.

The IPO says that trademarks cannot be registered if they:

- Describe goods or services or any characteristics of them, for example, marks which show the quality, quantity, purpose, value or geographical origin of the goods or services (e.g. Cheap Car Rentals or Quality Builders);
- Have become customary in this line of trade;
- Are not distinctive;

- Are three-dimensional shapes, if the shape is typical of the goods being traded. This can be very subjective. For example, while Toblerone has been able to trademark the shape of its chocolate bars, Kit Kat recently had its claim to trademark the shape of its bars rejected by the UK IPO;
- Has a function or adds value to the goods;
- Are specially protected emblems;
- Are offensive;
- Are against the law (e.g. promoting illegal drugs);
- Are deceptive.

Registered design®

If someone is creating products or articles, which are unique because they look different from anything else currently available, then they might want to protect the look by registering it as a design. A registered design is a legal right which protects the overall visual appearance of a product in the geographical area it is registered in. The registered design covers the things that give the product a unique appearance,

Case insight 11.1 Xmi

Combating counterfeiters

Ryan Lee started his company, Xmi, to manufacture and sell compact and portable capsule speakers that he had designed himself. His first speaker, the X-mini™, had built-in rechargeable batteries and incorporated a system that allowed the speaker to compress for portability and expand to produce fuller sound. It sold at a premium price. In order to minimise his costs Lee subcontracted manufacture and assembly to companies in China. The X-mini™ was launched in 2007 and was an immediate success, selling internationally. However, within six months Lee started receiving calls from distributors in Europe asking for a discount because they had been offered what looked like identical X-mini speakers at a much lower price. Upon investigation he found that, although these imitations had plastic casings that were identical to the X-mini, they had far poorer sound quality, different packaging and did not carry the company's serial numbers. It was relatively easy for Lee to demonstrate to distributors that these were fake products with inferior sound quality but the speakers continued to circulate in the market. Lee started splitting up components manufacture among different subcontractors, switching contracts to ones with a reputation for trustworthiness. In 2011 he started to manufacture





some of the highly sensitive components himself in China. Lee is philosophical about his experience and feels that ultimately the only way to combat these copycat products is to keep one step ahead by constantly innovating and improving the product:

> *'There was no other small speaker that was better than this at the time. That is why we demanded the [price] premium. Customers are willing to pay for quality … I'd rather throw my money to the engineers, not to the lawyers. You innovate faster than your fakes. That's how you play the technology game.'* (BBC News Business, *25 March 2013*)

Access the *Digital Links* booklet to visit the company website and to watch a video review of the Xmi Mini speaker.

Questions:

1. In what circumstances is safeguarding your IP through legal means worthwhile?
2. How might you combat counterfeiting through commercial means?

such as the lines, contours, colours, shape, texture, materials and the ornamentation of the product (e.g. a pattern on a product or a stylised logo). It is a valuable asset that allows the originator to stop others from creating similar designs. It does not offer protection from what a product is made of or how it works. Registering a design gives them exclusive rights for the look and appearance of the product. This may be enough on its own to stop anyone using the design, irrespective of whether it was copied or whether they came up with the design independently. Once a design is registered it can be sold or licensed. In the UK, *design rights and Community design rights* may also give you automatic protection for the 'look' of a product.

Case insight 11.2 Trunki

Registered design infringement

The Trunki is a fun , ride-on suitcase that looks like an animal, designed for children. It is estimated that 20% of three- to six-year-olds in the UK own one. It was an idea that Rob Law came up with in 1998. He protected the design through computer-registered design (CRD). However, Trunki proved so successful that it attracted many imitations and his company, Magmatic, has spent considerable sums on legal fees but seen only limited success in protecting their design.

After a protracted legal case, in 2013 Magmatic finally won a lawsuit in the UK against PMS International, a Hong Kong company that had been selling a copycat product called the Kiddee Case. The court ruled that the Kiddee Case breached Law's design rights in that the 'overall impression' created by it, including the horn-like handles and clasps resembling the nose and tail of an animal, was similar to the designs underpinning the Trunki. However, PMS immediately appealed against the decision and the decision was reversed in 2014. This decision was subsequently upheld by the UK Supreme Court in 2016.

The Supreme Court found that while the Kiddee Case had a 'number of features similar' to Trunki's CRD, it had notable differences to the original copyright such as its use of colour and having covered wheels. Certain minor infringements of copyright were upheld: the use of the Trunki safety notice, breach of unregistered design rights (which, like copyright, are granted automatically) relating to the external locking mechanism, the method used to attach a plastic key to the strap and the internal elasticated cross-strap and side pocket. The judge said he reached his decision with 'some regret' as it did appear



that PMS conceived their idea as a result of seeing a Trunki; however, the appeal was 'not concerned with an idea or an invention, but with a design'.

The decision has wide-ranging implications since about a third of designs in Europe are protected by CRD. Jeremy Drew, head of IP at RPC (a business advisory network), explained that by including specific features on the drawing for the CRD, such as dark wheels and a dark stripe along the suitcase, those elements became a core part of the specific design of the product:

> *'When someone copies the case but doesn't have that contrast, it means there's one big difference between designs. You need someone to copy the product very closely to be an infringement'.* (The Telegraph, *9 March 2016)*

Access the *Digital Links* booklet to visit the company website and to watch a video showing the range of Trunki products.

Questions:

1. What are the implications of this case and how important are they for designers?
2. What do you learn from this case about protecting design?

The IPO say that to be able to register a design it must:

- Be new – in the UK a design is considered new if no identical or similar design has been published or publicly disclosed in the UK or the European Economic Area;
- Have individual character – this means that the appearance of the design (its impression) is different from the appearance of other already known designs.

Copyright©

Copyright allows original material to be protected and stops others from using work without permission. It can be used to protect any media:

- Literary works such as computer programs, websites, song lyrics, novels, instruction manuals, newspaper articles and some types of database;
- Dramatic works including dance or mime;
- Musical works;
- Artistic works such as technical drawings, paintings, photographs, sculptures, architecture, diagrams, maps and logos;
- Layouts or typographical arrangements used to publish a work (e.g. for a book);
- Sound or visual recordings of a work;
- Broadcasts of a work.

Copyright does not protect ideas, only how ideas are 'published', for example in writing, in which case the words cannot be copied. This happens automatically in most countries, which means that it does not have to be applied for so long as it falls within one of the categories of media protected, but it also means there is no official copyright register. Although not essential, the material should be marked with the © symbol, the name of the copyright owner and the year in which the work was created (e.g. © 2021 Paul Burns). Copyright owners may also choose to use technical measures such as copy protection devices to protect their material. In the UK, in addition to or instead of copyright protection, a database may be protected by the 'database right'. Trademarks can be both registered designs (for the artwork) and copyright. Work protected by copyright can only be copied with the owner's permission, even when it crosses media boundaries (e.g. crossing from the internet to print).

A copyright owner has the right to authorise or prohibit any of the following actions in relation to their work:

- Copying the work in any way (e.g. photocopying, reproducing a printed page by handwriting, typing or scanning into a computer, and taping live or recorded music);
- Renting or lending copies of the work to the public, although in the UK some lending of copyright works falls within the Public Lending Right scheme and this does not infringe copyright;
- Performing, showing or playing the work in public (e.g. performing plays and music, playing sound recordings and showing films or videos in public);
- Broadcasting the work or other communication to the public by electronic transmission, including transmission through the internet;
- Making an adaptation of the work (e.g. by translating a literary or dramatic work, or transcribing a musical work or converting a computer program into a different computer language).

The copyright owner can sell or license the work and sell or retain their ownership. They can also object if their work is distorted or mutilated. As with other forms of IP protection, the existence of copyright may be enough on its own to stop others from trying to copy the material. If it does not, the copyright owner has the right to take legal action to stop their copyright being exploited and to claim damages – that is if they can afford to go to court. Copyright infringement only occurs when a whole work or substantial part of it is copied without consent. However, what constitutes a substantial part is not defined and may therefore have to be decided by court action. Copyright is essentially a private right and therefore the cost of enforcing it falls to the individual.

LEGAL FORMS OF BUSINESS

Starting up in business is inherently risky and how it is structured has implications for how much risk an entrepreneur faces personally. The three most popular legal forms of business are: sole traders (almost 60 per cent of businesses), partnerships and limited liability companies. High-growth companies are more likely to be set up by groups rather than by individuals, and these groups share in the management and ownership and therefore the success (or failure) of the business. Partnering and forming a company with others to set up a business can bring the same advantages as age, that is, knowledge, experience and networks. The advantages and disadvantages of the different forms of business are summarised in Table 11.1. In many countries a business needs a licence to operate, which can normally be obtained from the local council. In the UK certain types of businesses, such as those selling food or alcohol, employment agencies, mini cabs and hairdressers, need a licence or permit.

Table 11.1 Advantages and disadvantages of different forms of business

	SOLE TRADER	PARTNERSHIP	LIMITED LIABILITY COMPANY OR CORPORATION
ADVANTAGES	* Easy to form * Minimum of regulation	* Easy to form * Minimum of regulation	* Limited liability * Easier to borrow money * Can raise risk capital through more share capital * Can be sold on * Pays corporation tax (which can be lower than personal tax)
DISADVANTAGES	* Unlimited personal liability * More difficult to borrow money * Pays personal tax (which can be higher than corporation tax)	* Unlimited personal liability for debts of whole partnership * Can be difficult to borrow money * Pays personal tax * 'Ceases trading' if partners change	* Must comply with Companies Acts * Greater regulation * Greater disclosure of information

Explore further 11.4

Advice on forms of business

Access the *Digital Links* booklet:

- For web links to UK government and other sites that provide advice on legal forms of business in the UK.
- For information on and web links to the various agencies where a licence or registration is required before starting a business. This includes a web link to an interactive guide to the permits and licences needed to start a business in the UK.
- For information on and web links to the various agencies involved in meeting UK health and safety legislation.

Sole traders

This is a business owned by one individual. The individual is the business, and the business is the individual. The two are inseparable. A sole trader is the simplest form of business to start – all that is needed is the first customer. It faces fewer regulations than a limited company and there are no major requirements about accounts and audits, although the individual will pay personal taxes which are based upon the profits made by the business.

There are two important limitations, however. The first is that a sole trader will find it more difficult to borrow large amounts of money than a limited company. Despite the fact they are likely to ask for collateral and personal guarantees (see Chapter 19), lenders prefer the assets of the business to be placed within the legal framework of a company because of the restrictions then placed upon the business. It is, however, quite common for a business to start life as a sole trader (or partnership) and incorporate later in life as more capital is needed. The second disadvantage is that the sole trader is personally liable for all the debts of the business, no matter how large. That means creditors may look both to the business assets and the proprietor's assets to satisfy their debts. However, this disadvantage may be overcome by placing family assets in the name of the spouse or another relative.

Partnerships

Partnerships are just groups of sole traders who come together, formally or informally, to do business. As such, it allows them to pool their resources: some to contribute capital, others their skills. Partnerships, therefore, face all the advantages of sole traders plus some additional disadvantages. The first of these disadvantages is that each partner has unlimited liability for the debts of the partnership, whether they incurred them personally or not. Clearly, partnerships require a lot of trust. The second disadvantage is that the partnership is held to cease every time one partner leaves or a new one joins, which means dividing up the assets and liabilities in some way, even if other partners end up buying them and the business never actually ceases trading. In the UK some professions, such as doctors and accountants, are required by law to conduct business as partnerships.

Generally, those considering a partnership would be well advised to draw up a formal partnership agreement. It is very easy to get into an informal partnership with a friend, but if they cannot work together, or times get hard, both partners may regret it. If there is no formal agreement, then in the UK the terms of the Partnership Act 1890 are held to apply. Partnership agreements cover such issues as capital contributions, division of profit and interest on capital, power to draw money or take remuneration from the business, preparation of accounts and procedures when the partnership is held to 'cease'. Solicitors can provide a model agreement which can be adapted to suit particular circumstances.

Companies and corporations

A for-profit company or corporation is a separate legal entity distinct from its owners or shareholders, and offers limited liability in the event of failure. It can enter into contracts and sue or be sued in its own right. It must be registered and comply with the legal requirements of a company or corporation in a particular country and is taxed separately through corporation tax (in the USA a business entity elects to be treated either as a corporation or as 'other than a corporation' for tax purposes.) The shareholders own the business but elect a board of directors to direct it, and they in turn appoint the management who are responsible for the day-to-day running of the business. The shares in the company or corporation can be either privately held by a small group of individuals or publicly held and traded on a stock market, in which case the additional rules of the stock market apply.

The major advantage of this form of business is that the liability of the shareholders is limited by the amount of capital they put into the business. However, banks are likely to ask for personal guarantees from the founders to get around this problem. A company also has unlimited life and can be sold on to other shareholders. Indeed, there is no limit to the number of shareholders. A company or corporation can therefore attract additional risk capital from backers who may not wish to be involved in the day-to-day running of the business. Also, because of the regulation they face, bankers prefer to

lend to companies or corporations rather than sole traders. Clearly this is the best form for a growth business that will require capital and face risks as it grows.

There are also some disadvantages to this form of business. A company or corporation must keep certain books of account and appoint an auditor. Accounts and other company information must be filed with relevant authorities on a timely basis. This takes time and money and means that competitors might have access to information that they would not otherwise see.

An internet search of '*how to start a company*' (or corporation) followed by the name of the country should provide you with the country-specific information needed to set up a company. The appropriate government website will give you the legislative framework, but the easiest way to actually set one up is to purchase an already registered one from the many private organisations advertising on the internet. In the UK these are called 'company registration agents'. This saves time and avoids all the tedious form-filling that is otherwise required. In addition, agents will show you how to go about changing the company's name if you want to.

In the UK a company must be registered with Companies House in accordance with the provisions of the Companies Acts and must file an annual return with Companies House, which includes accounts and details of directors and shareholders. Certain companies must be registered with the Financial Conduct Authority.

In the USA corporations are organised under the authority of the state as either 'C Corporations' (C Corp) or 'Subchapter S Corporations' (S Corp). These are broadly similar to limited liability companies. The major difference between a C Corp and an S Corp is their tax treatment. C Corps are subject to double taxation at both the corporate and shareholder level. S Corps do not pay tax, instead all profits or losses are passed through to individual shareholders. Therefore losses in a C Corp reside with the company and cannot be deducted from shareholders' other sources of income – unlike an S Corp (a limited liability company can elect for different tax treatments). Because of this, private investors tend to prefer these two legal forms if there are losses at start-up. However, most venture capital funds will not invest in S Corps because the number of investors is restricted to 100 – unlike C Corps or limited liability companies, where there is no restriction. So, the planned funding structure may affect the legal framework a corporation adopts, although a company can change its legal form later in life.

PARTNERSHIPS, STRATEGIC ALLIANCES AND JOINT VENTURES

Partnerships, strategic alliances and joint ventures can take many forms. They offer many advantages to entrepreneurs. They can enhance a business model without requiring additional capital outlay by simplifying operations, leveraging knowledge and capabilities and spreading the business risk. Numerous academic studies have shown that there are real benefits from strategic alliances and partnerships for organisations of all sizes. A government survey in the UK concluded that: 'in both the UK and the US, we observe that the highest growth firms rely *heavily* on building relationships with other firms, either through supply chains or through formal strategic alliances' (DBER, 2008, emphasis added). Alliances can create economic advantage by leveraging market presence (Lewis, 1990; Lorange and Roos, 1992; Ohmae, 1989). An example is Oneworld, a strategic alliance of a dozen airlines including British Airways and American Airlines whose primary purpose is to encourage passengers to use partner airlines. Alliances can also provide vertical integration and scale economies at a greatly reduced cost (Anderson and Weitz, 1992). In its simplest form this is the arrangement a distributor has with a manufacturer when they have sole distribution rights.



Source: You X Ventures on Unsplash

The potential disadvantages of partnerships and alliances include the risk of losing intellectual proprietary

information, increased management complexities, increased risk of becoming over dependent on the partner and partial loss of decision-making autonomy (Barringer and Harrison, 2000). Potential advantages and disadvantages of partnership and alliances are summarised in Table 11.2. The closer the relationship between partners, the greater the need for trust (on both sides). The best partnerships are based on mutual advantage, with a balance of power and advantage meaning one partner does not over exploit the other.

Generally partnerships can be either informal or formal, based upon legally binding contracts. They can range from the more structured ones outlined below, to simple, ad hoc, subcontracting to other firms, the use of sales agents in overseas markets, zero-hours employee contracts and 'gig-workers' (argued to be more like involuntary self-employment). The internet has made outsourcing work, even to other countries, relatively easy. Crowdsourcing – another form of partnership – can even be used to find skills and knowledge that a firm does not have. These are structures that shift the risk of employment entirely onto the worker, agent or subcontractor and turn what might have been a fixed, into a variable cost. They can source skills and resources that a small firm does not have and allow it to compete with far bigger companies.

The manufacture of computers provides an excellent example of how partnerships underpin many of today's complex supply chains. Every element of the value chain might be located so as to provide the best combination of cost and expertise. Table 11.3 gives an example of how components and processes may be sourced globally. The 2020 pandemic exposed the risks associated with global sourcing and highlighted the need for risk management processes to be in place so as to ensure greater resilience in the face of supply chain disruption (Chapter 13).

Any partnership is usually only formed by mutual agreement and therefore where there is mutual advantage in the collaboration. The actual nature of these collaborations can vary from informal to formal, underpinned by legal contract.

Table 11.2 Potential advantages and disadvantages of partnerships and alliances

ADVANTAGES	DISADVANTAGES
* Opportunity to leverage up skills, knowledge and capabilities	* Risk of losing IP information
* Opportunity to gain access to new markets	* Risk of losing customers if markets too similar
* Opportunity to gain information on risks and opportunities	* Increased management complexity
* Sharing of investment funding requirements	* Loss of managerial control/autonomy
* Sharing of project risk	* Risk of over dependence on partner

Table 11.3 Global partnerships in a supply chain

COMPONENT/PROCESS	SUPPLIER LOCATION
Design	USA (in collaboration with third-party manufacturers)
Assembly	China
Microprocessor	Designed and manufactured in USA
Graphics card	Designed in Canada, manufactured in China
Screen	Manufactured in Korea
Hard disk drive	Designed in USA, manufactured in Malaysia
Lithium battery	Japan
Logistics	Subcontracted to third parties – some local, some global
Telephone sales/support	Subcontracted to third parties in key countries

Case insight 11.3 Specsavers (1)

Developing a partnership business model



Source: Tope Asokere from Pixabay

Specsavers was founded in 1984 by Doug and Mary Perkins, who met at Cardiff University. They started the business in their spare bedroom in Guernsey where they had moved to after selling their small chain of West Country opticians. In the early 1980s the UK government deregulated professional services, including opticians, allowing them to advertise for the first time. Doug and Mary seized the opportunity to try to launch a national chain of opticians. They opened their first stores in Guernsey and Bristol, followed rapidly in the same year by stores in Plymouth, Swansea and Bath. They wanted the company to establish its brand so that it would be seen as offering a wide range of stylish, fashionable glasses at value-for-money prices. They wanted Specsavers to be seen as trustworthy, locally based but with the huge buying power of a national company that meant savings could be passed on to the customer. Specsavers also sells contact lenses and hearing aids. With over 2,100 branches throughout the world and a turnover of some £2.8 billion, Specsavers is now the largest privately owned opticians in the world and the Perkins family are believed to be billionaires.

Specsavers has used an interesting joint venture approach to grow its business, a strategy which minimises its capital requirements and the risks it faces. Since optical retailing involves both commercial and clinical disciplines, Specsavers enters into a 'joint venture partnership' between the company and an optometry director (optometrist) and a retail director (often dispensing optician) for each store. Each joint venture is a separate legal entity. When the new company is formed, an equal number of 'A' shares and 'B' shares are issued. All the 'A' shares in the company are issued to the practice directors or partners. All the 'B' shares are issued to Specsavers Optical Group. 'A' shareholders are delegated responsibility for the day-to-day running of the store. As 'B' shareholder, Specsavers provides supporting services, expertise, experience and information – and their range of spectacles. As the number of practices has grown, so has the range of support services provided to practices, so that partners receive full support in all aspects of their business, tailored to their requirements. These can include property services, practice design, practice start-up, buying and distribution, retail training, professional recruitment as well as support in producing accounts, audits and tax returns. Individual opticians can sell on their 'A' shares, subject to certain conditions.

Specsavers does not specify the cost it charges for a joint venture partnership, saying it depends upon location and practice size, but it has been estimated as in excess of £150,000. In addition, partners are expected to provide the joint venture with a start-up loan that Specsavers will match. Specsavers Finance will provide a further five-year loan for the remainder of the capital. Personal collateral is not required by Specsavers Finance to secure this loan. Specsavers and the partners sign a specific finance agreement. Loans are repaid from practice profits, sometimes within three years. Partners are responsible for the running of their store while maintaining Specsavers' standards of care. Specsavers claim the following advantages for opticians from this joint venture approach:

- A lower level of financial commitment from the opticians compared to a franchise.
- If targets are met the initial loan can be repaid from operating surpluses.
- Unlike a brand partnership or franchise, a joint venture partnership gives the partner the possibility of selling their shares in the future.
- The partner can end the relationship when they want.

We look at job roles within Specsavers in Case insight 14.2.

Access the *Digital Links* booklet to visit the company website and to watch an interview with Specsavers' founder, Doug Perkins, talking about the future of optometry.

Question:

1. What are the advantages and disadvantages of this form of joint venture to both Specsavers and its partners?

Partnership

Partnering with others or organisations in setting up a new venture simplifies the operating tasks faced and mitigates risks. Since assets are owned or contributed by all the partners, the financial resources needed and the associated risks are spread and flexibility is increased. True partners can become part of a team pursuing a particular opportunity, even though not part of the same legal entity. They can help in unexpected ways and their capability and resources can often be leveraged – to mutual advantage. So, just as an entrepreneur tries to develop relationships with customers, they should also try to develop them with other business entities, viewing suppliers as partners, rather than just suppliers of a resource. But there are a wide range of partners and partnerships.

Strategic alliances

These are a form of partnership whereby separate organisations come together to pursue an agreed set of objectives. They can be an effective way of sustaining competitive advantage and are particularly important in relation to innovation, where the partners have different competencies that they can apply in pursuing a commercial opportunity. There are often explicit strategic and operational motives for alliances, such as gaining access to new markets. Jaguar partnered with the Williams racing team in 2011 to produce a new hybrid electric/petrol supercar. Nokia partnered with Microsoft to rejuvenate its smartphone offering in 2012 with the Lumia. Some start-ups have based their international expansion strategy almost entirely on foreign alliances.

Joint venture

A more formal strategic partnership is called a 'joint venture'. This usually has a degree of direct market involvement and therefore needs to be underpinned by some form of legal agreement that determines the split of resource inputs and rewards. Often the joint venture takes the form of a legal entity that is separate from either of the parties involved. Richard Branson has been particularly adept at using joint ventures as a basis for rolling out new business ideas. He partnered with Deutsche Telecom to create Virgin Mobile, and Singapore Airlines owned 49 per cent of Virgin Airlines. Some developing countries do not allow foreign companies to set up in their country, only allowing joint ventures with local organisations. The optician and hearing-aid specialist, Specsavers, operates a contract-based, joint-venture approach to retailing, tailored to professional practitioners, in this case opticians. It offers all the advantages of a franchise but gives the local operator greater professional autonomy and responsibility. Specsavers is now the largest chain of opticians in the UK and expanding rapidly in other countries.

FRANCHISING

Franchising is a form of legal partnership. A franchise is a business in which the owner of the name and method of doing business (the franchisor) allows a local operator (the franchisee) to set up a business under that name offering their products or services. This allows the franchisee to capitalise on their local knowledge but requires them also to take on many of the business risks. Their local market knowledge and dedication is vital if the market is to be effectively penetrated. For franchisors it is a way of rolling out a business format rapidly without the need for large amounts of capital. It is popular with franchisees who are less entrepreneurial but wish to run their own business. When entering the market in another country a franchisor often appoints a head franchisee who will be responsible for finding other franchisees in their country.

Explore further 11.5

Franchising

Access the *Digital Links* booklet and watch a short video that outlines the origins of franchising.

The terms of the relationship between franchisor and franchisee are set out in the franchise agreement. Franchisors need a proven, robust business model with an infrastructure to support local franchisees. In exchange for an initial fee (anything from a few thousand to hundreds of thousands of pounds) and a royalty on sales, the franchisor lays down a blueprint of how the business is to be run; content and nature of product or service, price and performance standards, type, size and layout of shop or business, training and other support or controls. Franchisees expect a detailed operations manual and operating systems and hands-on help in their start-up. They pay all the costs of establishing the business locally. Since a franchise is usually a tried and tested idea, well known to potential customers, the franchisee should have a ready market and a better chance of a successful start-up. Indeed, only about 10 per cent of franchises fail. In the UK most established franchisors are members of the British Franchise Association, which has a code of conduct and accreditation rules, based on codes developed by the European Franchise Association. Table 11.4 summarises the advantages and disadvantages of being a franchisee and a franchisor.

Case insight 11.4 Flying Tiger Copenhagen (2)

Growth through franchise

We looked at Flying Tiger in Case insight 9.5. It is a successful price-point retailer that has added other elements to its business model. It also has both a growth and an expansion model to facilitate its global rapid roll-out. Both rely heavily on effective partnerships.

Growth model: The company's growth model envisages growth coming from four elements:

- Increasing comparable store sales growth through the introduction of new products, conducting marketing campaigns to drive up volume of purchases and the frequency of store visits.
- Increasing store penetration in existing markets by opening new stores through its expansion model.
- Geographical expansion into new markets by expanding into new territories through its expansion model.
- Increasing operating margins from scale advantage by investing in what it calls its 'corporate backbone' – its operating model – and leveraging its cost structure.

Expansion model: Flying Tiger is owned by Zebra A/S. It has expanded by offering a 50:50 'partnership' with local partners who are offered exclusive territories that might be large cities, regions or even small countries. It stresses this is not a franchise. For example, the UK is split into four territories: South east, Midlands, Wales and Scotland (now run by the company).

These joint ventures are owned 50% by Zebra and 50% by the local partner. Zebra owns the concept and brand and supplies the products, store interior and marketing material while the local partner is responsible for store roll-outs and day-to-day operations including staffing, training and local marketing under specific guidelines set out by Zebra. Partners are expected to have comprehensive local retail experience, know-how and networks, an ability to run a minimum of 5–10 stores and access to at least €75,000. This model has enabled Zebra to grow rapidly. It has a contractually defined exit-mechanism and it is part of Zebra's strategy to take full ownership of the local operating companies when this is assessed to be more beneficial than the partner model. Some operating companies, like the one in Scotland, are now wholly owned by Zebra.

We shall look at Flying Tiger's operating model and the risks it faces in Chapter 13.

Questions:

1. Update Flying Tiger's business model from Case insight 9.5 with the information in this case.
2. Is the Flying Tiger growth and expansion model consistent and coherent?
3. Why is this partnership model attractive to Flying Tiger and how is it different to a franchise model?
4. What are the advantages and disadvantages of this model to partners?

Table 11.4 Advantages and disadvantages of being a franchisee or franchisor

	FRANCHISEE	FRANCHISOR
Advantages	* Business format proved; less risk of failure * Easier to obtain finance than own start-up * Established format; start-up should be quicker * Training and support available from franchisor * National branding should help sales * Economies of scale may apply	* Way of expanding business quickly * Financing costs shared with franchisees * Franchisees usually highly motivated since their livelihood depends on success
Disadvantages	* Not an original idea and creation * Lack of real independence * Franchisor makes the rules * Buying into franchise can be expensive * Royalties can be high * Goodwill built up dependent upon continuing franchise agreement; this may cause problems if business is sold on * Franchisor can damage brand	* British Franchise Association rules take time and money to comply with * Loss of some control to franchisees * Franchisees can influence the business * Failure of franchisee can reflect on franchise * May be obligations to franchisee in the franchise agreement

LEGAL FORMS OF SOCIAL ENTERPRISE IN THE UK

A for-profit company or corporation can still have social objectives as part of its ethical beliefs or, more formally, as part of its corporate social responsibility (CSR) commitments. However, many countries now have separate legal structures for what are generally called 'social enterprises' which carry some benefits (e.g. tax or access to government funding) but equally a number of restrictions. The restrictions generally are about what can be done with the profits or assets of the enterprise and involve greater accountability.

Explore further 11.6

Advice on social enterprise

Access the *Digital Links* booklet to web links that can provide help and advice in the UK including the UK government, Charities Commission and other social enterprise organisations.

Legislation varies from country to country. In the UK if the primary aim of a start-up is social good and *all* the profits will be ploughed back into these activities then there are six legal forms of social enterprise that offer certain advantages and disadvantages. These are summarised in Table 11.5 and details are provided below.

Unincorporated associations

These are informal associations of individuals that can form (and reform) quickly – similar to sole traders or informal partnerships. They enjoy great freedom because they are not regulated. They are not registered with anybody, but they can apply for charitable status, which means they have to comply with the regulations of the Charity Commission. They can trade but cannot own assets or borrow money because an association has no legal status. However, it may be possible to set up a trust (see below) to

Table 11.5 Advantages and disadvantages of different forms of social enterprise in the UK

	UNINCORPORATED ASSOCIATION	TRUST	CHARITABLE SOCIAL ENTERPRISE	BENCOM	COMMUNITY INTEREST COMPANY (CIC)	CHARITABLE INCORPORATED ORGANISATION (CIO)
Advantages	* Easy to form * Minimum of regulation * Can apply for charitable status	* Can hold assets * Can apply for charitable status	* Benefits from charitable status	* Can apply for charitable status	* Has limited liability status * Can hold assets but must have an 'asset lock'	* Benefits from charitable status * Can hold assets but must have an 'asset lock'
Disadvantages	* Unlimited personal liability * Cannot own assets or borrow money	* Must have trust deed * Must register with Companies House * Greater regulation * Greater disclosure of information * Profits cannot be distributed	* Must register with Companies House or FCA * Surpluses must be reinvested * Trustees cannot be paid * Profits cannot be distributed	* Must be registered with Companies House or FCA * Can raise funds by issuing shares * Profits cannot be distributed	* Must be registered with Companies House or FCA * Must issue annual community interest report and accounts * Profit distribution regulated * Cannot be registered charity	* Must be registered with Charities Commission * Profits cannot be distributed

legally hold ownership of property and assets for the community they are intended to benefit. Because these associations are unincorporated, each individual in the association is personally liable for any debts or loans.

Trusts

These are run according to the social objectives set out in the trust deed. Many organisations involved in health and social care and education are structured as trusts. Trusts are unincorporated bodies. Trustees manage the trust on behalf of the community for which it was set up, which will be laid down, along with the trust's social objectives, in the trust deed. The trust can hold assets but it cannot distribute any profits. However, trustees are personally liable for any debts or loans. Trusts may need to register with Companies House and, because they have social objectives, they can apply for charitable status through the Charity Commission.

Charitable social enterprises

These are set up wholly for charitable purposes that benefit the public. They must be registered with Companies House or the Financial Conduct Authority (FCA). They are regulated by Charity Commission regulations (HM Revenue & Customs in Northern Ireland and the Office of the Scottish Charities Regulator in Scotland). Charities benefit from tax and rate relief, and any surplus must be reinvested. The founder of a charity shapes its creation but not its strategic direction or operation.

The charity is run by directors or trustees, who cannot be paid for their work. They shape its strategic direction.

Community benefit societies (BenComs)

These are incorporated 'industrial and provident societies' (also known as 'cooperatives') – legal entities set up with social objectives, which conduct business for the benefit of their community. They are run and managed by their members, but profits cannot be distributed among members and must be returned to the community. BenComs can raise funds by issuing shares to the public and can be registered as charities. They are regulated by the FCA in the UK and must submit annual accounts. BenComs are different from cooperatives in that cooperatives operate for the mutual benefit of their members – which is not necessarily the same as the community – and therefore cannot be registered as charities.

Community interest companies (CICs)

These are essentially limited liability companies, registered with Companies House or the FCA, but with extra requirements. They can be limited by shares or by guarantee. They must demonstrate their social and environmental impact each year by issuing an annual community interest company report alongside the annual accounts. They must operate transparently and not pay directors excessive salaries. Profit distribution is also regulated; companies limited by guarantee may not distribute profits, whereas those limited by shares can do so under certain circumstances. CICs must have an asset lock, which means that profits or assets cannot be transferred for less than their full market value. People who start a CIC can steer the business as they see fit because they will be directors.

A CIC cannot be a charity. However, it is common for it to run alongside one. So, for example, it is common for a social organisation to have two forms: a CIC, which runs in a businesslike way while giving the community a stake in how it is run, and a charitable social enterprise to which the CIC's profits are transferred and which decides how they are spent. This dual form can maximise tax advantages. It also means that the charity can apply for grant funding that will help to get projects up and running, while the income generated by the CIC means that the organisation is not totally dependent on these grants or the goodwill of donors or government.

Charitable incorporated organisations (CIOs)

These are a form of incorporated organisation that is set up for charitable purposes and therefore reports to the Charity Commission rather than Companies House or the FCA. Like CICs they must benefit local communities and have an asset lock. They are not able to distribute profits or assets to their members. Unlike CICs which have directors, CIOs have charity trustees. CICs and charitable social enterprises can convert into CIOs.

PRIVATE OR SOCIAL ENTERPRISE?

In Chapter 8 we talked about how sustainable entrepreneurship using the broad area of CSR might enhance the profit potential of a business while also benefiting some (undefined) ethical, social or environmental issues. We always placed commercial objectives first, assuming that the entrepreneur would decide on any social mission and how it was to be met. However, the distinction between a private enterprise with strong social objectives and a social enterprise is not always clear. A social enterprise must normally operate in a commercial way to achieve its social objectives, allowing any profits it generates to be ploughed back to help achieve them. It is often also about creating social change at a community level, normally through voluntary or community groups. The social objectives come first and the commercial objectives second. Profit is a means to a social end. In the UK this has a long history, from Victorian hospitals to the modern-day hospice movement.

Case insight 11.5 Examples of social enterprise

Meeting local needs

Social enterprises can take many different forms, many addressing very local needs. Here are some examples from around the UK.

Hambledon Village Shop – Opened in 1992, this shop is run by the community for the community providing a shop, post office and café. It employs a manager who is supported by a team of volunteers.

Changing Perceptions – This is an upcycling furniture workshop that offers skills training and work opportunities for people affected by epilepsy and disabilities.

The No.1 Befriending Agency – This is a social enterprise that provides friendly, non-medical care services to lonely and socially isolated people: one-to-one befriendings; a home-help service; social lunches; and a volunteer programme which supports people who are socially isolated.

Seagulls – This is an environmental social enterprise that collects leftover and unwanted paint from household waste sites, reprocesses it and sells it through its two paint stores. It also sells its own branded new paint.

Global Music Visions – This CIC aims to inspire blind, visually impaired and disabled people to play instruments, compose, record and mix music using computer music software.

Baked: Cake with a Cause – This is a social enterprise café that sells homemade, locally sourced baked goods and a range of hot and cold drinks. It supports the community by providing young people with employment, training and skills development opportunities.

Edinburgh Tool Library – This is the UK's first tool library, promoting sharing as a way of reducing environmental impact. It lends members tools for DIY, gardening, decorating and machine repair, so that they don't need to own them. It also provides 'trainee' opportunities for young unemployed people who are interested in working in related trades.

Bee The Change – This not-for-profit aims to tackle the pollination crisis by connecting people to nature through bee conservation. It works towards this via a combination of education, mentoring and courses, community hives and the creation of bee habitats.

Access the *Digital Links* booklet to visit the websites of all these social enterprises.

Question:

1. What are the advantages and disadvantages of social compared to private enterprises?

However, even the simplest legal form of social enterprise faces many commercial hurdles. For example, an unincorporated association cannot own assets or borrow money because it has no legal status. Other legal forms of a social enterprise can be cumbersome and carry with them more restrictions, the primary one being that *all* the profits of the venture must be ploughed back into its activities. This can make raising capital difficult, although there are some sources of finance specifically offered to social enterprises. There are other pragmatic advantages to remaining a sole trader or private company, such as the avoidance of public accountability for decisions made by the founder. Remaining a commercial, for-profit entity ensures that the founder can decide on the balance between commercial and social objectives without interference. This may be attractive to a social entrepreneur with strong views but it may also prove to be a barrier to persuading other people to join the organisation.

CORPORATE GOVERNANCE

If a start-up takes the legal form of a company or corporation its board of directors has the legal responsibility for what is generally called 'corporate governance'. These legal duties and responsibilities arise out of common law and statute, varying from country to country, and may also be detailed in the bylaws of an organisation. The directors have a fiduciary duty – a legal duty of loyalty and care – to act honestly and in good faith, exercise skill and care and undertake their statutory duty. They must act in the best interests of the company and its shareholders. This may seem an academic distinction if there are only two shareholders (e.g. the entrepreneur and their spouse) and one of

these is the sole director of the company (e.g. the entrepreneur). However, even if this is the case, the entrepreneur must realise that they have certain legal responsibilities. If the start-up is larger, or the entrepreneur has aspirations for it to grow, then the board of directors may comprise more than just the entrepreneur. It might include other key members of their executive management team, who might also be shareholders, and even non-executive directors – outside directors who are not employees or part of the executive management team. Often, if outsiders have provided equity funding for a start-up, one of the conditions will be the appointment of specified non-executive directors (see Chapter 19). Non-executive directors have a valuable role in bringing different skills, an independent and objective perspective and a new network of contacts that can contribute to organisational knowledge and learning. They can also act as an early warning system for potential future difficulties and a safeguard against potential business failure. They can be particularly valuable in helping to resolve conflict in family firms.

The broad functions of the board are summarised in Figure 11.1, using the dimensions of inward-/outward-looking and past/future orientation.

» **Future orientation –** Arguably the prime function of the board is to be outward-looking and future-orientated – to review and guide corporate strategy and policy. This might include overall strategic planning, approval of strategies or investments in key areas, changes in the scope or nature of operations, major company decisions and so on. The board is also responsible for how these translate into internal policies for the organisation such as annual budgets, performance objectives, changes in organisational structure, compensation policy for key objectives, risk policy and so on.

» **Past and present orientation –** The board then monitors performance against these strategies and policies and the ensuing risks it faces, as well as compliance with the law. These responsibilities include ensuring the integrity of the company's accounting and financial reporting systems, monitoring and supervising management performance, planning for management succession, providing proper accountability to other stakeholders in the firm; for example, by appointing auditors and approving the annual financial statements, as well as ensuring that the company complies with all aspects of the law.

> *Entrepreneurs are rebels who diverge from the norm, and the most successful are willing to tolerate in-house opposition; they realise that harmony is less important than finding the right answer ... External non-executives can bring useful perspective and diverse experience. Sometimes they can see the big picture in a way that full-time executives, possibly too close to the action, cannot.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 7 May 2017

> *Floatation gives a public face to your business and access to finance that is so often the key to development. But there needs to be a lot more attention to strategy.*
>
> Elizabeth Gooch, founder of eg solutions, *The Sunday Times*, 23 November 2008

While establishing corporate strategy and policy may be the most important job for the board, it is unlikely that it will be given the appropriate weighting in terms of time allocation. Most boards, particularly in larger companies, spend too much time on the other functions, particularly monitoring management performance and legal compliance.

The board becomes more important where there is separation between day-to-day management and ownership of the firm and there are multiple stakeholders. Their role therefore becomes key once a company grows to the point where it is floated on a stock market. Once this happens the board needs to function in a more formal way. For example, in Europe separating the role of chief executive or CEO from that of the board chairman is considered good practice – to help avoid potential conflicts of interest between stakeholders and executive directors. For the same reason most of the Financial Times Stock Exchange (FTSE) companies comply with the recommendation that they have non-

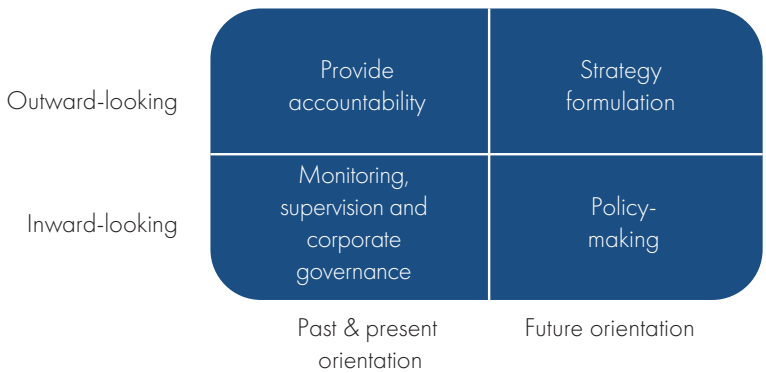


Figure 11.1 Role of the board of directors

executive directors, although in small unquoted companies the proportion is much smaller. In the USA, the Sarbanes-Oxley Act imposed new standards of accountability on US public companies that made directors directly responsible for internal control, facing large fines and prison sentences in the case of accounting crimes.

TAXATION

All commercial businesses are liable to tax and there are a number of different taxes all organisations may have to deal with. Laws and regulations relating to business and personal tax vary from country to country. A newly established business needs to inform the tax authorities of their existence, particularly one with employees, where arrangements to deduct tax from wages may have to be made.

Value added tax (VAT)

This is a form of sales tax that is common throughout the European Union. If the turnover of any legal form of business is above a certain level it must register for VAT (in 2019/20 the level was £85,000 in the UK). If turnover is above this level, VAT must be charged on all goods or services the firm supplies, but at the same time VAT on the goods or services it receives can be deducted from the amount it pays to the government. Different countries have different rates and there can be different rates for different sorts of products or services. Certain goods or services may also be 'exempt' from VAT, which means that VAT is not charged on the goods or services the firm supplies, but it cannot claim back VAT on the goods or services it receives.

Corporation tax

Limited liability companies pay corporation tax on their profits (in the USA this is by election). This can be imposed at the country and/or state level. There are rules about how profit is calculated for tax purposes and these vary from country to country. Tax laws are usually complicated. Some expenses are not tax deductible and normally there are set rates of depreciation for fixed assets. Companies (as well as sole traders and partnerships) are legally entitled to *avoid* paying taxes by maximising allowances, exemptions etc., but it is illegal to *evade* paying the appropriate taxes. The rate of corporation tax also varies from country to country and can increase with taxable profit. Shareholders receiving dividends from the company (paid out of profits) are charged income tax. In the UK the way this is calculated ensures that this income does not face corporation as well as income tax. In the USA, C Corps are subject to double taxation.

Income tax for sole traders and partnerships

Sole traders and partnerships pay income tax on their business profits. Although the expenses that can be deducted to arrive at the income of a sole trader or partner are similar to those for corporation tax, the detailed regulations and rates of tax can differ from country to country. Because there are often different rates of personal income tax depending on levels of income, personal income tax rates are often higher than corporation tax rates.

Local taxes

Most countries have local taxes. In many countries this takes the same form as corporate or income tax. In the UK it takes the form of a lump-sum tax based on the size of the business premises and is called 'Business Rates'.

Income tax due from employees

In many countries businesses are responsible for collecting income tax from employees and remitting it to the government (in the UK this is called the pay-as-you-earn or PAYE system).

Charities

Registered charities are normally exempt from tax on their income and exempt from VAT, but they have to deduct income tax from employees (PAYE).

Explore further 11.7

Advice on taxation

Access the *Digital Links* booklet for web links to:

- The UK government for advice on business taxation for different legal forms of business, value added tax (VAT) and pay-as-you-earn (PAYE).
- The US government for advice on federal and state business taxation.

SUMMARY

- It may be possible to safeguard the IP on a business idea through patent, trademark, registered design and copyright. However, this can be expensive and time-consuming. Sometimes being first to market is more effective in creating competitive advantage. Another possibility is to get employees or third parties to sign a confidentiality or non-disclosure agreement which prevents them from disclosing the business idea.
- There are three legal forms of business: sole trader, partnership and limited liability company. Their advantages and disadvantages are summarised in Table 11.1.
- Responsibility for corporate governance legally rests with the board of directors. Directors have a fiduciary duty to act honestly and in good faith, exercise skill and care and undertake their statutory duty. They must act in the best interests of the company and its shareholders.
- Partnerships, strategic alliances and joint ventures can be very important for new ventures, particularly in the context of innovation and market penetration. They can enhance a business model without requiring additional capital outlay by simplifying operations, leveraging knowledge and capabilities and spreading the business risk. Their advantages and disadvantages are summarised in Table 11.2.
- As a franchisor, franchising can be an effective way of rolling out a business model quickly by leveraging the capabilities and capital of franchisees. As a franchisee it can be a low-risk way of obtaining a tried and tested business model. The advantages and disadvantages are summarised in Table 11.4.
- There are six forms of social enterprise: unincorporated associations, trusts, charitable social enterprises, community benefit societies, community interest companies and charitable incorporated organisations. Their advantages and disadvantages are summarised in Table 11.5.
- All commercial businesses are liable to tax and there are a number of different taxes all organisations may have to deal with.

GROUP DISCUSSION TOPICS

1. Is spending time and money on legally safeguarding your IP worthwhile?
2. How might you go about protecting IP without resorting to law?
3. A big company with plenty of resources can always 'steal' a business idea, even with legal safeguards. Discuss.
4. Under what circumstances might a partnership business form be more attractive than a sole trader form?

5. What are the advantages and disadvantages of having external directors on a board of directors?
6. What are the advantages and disadvantages of partnering with other individuals or organisations?
7. Why and for what sorts of businesses is being a franchisor an attractive way of rolling out a business quickly?
8. You never get rich being a franchisee. Discuss.
9. Is it better to set up a new venture with social objectives as a commercial enterprise or social enterprise?
10. What are the advantages and disadvantages of each of the legal forms of social enterprise?
11. There are only two certainties in life – death and taxes. Discuss.
12. Avoiding or minimising tax is legal but evading it is illegal. But is it really ethical to avoid tax, for example by diverting income to another country with lower tax rates?

START-UP ACTIVITIES

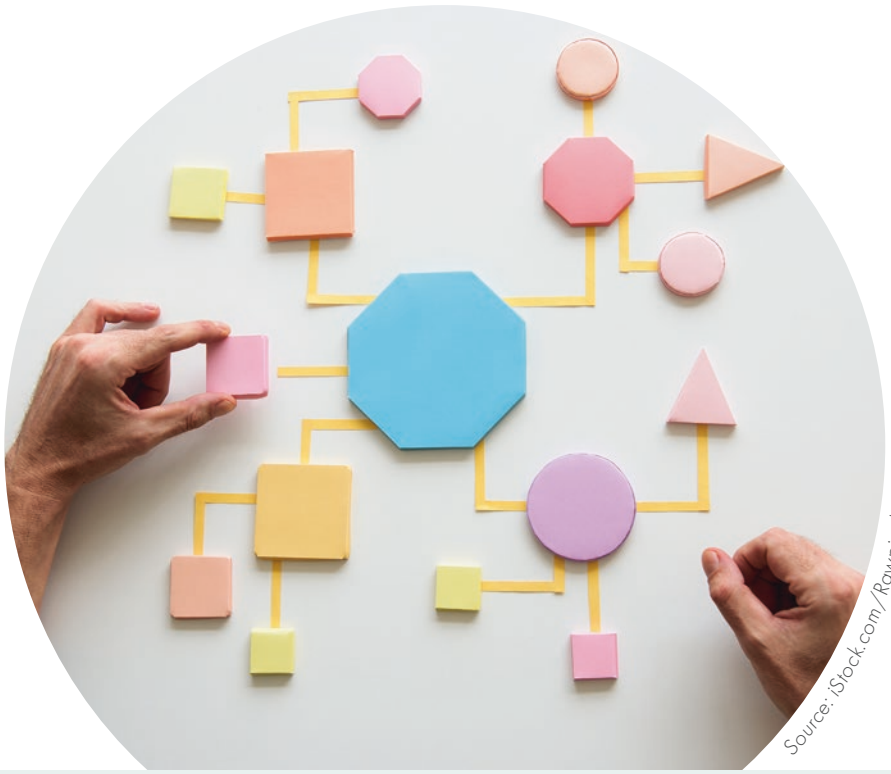
1. Decide whether the IP in your business should or can be safeguarded in any way. List the actions you may need to do to ensure this.
2. Decide on your legal form of business. Whether it is to be a commercial or social enterprise, decide who else needs to be involved and what will be their status.
3. Explore the areas of activity in your business where partnership is possible and the types of partnership that are practical (partnership, strategic alliance and joint venture). For each area and type of partnership write down the advantages and disadvantages.

12

DEVELOPING THE OPERATIONS PLAN

Contents

- Managing operations
- Planning operations
- Critical success factors
- Key operating activities and the business model
- Identifying key activities
- Retail business
- Internet-based business
- Manufacturing business
- Guidelines to reduce waste
- Service business
- Project planning and critical paths
- The operating plan
- Summary
- Group discussion topics
- Student activity
- Start-up activities



Source: iStock.com/Rawpixel Ltd

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Identify the key activities needed to launch and operate different sorts of business;
- Identify critical success factors;
- Prepare Gantt charts and undertake critical path analysis;
- Understand what goes into an operating plan.

Case insights

12.1 J&B Wilde & Sons
12.2 Boohoo
12.3 Sephora
12.4 wiGroup
12.5 Mamanpaz

Explore further links

12.1 Developing a retail website
12.2 Search engine optimisation
12.3 Business-to-business directories and websites
12.4 How to prepare a Gantt chart

MANAGING OPERATIONS

The purpose of a business is to deliver its product/service to customers and that means understanding all that is required to do that. This is particularly the case for sole traders where they have to do everything themselves – from marketing to operations. If someone wants to start a plumbing business, they need to understand how to plumb. They need to organise and manage themselves and, if they want the business to grow, later on they will need to manage other plumbers. No amount of effective marketing can compensate for a poor product/service and the quality of that depends on how good the operations of the business are organised and managed. They need to be able to deliver what they promise.

Managing is concerned with handling complexity in processes and the execution of work. Back in the nineteenth century Max Fayol defined the five functions of management as planning, organising, commanding, coordinating and controlling. Today, these sound very much like the skills needed to lead a communist-style command economy, but they still underpin the work of managers, only how they go about it has changed and perhaps we should drop the word 'commanding'. Fayol's work outlined how these functions required certain skills which could be taught and developed systematically. This chapter looks at how the operations of a business might be managed – planned, organised, coordinated and controlled – while Chapter 13 looks specifically at risk management. Chapters 14 and 16 address broader issues of management and leadership and give a twenty-first century view of what is meant by 'command'.

> *Understanding the nuts and bolts goes a long way to reducing the risk. I want to see that the person ... has a very clear grasp of what he or she is trying to accomplish.*
>
> Ajith Jayawickrema, serial entrepreneur and business angel, *The Sunday Times*, 2 June 2013

PLANNING OPERATIONS

Management on a day-to-day basis is therefore about detail and logic. It is about efficiency and effectiveness. Success depends on understanding how to attract customers but then how effectively the business can satisfy their requirements. Generally this will involve some combination of factors such as design, performance, quality, price and delivery speed. Achieving the necessary balance between market demands and performance criteria is the role of operations planning. This would be reasonably straightforward if market demand was stable – but unfortunately it is not. When and how many products, or how much of a service, will be required is uncertain. Consequently, a business has constantly to make trade-off decisions between the costs of the investment required to cushion the impact of the unstable market on the operations, processes and the costs associated with the impact of volatility on these processes.

A bricks-and-mortar retail business needs goods to sell. Customers expect to see the goods they will buy in the shop. Holding too few or having the wrong styles or sizes can mean losing custom. So the investment needed can be high. And having too much stock can mean that unsold goods might have to be sold off at lower prices or, worse still, thrown away. There is, however, the possibility that the retailer has a sale-or-return agreement with the supplier. The retailer may also need to employ sales staff – how many depends on the number of customers and the volume of sales, all of which might be difficult to predict. An internet retailer may be able to keep lower stocks of physical goods, relying more on just-in-time deliveries, and the cost of storing virtual goods or services is almost zero.

A service business needs people to deliver the service and, like retailers, this depends on the number of customers and the volume of sales, all of which might be difficult to predict. The only way to mitigate these risks is by employing staff on flexible contracts so that their working hours can be better matched to customer demand. We explore this in Chapter 14.

A manufacturing business can cushion itself from fluctuations in supply and demand by holding stocks/inventory of raw materials and finished goods. However, this can be expensive and in today's just-in-time world there is a strong temptation to keep these buffer stocks very low. However, if supply lines get disrupted unexpectedly, as they did during the coronavirus pandemic in 2020–21, the cost of not holding sufficient buffer stocks becomes quickly apparent. Subcontracting work might be another option, so long as the subcontractor is not affected by the same supply-line disruptions. An example of how this mixed plan of production, stock/inventory build-up/reduction and subcontracting might work is shown in Figure 12.1. Nevertheless, stock/inventory control can be a major challenge for a start-up and Chapter 15 shows how some metrics can be used to monitor this.

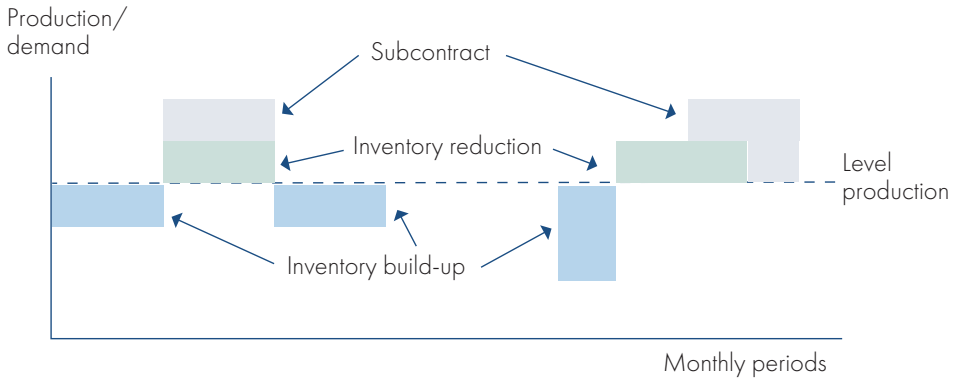


Figure 12.1 Using stock/inventory and subcontracting to smooth production

Whatever the difficulties, it is essential that a start-up produces estimates of sales – volumes and timings. The operations plan can then be drawn up so as to ensure there is sufficient capacity to meet forecast demand (explained in Chapter 15). At this point trade-off decisions can be made between stock/inventory holding, rates of throughput, size of workforce, overtime, additional shifts, the ratio of permanent to temporary staff etc. Indeed, as we explained in Chapter 9, it may be possible to influence the pattern of demand through differential pricing or by seeking out complementary products/services such that the high sales of one are at a time of low demand for another (e.g. out of season offers at resort hotels). Changing the pattern of demand is particularly useful for most service and make-to-order manufacturing businesses, where it is difficult or impossible to prepare or make ahead of demand. In addition, service businesses may be able to reschedule demand by allocating routine activities to times of low demand (e.g. regular servicing of machinery). This leaves the non-routine demand peaks to better fit with remaining capacity.

A major objective for a start-up should be to maintain maximum flexibility with as many strategic options as possible. One way of doing this is by subcontracting work. This may increase the cost and offer less control over quality and delivery, but it means that capacity is increased. Another approach is to work in partnership with another firm that has complementary skills and capabilities. For a sole trader the ultimate buffer against uncertain customer demand is their time and it is not unusual for them to be rushed off their feet one day but with little to do on another. In a family business, other members of the family can often be brought in to help cope with periods of peak demand.

CHAPTER 12

> *You must have the flexibility in your operational capability to flex and pivot as required.*
>
> Paul Williams, Chief Operating Officer, Brompton Bicycle, *The Manufacturer*, 28 May 2020: https://www.themanufacturer.com/articles/how-brompton-is%20steering-the-future-of-electric-bicycles/

CRITICAL SUCCESS FACTORS

Management involves being able to prioritise activities and decide which is more important than another – deciding which activities are urgent and which important. Urgent and important activities should always get priority, but sometimes dealing with urgent rather than important matters can cost a business dearly. And when the pressure is on to do something urgently it can be difficult to focus on whether it is the most important of outstanding tasks. Urgent matters appeal to the right-brain, important matters require engagement of the left-brain. Prioritisation is a question of judgement and priorities vary from business to business, and situation to situation. So it is important that an entrepreneur has a clear idea of what are the important tasks that face their business and plan to ensure they are undertaken.

Critical success factors (CSFs) are the things that are essential to get right if the business is to achieve its mission; things that make or break the success of the business model (e.g. getting a website up and running on time) and ultimately the business. It is vital for a start-up to understand what these are. Critical success factors are distilled from key marketing and operating activities – activities that are essential if the business is to run efficiently and effectively. Key activities may be business imperatives but they are not necessarily critical. Which *activities* are *critical* is a question of judgement. It is not just

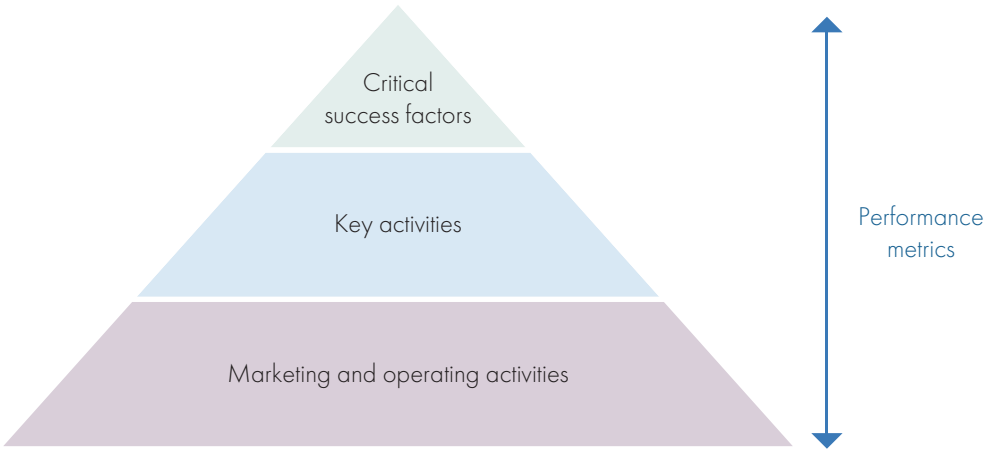


Figure 12.2 Hierarchy of activities

about urgent tasks – most tasks are urgent for a start-up. It is not just about efficiency and effectiveness – although this is likely to be important and take up much of the working day. It is not just about identifying risks that might set you back – there will be many of these. It is about deciding which things might fundamentally affect the success of the venture.

Key activities are derived from elements of the business model – from all the activities that need to be undertaken to deliver both the marketing and operating plans – and from the things that need to be done to manage the risks that the business faces. Risks can be a major source of CSFs and we shall cover this in the next chapter. This hierarchy of activities is shown in Figure 12.2. Some activities will need to have been completed *prior* to the launch of the business and others will be part of the day-to-day operating activities *after* launch. This chapter will highlight the key pre- and post-launch *operating* activities for major business sectors: retail, internet, manufacturing and service.

Performance metrics can usually be developed to measure how well these key operating activities are being undertaken. These were discussed in Chapter 6 in terms of measuring the success of the MVP. Now the metrics need to be extended to cover the actual launch of the business. Many CSFs, particularly those derived from understanding the risks facing the business (Chapter 13), will be binary – simple 'achieved/not achieved' or 'risk materialised/not materialised'. There are also a whole range of financial metrics that can be used to measure and control the financial performance of a business post-launch, some of which have operational implications and some of which, in certain circumstances, can become CSFs. Whether binary or measured by degree of achievement, performance metrics need to be monitored on a regular basis and corrective action taken when necessary.

KEY OPERATING ACTIVITIES AND THE BUSINESS MODEL

Some of the key operating activities (and therefore possible critical success factors) of a business are derived from their business model. Obviously these vary from business to business; however, the generic models outlined in Chapter 7 (low price/cost, high differentiation and customer focus) have some important and different operational implications. Table 7.1, reproduced as Table 12.1, sets out the business imperatives for each of the models. These need to be translated into specific key operating activities for a business – what the company needs to do to ensure they are achieved. For example, Amazon originally set out to be a low-cost online retailer of books, so it located in Seattle, a major distribution hub for several large publishers. Companies with a differentiated product, like Apple, continuously innovate while building their brand based upon what they see as their differential advantages, such as design simplicity. Companies with a strong customer focus like Virgin continually seek out new opportunities for brand extension, and Virgin does this while reinforcing its brand

through the image of its founder, Richard Branson. Dell has a low-cost focus, so one of its key activities includes supply chain management. As this focus changes, the relative importance of the supply chain will change and other key activities will emerge.

Table 12.1 Generic business models and business imperatives

HIGH DIFFERENTIATION	HIGH CUSTOMER FOCUS	LOW PRICE/COST
* Understanding the basis for the differential advantage * Building on the differential advantage * Building barriers to entry * Building the brand * Continuous innovation * Encouraging creativity and innovation	* Maintaining close relationships with customers * Keeping in touch with and understanding changes in customer needs * Maintaining customer loyalty * Maximising sales to existing loyal customers (economies of scope) * Building the brand	* Maintaining cost leadership through economies of scale * Continually driving down costs * Achieving high sales volumes * Improving efficiency * Standardisation

Some key operating activities derived from the business model may be critical success factors. Some may conflict with other critical success factors that are specific to the firm. For example, the business model adopted by any low-cost airline means it must keep its costs low. This has numerous operations implications – from turnaround time to staff rostering, ticket pricing to luggage allowance, website design to branding. However, an overarching critical success factor for any airline is safety. An airline with a poor safety record will not stay in business for long. And that means safety trumps any cost-minimising activities that might endanger safety. However, usually any conflict is not so dramatic and there are ways of resolving it. For example, some large companies with product ranges based on different value propositions have unbundled their activities and set up separate organisations focused on those products with similar core value propositions. In this way, products/services have clear value propositions (and brand identity) and managers of these organisations have clear operating imperatives. Both key operating activities and critical success factors can change over time and need to be reconsidered whenever there is a change in strategy.

IDENTIFYING KEY ACTIVITIES

Key operating activities have implications for all aspects of the business, including the resources needed. Every business has its own set of key activities upon which its competitive advantage probably hinges and techniques such as brainstorming and mind maps (outlined in Chapter 4) can help in deciding what these are. Some will need to be completed prior to launch, for example selecting an appropriate location for a retail business or obtaining appropriate licences. If the entrepreneur hopes to sell an innovative product, they will probably need to at least have a working prototype before trying to get finance, and they will certainly need to have refined that prototype and be able to deliver the product in the required volumes before they go to market. However, they may not have to manufacture or even assemble the final product themselves – it might be possible to subcontract this activity.

Some key pre-launch activities have implications for future operations. For example, Amazon's business model requires it to have an efficient and effective web platform. This was needed at start-up, but the platform continues to be developed so the company can maintain its competitive position. Google's original business model required a working word-search algorithm. Today it needs to keep at the forefront of internet-based search and retrieval technology and developments. Dell set out to be a low-cost provider of computer equipment and developed an innovative B2C2B integrated supply chain to facilitate this. Now this is commonplace and Dell is struggling to differentiate itself.

Some key operating activities need to be in place for the life of the business, for example keeping an up-to-date and engaging website or maintaining service levels. These are the day-to-day operating issues that are essential in order to deliver the customer value proposition. They are specific to each

business, but there are some generalisations that can be made for specific industries – retail, internet, manufacturing and service. So for example, while the location of a bricks-and-mortar retail business is a critical pre-launch decision, once you have opened a shop promotions and merchandising become more important. The effective operation of the website is a vital activity pre- and post-launch for an internet retailer. Many service businesses such as consultancies are based around some key skills, knowledge or problem-solving abilities, and training might therefore feature as a key updating activity. Production activities that underpin quality or efficiency might dominate the key activities for a manufacturing firm. Key operating activities may change over time as the business develops and should be reviewed regularly.

Key activities cascade down an organisation and what might be important or critical for one function within a business might not be of the same importance for the business overall. Paying salaries and wages on the due date is critical to many employees but is unlikely to feature on the key activities or critical success factors list for your business. It is all a matter of judgement.

RETAIL BUSINESS

Launching a bricks-and-mortar retail business – a shop, store, restaurant, bar etc. – poses particular challenges. Stiff competition from internet retail sites caused many businesses to close, even before the coronavirus outbreak. Retail businesses may be easy to launch, but they can close just as quickly. These are the sectors with some of the highest 'churn' statistics (open and close). Chapter 9 highlighted the high fixed costs these businesses face and the resulting high margins that they must aim for. Attracting customers, and not necessarily through low prices, is the key to success.

For any retailer, the 'place' element of the marketing mix is very specific and very important. The location must provide access to their target market. If they want the casual shopper or diner, they might locate in the high street or at a transport hub – wherever there is high footfall. High-footfall locations are called 'prime sites' and can be expensive. However, just because there are lots of people passing a location, it does not mean that those people are potential customers for the product/service offered. If the business involves selling something that customers will seek out and can be relied on to 'pull' them into the shop or restaurant then it can afford to be located at a secondary site, with lower footfall. You often see stores relying on infrequent purchases (e.g. furniture, cars, do-it-yourself etc.) located in secondary locations. Secondary locations have much lower rent and rates than primary locations. However, there may be additional marketing costs associated with 'pulling' customers into that location. Sometimes small retailers group together in areas which have lower rent and rates and establish their own customer 'pull' because of the charm the area has or because of the variety offered. Retailers offering similar products/services can also group together to establish specialist 'quarters' such as a jewellery quarter or restaurant quarter. Some of the factors affecting location decisions are listed in Table 12.2.

For any retail outlet the shop or store frontage is the equivalent of a huge advertising hoarding or billboard for the things it sells. It therefore needs to reflect the value proposition to customers. The ambiance is also very important – design, hygiene, layout etc. – and must also reflect the value proposition. It must be consistent with the rest of your marketing mix. If you are selling on price (e.g. like Poundland stores in the UK) you do not need expensive frontage or point-of-sale displays because it is not consistent with the low-price value proposition. On the other hand, you may still need to locate in prime sites.



Source: Artem Gavrysh on Unsplash

The launch of a new retail outlet needs to attract potential customers into the building in which they are located. They therefore often have opening events, perhaps with celebrities or even bands, trying to generate a party atmosphere with banners, balloons, special decorations etc. Shops and stores often have opening sales. While shoppers might just browse, drinkers or diners will want to try out the

Table 12.2 Retail: Factors affecting the location decision

* Size of population in local area
* Demographic and nature of population
* Footfall outside specific location
* Visibility of site
* Proximity of 'magnets' such as anchor stores or transport hubs
* Strength of competition
* Consistency with customer value proposition
* Site costs
* Availability of parking
* Availability of public transport
* Potential for expansion
* Nature of legal agreement (e.g. lease term, rent reviews etc.).

products on sale, so special opening price discounts might be offered. Rather than relying on price offers, exclusive bars or restaurants might have special opening events which only selected people are invited to, creating an atmosphere of exclusivity. And while retailers located in prime sites might rely on attracting passing customers, other retailers will need to promote their opening event.

Once through the doors customers still need to be encouraged to stay. Increasingly stores are offering refreshments – for example many Waterstones bookshops have coffee bars. Many retail businesses offer free internet access. Customers also have to be encouraged to return by mounting special events. For example, clothes shops might host fashion shows, restaurants and bars might have special tasting nights.

Even bricks-and-mortar shops and stores need a website these days. The ability to continue selling goods online proved vital for many stores during the coronavirus pandemic. Customers have now become used to browsing a website and purchasing goods online – a trend accelerated by the pandemic. A good website can be used to attract customers, advertise products or sales promotions, and allow customers to check availability of goods and place an order (click-and-collect), even if it is not used for online sales. While increasingly transactions are electronic (retailers need to open a credit/debit card merchant account), any business handling cash needs to ensure that there are safeguards in place to prevent theft. Staff theft is particularly problematic in bars. Increasingly, cameras are being used to supplement electronic cash registers. Cameras are also used extensively to discourage shoplifting. Table 12.3 provides a checklist of possible key activities for a shop or store, based upon the mind map in Figure 4.4. It is split between pre-launch activities and post-launch operations.

Restaurants will need to develop attractive menus and make certain they have the chefs to deliver them. Waiting staff will need to be trained. Most restaurants have an online presence that can be used

Table 12.3 Shop or store: Key operating activities checklist

PRE-LAUNCH	POST-LAUNCH OPERATIONS
* Location	* Merchandising
* Licences and leases	* Stock (inventory) control
* Shop or store design and fit-out	* Promotions (customer 'pull')
* Merchandising and stocking	* Security (cash and shoplifting)
* Internet sales and website	* Service levels
* Sales staff recruitment and training	
* Credit/debit card merchant account	
* Launch event	

for promotions and the internet can be used to offer takeaway or home delivery services. Hygiene will be an important consideration and in the UK they will need to obtain a hygiene certificate from the local authority. Any retailer selling alcohol in the UK needs to obtain a licence from the local authority. Table 12.4 provides a checklist of possible key operating activities for a restaurant or bar.

Table 12.4 Restaurant or bar: Key operating activities checklist

PRE-LAUNCH	POST-LAUNCH OPERATIONS
* Premises location * Premises lease * Licences * Restaurant/bar design and fit-out * Menu design * Chef recruitment * Staff recruitment and training * Credit/debit card merchant account * Website * Launch event	* Hygiene * Promotions (customer 'pull') * Cash control * Stock control (food and drink) * Staff rostering * Menu rotation * Service levels * Customer security

Explore further 12.1

Developing a retail website

Access the *Digital Links* booklet and watch a short video about how the toy retailer, The Entertainer (Case insight 8.2), went online using SAP Commerce Cloud.

Case insight 12.1 J&B Wilde and Sons

SME flexibility and durability

The family business of J&B Wilde and Sons has had a stall in Manchester's New Smithfield Fish Market for 100 years. However, it has had to adapt and change in order to stay in business. Originally, it sold British white fish, made popular with the growth of fish and chip shops. Today British white fish is hard to find, fish and chip shops are in decline and the family has had to develop new products and find new customers just to survive. Fish has now become a food that is susceptible to fashions and fads, and the family have to keep on top of market trends. It still sells fish, but most fish is now flown in from around the world, and it is now sold filleted. J&B Wilde and Sons has also developed a reputation for stocking a wide variety of 'exotic' fish which are sold mainly to Chinese restaurants. Many years ago it started selling chicken, mainly to Indian restaurants in the area. Building on this success, it now sells a range of fresh and frozen poultry, meats and game, offering free local delivery in the Manchester area to the public, retailers, caterers, hotels and restaurants. However, the 2020 Covid-19 outbreak hit it badly as many of its caterers, hotels and restaurants had to close down and it was not geared up to expand its home deliveries. Nevertheless, it still survives to this day.



Source: Gerhard G. from Pixabay

Visit the company website via the *Digital Links* booklet and take a video tour of the Smithfield market in Manchester.

Question:

1. Why has have J&B Wilde survived for so long? What do you learn from this case?

INTERNET-BASED BUSINESS

Internet businesses might sell real products (e.g. books and other goods) or services (e.g. events such as theatre tickets, travel etc.) which still need to be 'manufactured' or delivered in physical form. They might sell virtual products (e.g. apps) which still need to be 'manufactured', but once they are can be resold at virtually zero cost, often called 'knowledge products', where pricing is a major issue (see Chapter 9). Selling real or virtual goods or services is often called 'e-commerce'. On the other hand, internet businesses might sell nothing, with the website itself acting as a platform for e-commerce. They might provide information or virtual services (e.g. social media) and derive their income from other companies that pay to advertise or have customers 'click-through' to their site. The key operating activities for an internet business stem from the business model they adopt (see Chapter 7).

E-commerce retailers do not require the major fixed costs of a brick-and-mortar retail business, costs like the high-street shop rent and the shop-floor staff. It can often therefore undercut the price charged by them. However, many traditional bricks-and-mortar businesses are now trading on the internet as well, trying to offer customers the best of both worlds (bricks-and-clicks model). E-commerce retailers can have access to international markets almost immediately upon start-up. Selling on the web offers the opportunity to do business 24 hours a day, seven days a week – worldwide. It also offers the chance to build relationships and develop an understanding of individual customers' buying patterns. Internet-based retail is most successful for branded products where the features are already understood, or for 'low-touch' products or services such as music downloads, books, airline or theatre tickets where, once again, customers understand precisely what they are buying. About half of all computers are now sold online, compared to about 10 per cent of clothing and footwear.

The key to successful trading with any of these retail businesses is a good website – one that gets people to visit and then revisit. Of course an internet retailer can trade on other ready-built e-tail platforms such as Amazon, eBay or Alibaba. However, these platforms charge for their services and the entrepreneur may want to control content and presentation and to have their own web presence. Having an interesting, attractive website is, of course, essential for those internet business models which rely on attracting visitors and derive income from advertising or pay-per-click. Microsoft software contains a basic website writing tool on Microsoft Office Live, which provides links to free web design tools. If the entrepreneur does not want to build their own website from scratch, they can buy skeleton sites that they can customise or they might employ professional web designers. You can spend as much as you want to design and set up a website. It will depend to a large extent on the functionality required. A basic one might cost as little as £500 but a good one could easily cost £20,000. A quick search online will yield many website design services, and friends and colleagues may be able to give recommendations.

The website for an e-commerce retailer should enable customers to order quickly and easily. A site with a difficult sales process is likely to lose customers before they reach the checkout. It should also be easy to navigate, so customers do not get frustrated and leave without even attempting to make a purchase. Data and transaction security should also be a priority, and potential customers should be assured that their details will be kept safe. The content of the website needs to be updated regularly so as to maintain customer interest. It should also present a 'human face' and, better still, build a community of interest that encourages the visitor to communicate with the company, ideally leaving their email address so that they can be contacted directly. It is just as important to establish a relationship with customers in the virtual world as it is in the real one and, as we saw in Chapter 8, the internet can be an important part of a communications campaign that helps build a loyal customer base.

Customer information is valuable, not least because it allows communication, but also because it allows a firm to build an understanding of customer preferences through their buying habits. Membership sites (where customers provide data about themselves in exchange for benefits such as

> *Optimize your website. Keep driving customers to your website using PR and marketing and make your site sticky. It's your portal to world markets.*
>
> Calypso Rose, founder of Clippykit, *The Daily Telegraph*, 6 February 2009

additional discounts) allow a deeper understanding of customer preferences and better customer experience. They also offer the opportunity for economies of scope. Communication by email or text can be used to announce 'flash sales' (sales that run for only a day or two). If a firm offers 'overlapping' products or services they can be offered on more than one website, allowing sites to target different markets but offering potential economies of scale.

Any internet-based business needs to get people to visit their website in the first place. Just like a bricks-and-mortar business, they need to create awareness – something they often seem to forget. This can be done using all the media outlined in Chapter 10, particularly advertising on other websites or in print media. As we have seen, services such as Google AdWords can be very cost-effective for an internet retailer because they operate on a 'pay-per-click' basis. Social media such as blogs, chat rooms and discussion forums can also be cheap ways of getting customers to become aware of a website.

All internet businesses need to ensure that potential customers searching the web for sites such as theirs get links to their site as quickly as possible. Search engines thrive on content, and the more relevant content with keywords or phrases, the more likely a site is to be featured on a search. However, few people searching the web look beyond the first couple of pages of results. 'Search engine optimisation' (SEO) ensures that potential customers searching for a particular type of product/service on search engines such as Google can be directed to a relevant site as quickly as possible; however, companies offering this service can be expensive. Table 12.5 provides a checklist of possible key operating activities for an internet business.

Table 12.5 Internet business: Key operating activities checklist

PRE-LAUNCH	POST-LAUNCH OPERATIONS
* Computing and IT equipment * Web design and navigation * Search engine optimisation * Website advertising and promotion * Launch advertising and promotion	* Promotions * Social media promotions (e.g. blogs, chat rooms and discussion forums) * 'Community' building activities * Website update
Direct sales model: * Credit/debit card merchant account * Transaction security * Merchandising and stocking	Direct sales model: * Stock (inventory) control

Explore further 12.2

Search engine optimisation

You can employ a specialist or you can learn how to do SEO with the help of a good book, an online course and some specialist software which helps you monitor and analyse the traffic on a website. Access the *Digital Links* booklet for guides, tips on SEO and other useful links.

Case insight 12.2 Boohoo

Online fast-fashion retailing

Boohoo is an online 'fast-fashion' retailer founded in 2006 by Mahmud Kamani and Carol Kane and is now a public company. Its founders used to supply a number of high-street fashion stores before spotting the opportunity presented by the internet to sell direct to shoppers. The range of fashion brands owned by the company includes Nasty Gal, Miss Pap, Coast, Karen Millen, Pretty Little Thing (purchased for £330 million in 2020) and Warehouse and Oasis (bought out of administration one month later for £5.25 million – see Case insight 20.2). It is one of the companies that has benefited from the lockdown associated with the 2020 Covid-19 pandemic.

Boohoo's business model involves owning different fashion brands targeted at different market segments. It does not sell brands it does not own and therefore the profit margin is not diluted. Being online helps keep its costs low but at the same time it has also ploughed hundreds of millions of pounds into marketing, making extensive use of online 'influencers' (Case insight 10.4). The company also kept capital spending low by purchasing off the shelf IT for its website rather than having it custom made – giving it more money for marketing.

Boohoo is in the 'fast-fashion' business, changing its range daily. It drops 500 new products each week, giving shoppers a reason to regularly visit the website. It therefore needs to be able to respond quickly to changes in fashion and demand and has developed short supply lines with half of its garments being made in Leicester. This means that it does not have to wait for products to be shipped from overseas factories. However, it makes only a limited quantity of each item in Leicester and reorders only if the line is selling well, avoiding over stocking or the danger of having to sell lines at discounted sale prices. As a result margins are strong. However, in 2020 conditions and wage rates in these Leicester factories were heavily criticised and Boohoo itself was criticised for allowing the situation to arise.

Boohoo intends to stay an online-only retailer. It is already expanding overseas and is buying up more fashion brands as high-street stores close, allowing it to spread its costs and benefit from economies of scale (see Case insight 18.5). In 2020 it raised almost £200 million from shareholders to take advantage of the distressed state of the fashion retail business around the world. This was in addition to the £162 million it raised to help fund the purchase of Pretty Little Thing. In 2021 £55 million of this was used to buy the brand name and website (but not the stores) of the UK department store Debenhams that went into administration in the previous year. Chief executive John Lyttle commented:



Source: Jerrit Clark/Stringer/Getty Images

> *'Boohoo reacts in hours and days, not weeks and months ... A lot of retail is not in a good place and we will see a lot more brands unfortunately fall and we see that as an opportunity ... [We] continue to appraise opportunities'* (The Times, *18 June 2020)*

Visit the company website via the *Digital Links* booklet. You can also watch a video which explains how Boohoo became so successful, while sounding a note of caution.

Questions:

1. What are the critical success factors for Boohoo and how are these different from a more traditional fashion retailer?
2. What might be the limitations to Boohoo's growth?

Case insight 12.3 Sephora

Innovation in retailing

While other cosmetic companies depend on department store sales, Sephora is revolutionising retail by offering customers new in-store and online experiences such as trying on make-up virtually using augmented reality, matching their skin tone to a foundation using artificial intelligence (AI), and sampling a fragrance via a touchscreen and scented air. Founded in 1970, and acquired by the luxury goods conglomerate LVMH (Moët Hennessy Louis Vuitton) in 1997, Sephora is a French retail cosmetics chain with some 2,300 stores operating in 33 countries and generating revenues of over $4 billion in 2013. It sells its own and other brands of cosmetics over-the-counter and online in a highly competitive and changing industry where brands like Glossier and Huda Beauty are rapidly building market share almost entirely through the new channels of social media and user-generated content. To help it counter this competition and bridge the gap between its online and in-store experiences, Sephora set up an Innovation Lab in 2015 to help it develop, test and launch new offerings for shopping in-store and online using AI technologies such as natural language processing, machine learning and computer vision.

One of the innovations that came out of the Lab was the Sephora Virtual Artist app, the product of a partnership with the facial analysis and visualisation technology firm ModiFace. Launched in 2016, it allowed customers to enjoy the personal attention they might have from an individual sales representative in-store and online using AI, albeit at a fraction of the cost. The Sephora Virtual Artist app is an augmented reality platform that allows users to upload a photo and then apply a virtual make-over, experimenting with different product and shade combinations for lips, eyes or cheeks. The app can be downloaded and used on a mobile device but in stores customers can also 'try on' any product virtually inside a kiosk by simply tapping on a screen. There is even a device that scans the surface of their skin and matches it precisely to foundation products. Alongside this, Sephora also developed a system called InstaScent, which allows a customer to test out 18 different kinds of scent groupings in-store.

With online shopping becoming more popular, particularly for the customers Sephora targets, the Sephora Visual Artist platform is an attempt to replicate an in-store experience for online shoppers. Hosting the app on Facebook Messenger, which has almost one billion daily users overwhelmingly on mobile devices hosting social media content, also helps target it to the same younger audience. Sephora advertises extensively on social media and is partnering with Dynamic Yield to provide personalised product ads for customers using algorithms that weigh factors like location, items previously viewed, and items purchased. Using a product called Storyboard, Sephora has also started blending its ads into the flow of articles, images, videos and blogs on Flipboard, a social media app that is focused less on connection to other users and more on the personal interests of the main user, giving it a higher potential for targeting, since the user is constantly providing data on the content that interests them.

> *'We are very focused on our customers, and we know that her life is increasingly reliant on digital. So we know to be successful as a retailer, we've got to be where our clients are, and give her tools and experiences that meet her needs.' (Mary Beth Laughton, Executive Vice President of Omni retail, Sephora,* IncubateIND, *18 February 2018)*

Visit the company website via the *Digital Links* booklet and watch a video explaining what the company does.

Questions:

1. Is it important to have similar shopping experiences in-store and online?
2. If it is, what are the implications for the business model and operations in particular?
3. Why is it important to have the same target market in mind when developing new 'experiences'?
4. Are there any lessons here for other retailers?

MANUFACTURING BUSINESS

Manufacturing and assembly can be complicated and often require expensive machinery. So the first question an entrepreneur should ask themselves is whether they need to undertake the task themselves or whether it can be subcontracted, allowing them to focus on other more critical elements of the business model. Subcontracting can be cheaper (if volumes are sufficient) and might ensure a higher quality of product if the subcontractor has the required skills (and the entrepreneur does not). On the other hand subcontracting might take longer, might endanger any IP in the product and might result in quality control problems.

If the entrepreneur decides to manufacture their product themselves they will probably need machinery and equipment of some sort. Trade magazines can be used to search out suppliers. Quality control is likely to be an important operating issue and there are UK/international quality standards that may help (BS/ISO 9000 series). They will also need to source raw materials or components. Business-to-business directories and websites can help with all these issues.

Explore further 12.3

Business-to-business directories and websites

Business-to-business directories and websites like Applegate, Alibaba and Kompass can help you source suppliers and manufacturers from around the world. Access the *Digital Links* booklet for these websites.

There are five types of operations processes involved in manufacturing or production.

Project

This is the production of one-off, large-scale products to meet the specific requirements of a client, for example buildings. Normally the project is built or manufactured on-site around the needs of the client, because it is not practical to move it once it is produced. Operational issues include effective resource delivery to and allocation around the site and the coordination of a large number of interrelated activities. The challenge is to deliver the project on time and on budget. Because it is one-off, specialist knowledge of this sort of project and accurate costing are vital. Launching a business is a project in itself and later in this chapter we outline how a Gantt chart can be used to determine the time needed to undertake this.

Jobbing

This is one-off production to meet the specific requirements of a client, but the process can be undertaken in a factory and then shipped to the client, for example the production of a machine tool. This would normally make the organisation of operations easier. The challenge remains to deliver the project on time and on budget, and specialist knowledge and accurate costing are vital. Because the exact nature and duration of the job may be uncertain there is a need to monitor and control the progress of the job, allowing revisions to scheduled processes and highlighting the knock-on effects to subsequent jobs.

Batch

This is where there is sufficient volume of production to justify organising production in the most efficient and effective way (see for example UK Sofa-beds, Case insight 9.3). There is a degree of task repetition, but volumes rarely justify the investment of time in task analysis. An example is the manufacture of components that go on to be assembled into a bigger, more complicated product. Because in batch production a job is broken down into a series of operations, the order volumes will be for a number of products/services and these will be competing for common processes. Consequently it is important to monitor jobs through these processes, particularly if there are capacity constraints or changes in volumes. A typical control procedure is to break down each order into a sequence of operations and then, having assessed the time and/or resource required to undertake each operation, load each job into the process, making sure that the total loading is within available capacity.

Table 12.6 Manufacturing: Key operating activities checklist

PRE-LAUNCH	POST-LAUNCH OPERATIONS
* Premises location * Premises lease * Premises design and layout * Licences * Equipment purchase/lease * Staff recruitment and training * Materials and stocks * Safety procedures	All manufacturers * Quality control * Stock (inventory) control * Safety checks Project and jobbing * Project scheduling and management * Knowledge and skills update Batch * Scheduling and monitoring of orders against processes involved * Handling complexity Line/Continuous * Staff control * Efficiency studies

Line

This is where there is a further increase in volume, with a regularity of order that justifies the investment in task analysis and dedicated resources, for example the production of a limited range of clothing. Assembling subcomponents (which may come from subcontractors) to form the final product is usually an important part of the process. Organising these processes in the most efficient and effective way is important.

Continuous

This is where volumes have increased to such an extent that an inflexible, dedicated process is in place to run all day, every day, with a minimum of shut downs, for example the production of consumer durables like washing machines. This is something that a small business would not normally be involved in.

Operating imperatives in manufacturing vary considerably. Project and jobbing manufacture requires a high degree of specialist knowledge and skill and may require expensive specialist equipment. Project management skills are also important. There is the opportunity to differentiate and brand the business based upon this. Small businesses seem attracted to batch manufacturing, probably because the batches are not sufficiently large to warrant pursuing efficiencies and economies of scale. However, batch manufacturing can involve high volumes and a relatively wide range of products with different orders competing for the same processes and therefore control can be complex. Line manufacturing involves the ability to organise assembly and manage repetitive, routine operations efficiently and effectively. Cost control, plant utilisation and economies of scale are likely to be important. Table 12.6 provides a checklist of the possible key operating activities for a manufacturing business.

GUIDELINES TO REDUCE WASTE

Many academics and business people have observed that what is good for the environment can also be good for business. Sustainability means doing more with fewer resources, and that reduces costs. Scott (2010) gave the example of Walmart, which demanded that its 60,000 suppliers reduced packaging by at least 5 per cent and as a result expected to reduce solid waste by 25 per cent and shave $3.4 billion off operating costs. General Electric decided to become 'greener' in 2004. By 2008, 'green' practices had reduced costs by $100 million and yielded a portfolio of 80 new products and services that generated $17 billion in annual revenues. Here are Scott's ten guidelines to reduce product waste:

1. Carefully design the product to minimise resources so it can be reused in a closed-loop system.

2. Design products so they can be disassembled easily.
3. Reduce the use of hazardous inputs.
4. Switch to non-hazardous manufacturing methods.
5. Reduce the amount of energy required in manufacturing and use sustainable energy.
6. Use newer, cleaner technologies.
7. Use sustainable, remanufactured, recycled or scrap materials in the manufacturing process.
8. Improve quality control and process monitoring.
9. Find ways to get the product returned for disassembly and harvesting of parts.
10. Reduce packaging or use recycled materials.



Source: Bas Emmen on Unsplash

SERVICE BUSINESS

The most important activity for a service business is the ability to deliver that service, and that depends upon the knowledge, skills and abilities of those delivering it. All service businesses involve people, and their training is important. This training might reflect the specialist nature of the service – for example in consultancy and training. It might reflect the service process – for example where efficiency and effectiveness are important. Where direct contact with the client is involved, training should help develop the interpersonal skills of staff and their ability to manage client relationships as well as other staff.

Perhaps surprisingly, service delivery has many similarities with manufacturing. Larger consultancy assignments take the form of projects and require the same degree of coordination and control. A tailor-made training programme is similar to jobbing. A computer bureau that processes different clients' work is, in effect, a batch manufacturer. A fast-food restaurant has more than a passing similarity to line manufacturing. So the first task is to identify which of the five types of operations process outlined in the previous section most closely resembles the service to be provided. Table 12.6 therefore also acts as a checklist of possible key operating activities for a service business.

PROJECT PLANNING AND CRITICAL PATHS

Launching a business is a project in itself and that whole operation needs to be carefully planned and coordinated. Each major activity can be broken down into more detail, showing linkages and critical paths. Delivery of the planned activities needs to be scheduled and then monitored and controlled. The activities can then be ordered, with critical and high-risk ones scheduled as early as possible. Gantt charts are an excellent way of showing these linkages and allowing completion of a project to be planned, scheduled and controlled. They show how long a project will take to complete. Figure 12.3 shows a highly simplified Gantt chart for a retailer based upon the mind map in Figure 4.4 and pre-launch key activities checklist in Table 12.3 (assuming store location is already decided):

- Against each activity a block of time is drawn that represents the estimated length of time it will take to complete the task.
- The blue arrows show the linkages between these activities.
- The green arrows indicate the critical path along which each activity must be complete before the next begins.

The critical path (shown by the blue line) is the longest path through the diagram and is the shortest possible time to complete the project – in this case opening the store. Unless the time taken for tasks

Case insight 12.4 wiGroup

Operations planning

Bevan DuCasse was keen to find a technology-based business opportunity and he realised that Africa was becoming the largest and fastest-growing mobile money market in the world. He therefore thought that anything that built on this opportunity would be a winner. In 2007 he launched wiWallet, a mobile transaction payment app that linked to credit cards, which DuCasse claimed was the first of its kind. However, on its own it proved to be unsuccessful partly because of competition from existing banks and retailers and partly because it was targeting the wrong customers – the app users – who were unwilling to pay for it. At the time there were very few apps and there were no app stores.

DuCasse was joined in the business by Basie Kok in 2008 and they decided to 'pivot' the business model from a B2C to more of a B2B model. This involved developing two core service offerings with an integrated range of enhanced benefits to a range of different customers. The company changed its name to wiGroup. The two core service offerings were:

1. *wiCode* – This was an integrated platform that allowed merchants to accept payments via their point-of-sale (POS) devices from mobile phones linked to a wide range of credit or payment providers (including mobile-based payment options such as Vodacom's M-Pesa or MTN's Mobile Money). The company developed a small reader that merchants could plug into their POS terminal to accept payments and transactions from mobile apps.
2. *wiBlox* – This was a card-free service that allowed companies to offer customers a range of mobile-based benefits including loyalty, rewards, vouchers, coupons and gift programmes based upon transactions flowing through the app. At the same time companies using this service receive data on customer transactions. While many large retailers have card-based loyalty and rewards programmes, wiGroup's technology allowed for this to be integrated into one app offering payments, loyalty points redemption, coupons and vouchers.

These services were then targeted at four different types of customers:

- App users – who could now download the app free and can then use it for payments and to obtain and monitor their rewards or points status;
- Retailers and merchants – facilitating payment, enabling them to track purchases and offer promotions;
- Product manufacturers (particularly those of fast-moving consumer goods) and service providers – allowing them also to offer promotions and track purchases;
- Banks and other credit providers – enhancing their customer service.

This change in direction from a B2C to a B2B business model had a number of significant operational implications. The main target customers were no longer app users – they would download the free app if it provided benefits to them – it was retailers, merchants and product/service providers who were being asked to pay for the service. The key to success was scaling the company and gaining wide market coverage in South Africa as quickly as possible and benefiting from the network effects generated by this. The changes meant that the company had to sell the benefits of the platform to a range of different customers but wide coverage and market dominance were crucial.

wiGroup now has a market presence in Namibia, Nigeria, Mauritius and Ghana. Its mobile transacting network has grown to over 14,000 retailers and merchants with over 75,000 integrated till points accepting mobile payments, loyalty and reward transactions. It handles billions of transactions each year. It works with leading banks, insurance and telecoms companies as well as consumer goods companies and mobile money issuers, enabling everything from SnapScan to Discovery Vitality Rewards to integrate with banks and retailers. To achieve this growth the company has raised substantial venture funding from Investec Asset Management, Virgin Group and global retail solutions company Smollan. It is looking to expand into the rest of Africa and Europe focusing on France, Netherlands and the UK.

Visit the company website via the *Digital Links* booklet and watch a video featuring Bevan DuCasse explaining how wiGroup developed and a company promotional video aimed at the B2B market.

Questions:

1. Why was the old business model for wiGroup unsuccessful and why has the revised business model worked?
2. What were the original critical success factors for the revised business model?
3. What things had to be done to ensure these were met?
4. Will these critical success factors be the same in each country it expands into?

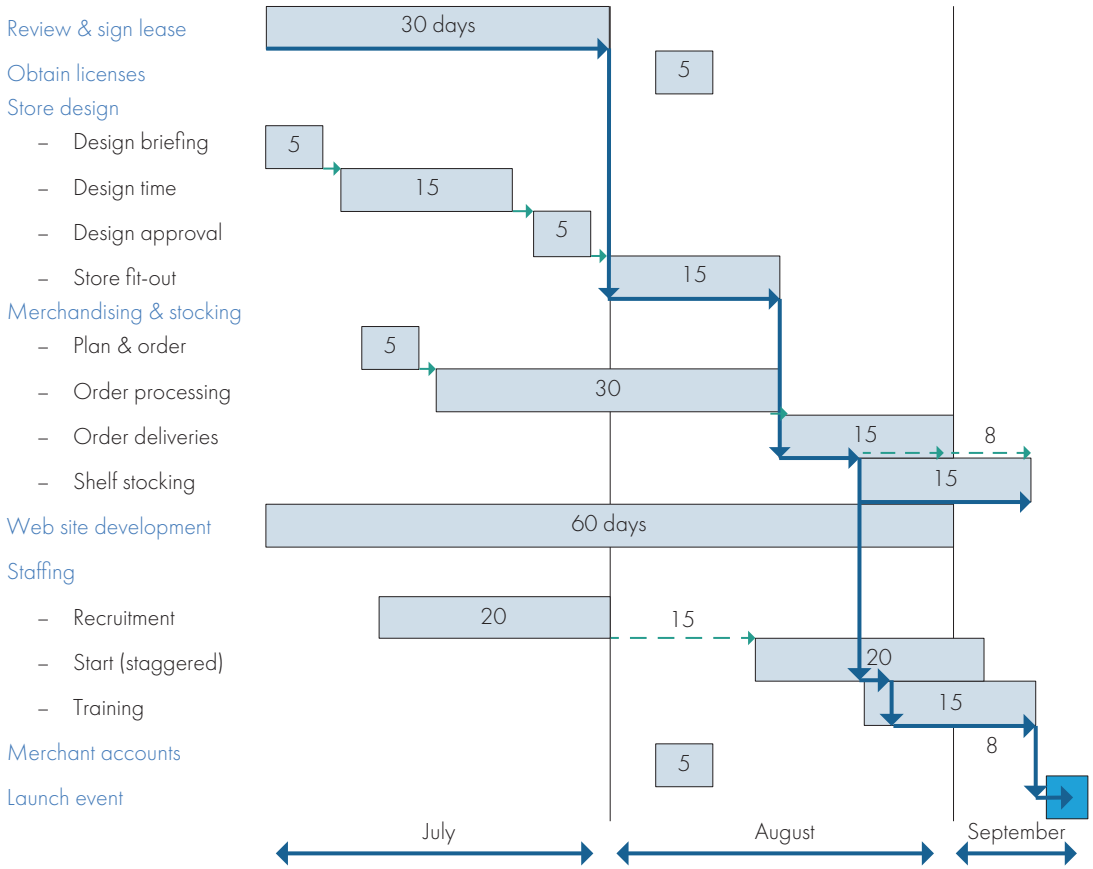


Figure 12.3 Gantt chart for opening a store

can be shortened, this will take 68 days. If any task along the critical path line overruns, then the opening will be delayed. As you can see from the chart, the last two weeks of August and the beginning of September are congested periods of activity when staff are joining, stocking shelves and undertaking training prior to the store opening on 9 September.

At the moment there is no slack built into these schedules. An added sophistication would be to build in fastest and slowest completion times and then check the effect on the critical path time. And it is very easy to fit dates into the format. Costs and responsibilities can then be allocated and assigned for the various tasks. The next stage would be identifying the risks that might delay completion of any activity. If this all seems a daunting task, there are computer programs that can help with this sort of project planning.

Explore further 12.4

How to prepare a Gantt chart

Access the *Digital Links* booklet and watch a short video explaining how to prepare a Gantt chart.

THE OPERATING PLAN

The operations plan highlights the practical things that need to be done to launch a new venture; the key operating activities, CSFs and strategic options, available if plans change. A summarised, 'high-level' version of the operating plan should be included in the business plan, if finance is being sought. Behind this there will be a number of detailed operations and action plans about things that are still important, but less critical. These will cascade down involving more detail – things that would never go into a business plan but still need to get done. Indeed, a number of operating and action plans could be produced for different levels of the business.

As we have seen, the operations plan can be split into two parts: pre-launch – the things that need to be in place before the business is launched – and post-launch operations – the things that the business will need to get right on a day-to-day basis after it has started trading. The marketing, operating and financial plans should together produce a series of SMART milestones – objectives that are measurable with time deadlines for meeting them. These would normally be highlighted in a business plan.

The operating plan should also identify the risks facing the venture and how they will be monitored and mitigated, for example through partnerships. We shall deal with risk in the next chapter, but risk management and mitigation can be critical success factors that are important to highlight in the 'high-level' plan, particularly if external finance is being sought.

Case insight 12.5 Mamanpaz

Organising meal deliveries

If you have been to Mumbai you may have come across the 'dabbawalla system' that delivers hot, home-cooked lunches to workers in their offices around the city. For reasons of taste and hygiene, most office workers prefer to eat home-cooked food in their workplace rather than eat outside at a food stand or at a local restaurant. The meals might come from central kitchens, work-from-home women or from home itself. It is estimated that the 'dabbawalla system' delivers 250,000 lunches each day using bicycles and the railways.

The Tehran-based Mamanpaz (meaning 'food like mother makes') is an online equivalent of the 'dabbawalla system'. It was founded in 2014 by Tabassom Latifi, an electrical engineer with an MBA who was working for a corporate bank before she started the business. Mamanpaz offers meals cooked by housewives working from home to customers who prefer home-cooked meals to canteen food or takeaways – meals such as 'Lubia Polo cooked by Maman Maryam' which is a combination of rice, green beans, minced meat, tomato and saffron, priced at around £2.

Originally Latifi did everything herself but within a year she had employed four office staff and five motorbike couriers. That has grown to seven office staff and 16 couriers. She posts menus and photos of the meals every day and has a network of some 50 women cooking them. Cooks keep 70% of the price charged. Customers can order meals by SMS, browser or from a dedicated app. Quality control is a challenge and to address this the company undertakes random food testing, hygiene inspections of kitchens and requests texted customer feedback and food-ratings. Mamanpaz has some 60,000 followers on Instagram and supplies around 2,000 orders a day.

Visit the Mamanpaz website via the *Digital Links* booklet. You can also watch a video telling the story of Mamanpaz and explaining how the service works.

Question:

1. List the key operations involved in this business and draw a simple Gantt chart for delivery to customers. How complex is coordination?

SUMMARY

- Management is about the day-to-day handling of complexity, about detail and logic, efficiency and effectiveness. It involves prioritising, deciding on what activities are important rather than just urgent.
- Operations planning is about finding a balance between the demands of customers and operating performance. This often involves trying to smooth out fluctuating demand – making trade-off decisions between the costs of the investment required to cushion the impact of the unstable market on the operations.
- Critical success factors (CSFs) are the things that are essential to get right if the business is to achieve its mission and be successful. They are distilled from key operating activities – activities that are essential if the business is to run efficiently and effectively. Some key marketing and operating activities (and CSFs) need to be completed pre-launch, and some will be ongoing once the business has been launched.
- Key operating activities and CSFs can be derived from the business model but are also specific to a firm. There are some general key activities that relate to specific business sectors. Strategic options are contingency plans should things go wrong.
- The Gantt chart can be used to identify the critical (longest) path for the completion of a project – including the launch of a business – and highlight potential bottlenecks.
- The operations plan highlights the practical things that need to be done to launch a new venture; the key operating activities, CSFs and strategic options if plans change. A summarised, 'high-level' version of the operating plan would normally be included in the business plan, and more detailed plans would cascade down behind this.
- The marketing, operating and financial plans should together produce a series of SMART milestones – objectives that are measurable with time deadlines for meeting them.

GROUP DISCUSSION TOPICS

1. In what sense can a sole trader also be a manager?
2. How can a retail business smooth demand?
3. How can an internet business smooth demand?
4. How can a manufacturing business smooth demand?
5. How can a service business smooth demand?
6. What are the pros and cons of subcontracting?
7. How important are key operating activities for a company following a low-price/cost business model?
8. How important are key operating activities for a company following a niche business model?
9. It has been said that the three most important decisions for a retail business are location, location, location. Discuss.
10. Ignoring the products for sale, what are the characteristics of a retail website that would encourage you to revisit it? What characteristics would cause you not to return? What is the relative importance of these?
11. Why are the imperatives for a service and manufacturing business so similar (Table 12.6)?
12. What types of business are the most complicated to launch: retail, internet, service or manufacturing? How might this complexity be simplified?
13. Why is it important to identify the key operating activities in a business?
14. Why is it important to identify the CSFs in a business?
15. When does a key operating activity become a CSF?
16. Does an operating plan need to be a formal document?

STUDENT ACTIVITY

1. Analyse the key operations involved in producing and delivering to the customer a product that you know well (e.g. a McDonald's meal). Are any activities 'key'? Are any 'critical' for to ensure delivery of the value proposition? (You may want to refer back to Table 8.3.)

START-UP ACTIVITIES

1. List the key operating activities you need to undertake to ensure the success of your venture pre-launch and post-launch. Identify which of these are CSFs. Where appropriate, identify strategic options. List the resource and/or operational implications from the above.
2. Select one key activity from the above and draw up a Gantt chart, identifying the critical path, highlighting any bottlenecks.
3. Draw up a Gantt chart for the launch of the business and identify the critical path, highlighting any bottlenecks.

13 MANAGING RISK

Contents

- Risk and 'unknown-unknowns'
- Generic risk management strategies
- A risk management framework for the known risks
- Identifying risks
- Assessing risks
- Mitigating risks
- Monitoring risks
- Financing risk
- Critical success factors and strategic options
- Cognitive reactions to risk management
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: Getty Images/Blend Images/Pete Saloutos

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand the difference between known and unknown risks and the risk management techniques appropriate to the different situations;
- Use the risk management framework for known risks outlined in this chapter to identify risk, evaluate the probability of it materialising, quantify its impact and find ways to mitigate it;
- Understand how risk might be reduced through partnerships and alliances, financial and legal structures and appropriate approaches to financing the venture;
- Understand the role of critical success factors and strategic options in the process of risk management.

Case insights

13.1 Gordon Ramsay
13.2 Best Fruit
13.3 Food-ATM
13.4 TechHub
13.5 Eurostar
13.6 Flying Tiger Copenhagen (3)
13.7 Covid-19 pandemic

Explore further link

13.1 Compiling a risk register

RISK AND 'UNKNOWN-UNKNOWNS'

It was Donald Rumsfeld, US Secretary of State for Defense, who famously observed in 2002 that there were 'known-unknowns' and 'unknown-unknowns'. This apposite observation underlines two approaches to risk management. The first is the more traditional, quantitative framework where the risks can be identified – the known risks. The probability of the risk materialising and the impact it will have can then be calculated. This approach works best for start-up projects involving incremental innovations where there is information that can be applied to the decision. It is also widely used once a business becomes more established in its product/market and there is more available and reliable information about the product and market. A risk management framework for these 'known-unknowns' is outlined later in this chapter.

The 'unknown-unknowns' are unknown risks – where the risks cannot be identified, such as a natural disaster that has never struck before. When any risk materialises, 'known' or 'unknown', it has the potential to create a crisis if an organisation is not prepared for it and, as we shall see in Chapter 17, coping with a crisis is not easy. Trying to prepare for unknown risks may seem impossible but the emergency services have to do it. They are trained to react to situations as they find them, breaking up their reaction into small, controllable actions and adapting to information as it emerges – not unlike how entrepreneurs make decisions and approach strategy development. Sometimes entrepreneurs developing radical innovations face many 'unknown-unknowns' – whether a new technology will work and whether there will be market demand for the product/service. The likelihood of these risks materialising and the impact they might have can be equally unquantifiable. And yet this is the context in which entrepreneurs thrive – making decisions in uncertain, risky environments often based upon unreliable or incomplete data. While they may be willing to take these decisions, they also seem to invest more certainty in their decisions, which is not always wise.

This entrepreneurial context, where there is very little information to go on (lots of 'unknown-unknowns'), is at the heart of the lean start-up methodologies outlined in Chapter 6. This starts by constructing a minimum viable product (MVP) and then building upon the information gleaned from concept and market testing. It is also at the heart of the concept of 'affordable loss', which sets fixed amounts of money that the entrepreneur can afford to lose at various stages of the concept roll-out, all the time gaining more information and knowledge about the project potential and thereby progressively minimising the risk it faces.

By limiting the financial exposure at various stages of the start-up project, the entrepreneur can limit their risk and exposure to potential bankruptcy. At the same time at each stage they gain more information about the viability of the project – from both inside and outside the business. Once 'unknown-unknowns' become 'known-unknowns' the appropriate approach to decision-making and risk management changes. At some point in this process the risk management framework for 'known-unknowns' (outlined later in this chapter) can then be used. However, even at this stage there may be several risk possibilities – several possible 'known-unknowns'. Each one can generate strategic options and/or critical success factors (CSFs) for the firm. These need to be evaluated systematically, using formal frameworks that ensure the use of both left- and right-brain – reconciling the apparent risk-taking of entrepreneurs with the risk-aversion of most people.

Another approach to dealing with 'unknown-unknowns', commonly used by serial entrepreneurs who have existing businesses to safeguard, is to set up any new, innovative project as a separate legal entity. In this way if it fails the entrepreneur limits their legal financial exposure to the amount invested in that project. It 'compartmentalises' the risks associated with each project. It is probably the only realistic way to approach projects involving truly radical innovation – where the 'unknown-unknowns' are greatest. It is also an approach used by larger firms where a holding company owns or partly owns numerous subsidiaries which are separate legal entities (e.g. Virgin Group).

> *As overwhelming as it might seem, if you have vision and you believe you have a unique product, then go for it. You need to take risks and accept that you will not succeed every time but that's part of the process. When it comes right, it's an amazing journey.*
>
> Wayne Edy, founder of Inov-8, *The Sunday Times*, 15 March 2015

> *We expanded very slowly and very carefully because in our other jobs we had some experience studying other industries ... We basically put into it what we could afford and we were prepared that if it didn't work out we weren't going to be on the streets.*
>
> Lyn Lee, founder of Awfully Chocolate, *BBC News Business*, 8 November 2010

GENERIC RISK MANAGEMENT STRATEGIES

There are numerous generic strategies that can be used to manage and mitigate risks whether known or unknown.

Case insight 13.1 Gordon Ramsay

Business models and risk

Gordon Ramsay is a famous TV chef with hit shows in the UK and USA such as *Hell's Kitchen, Kitchen Nightmares* and *Hotel Hell*. But that did not stop his business, Gordon Ramsay Holdings, from nearly failing in 2010/11 because he adopted the wrong business model and the wrong business partner. Most celebrity chefs license a partner such as a restaurant chain to use their name. They lend their name, create menus, hire key staff and undertake some promotion. In return, the chef receives a fee plus a percentage of turnover. However, the model Ramsay used was to set up and operate all the restaurants around the world himself and pay rent to the restaurant chain – potentially more lucrative but also more risky. This meant his capital costs and therefore borrowing was very high, and when the recession of 2008 hit, his fixed interest costs could not be met by his operating profits. What is more, often Ramsay committed to spend time at these restaurants – time that he did not have because of his TV appearances.

The result was a loss of £4.1 million in 2011, which meant that the company breached its loan agreements. Ramsay also fell out spectacularly with his father-in-law, Chris Hutchinson, who used to run the firm, accusing him publicly of siphoning off £1.4 million of company funds to support a secret family. After an acrimonious court battle, Ramsay bought his 30% stake in the firm, costing the firm some £5 million. Ramsay had then to inject £2.5 million of his own money into the company to prevent it from going into bankruptcy.

Ramsay set up a new company, Gordon Ramsay Group, and found a new partner, Stuart Gillies, who took 10% of the company. Many of the restaurants around the world were closed and debt was repaid. Some restaurants were even 'un-branded' as 'Gordon Ramsay' restaurants. The business model was also changed to one that is more conventional and lower risk. The Group no longer put up capital. They take a fee for Ramsay's name and between 6 and 8% of turnover. Ramsay takes no salary from the group but his media earnings, which exceed £15 million a year, go through a separate company. Ramsay spends most of his time working on TV and books that create the brand that pulls customers into his restaurants.

At present the Group's restaurants are concentrated in London: Restaurant Gordon Ramsay, the three Michelin-starred fine-dining flagship in Chelsea, and Petrus in Belgravia and at the more modest end of the scale Bread Street Kitchen, Heddon Street Kitchen, Union Street Café and Street Pizza. Profits of the new Gordon Ramsay Group were over £15 million in 2019 (on sales of over £54 million) and the Group is looking to expand once the coronavirus pandemic subsides both in the UK and overseas.

Access the *Digital Links* booklet to visit the company website and to watch a video which will introduce you to Restaurant Gordon Ramsay.

Question:

1. What lessons do you learn from Gordon Ramsay's experience?

Partnering and other forms of alliance

As we saw in Chapter 11, partnerships, strategic alliances, joint ventures and franchising, like any form of networking, can provide knowledge and information about the risks facing a business. Unknown risks might become known, or at least better understood. They might also offer opportunities to share the risk (and the reward) with the partner. More widely, the entrepreneur's network of contacts can be a rich source of information about both the risks and opportunities facing the firm.

Keeping fixed costs low and profit margins high

As we noted in Chapter 6, start-ups with low fixed costs and high contribution margins are the most attractive commercial propositions. Fixed costs, like property leases, taxes and interest payments, always need to be paid, so high fixed costs increase risk. Keeping fixed costs as low as possible reduces risk. But if the business has high profit margins it is more likely to be profitable. Combine the two into the financial structure of the business – low fixed costs and high profit margins – and the risk is lowered. In reality there is a tension between high margins and low fixed costs. Firms with high margins are often associated with high fixed costs. For example, their high differential advantage may come from a high investment in technology or marketing. At the same time, firms competing primarily on price may be keeping their costs low through economies of scale, which are normally associated with investment in fixed assets such as plant and machinery. Because of this tension, the important thing is not in the absolute level of contribution margin and fixed costs but the

relationship between them. This is measured by the breakeven point. We look at this and the relationship between cost and profit in Chapter 15.

Generating strategic options

Generating strategic options is about contingency planning. It is about creating as many options for future courses of action as possible. It is about maintaining as much flexibility as possible for as long as possible so as to better deal with an uncertain and rapidly changing commercial environment. Many of these strategic options will come out of a review of known risks. The more strategic options available, the more likely that a business will be able to deal with the event should it materialise. We will look at strategic options again later in this chapter.

> *The ideal business has no fixed overheads, commission only sales, large volume and low overheads.*
>
> David Speakman, founder of Travel Counsellors, *The Sunday Times*, 6 December 1998

Case insight 13.2 Best Fruit

Turning unexpected problems into opportunities

When coronavirus struck in March 2020 Best Fruit was a small market stall in Milton Keynes (UK) selling fruit and vegetables and supplying some local pubs and restaurants. Business tailed off in the market as the pandemic took hold but it completely stopped when the government imposed a lockdown on movement on 23 March. This was never a risk that had been anticipated or planned for. The stall-holders were left with no income, stocks of unsold fruit and vegetables as well as contracted future produce deliveries. However, they responded in true entrepreneurial style.

With most shops closed and long queues and empty shelves appearing at supermarkets people quickly looked for fresh produce. It started in a small way as local residents started contacting the firm by phone to see if it had fruit and vegetables to sell. Best Fruit quickly organised ad hoc deliveries (minimum order £20), often based around local pubs it supplied. Word spread quickly around these local communities using the internet and social media. Customers needed the home delivery service, liked the quality of the produce and wanted to support a local 30-year-old business that might otherwise have disappeared. Daily produce deliveries to Best Fruit could be delivered to customers in 24 hours. Demand exploded reaching over 150 deliveries per day in just over a week. By now orders were being placed by email. There were many organisational problems in these early days since the firm was just not geared up for small-order home deliveries – not helped by its delivery van breaking down. Customers were understanding and a hastily opened Facebook page kept them in touch with daily fresh produce deliveries as well as the problems facing the firm. However, within a couple of weeks the firm had its own website on which produce could be ordered. As a market stall it had dealt in cash and its pub/restaurant clients paid using bankers' drafts, so it also needed to open a credit/debit card merchant account. Best Fruit bought a mobile unit that allowed customers to pay for deliveries on the doorstep. Within a couple of weeks of a pandemic that closed down many retail traders, Best Fruit turned an unplanned risk into a commercial opportunity. When Covid restrictions eased in May 2021 Best Fruit reopened its market stall and started supplying pubs and restaurants again–while maintaining their home delivery service.



Source: Diogo Nunes on Unsplash

Access the *Digital Links* booklet to visit the business website and Facebook page.

Questions:

1. Is this new market for Best Fruit sustainable after the coronavirus crisis? Explain.
2. What additional skills and capabilities might the firm need to sustain this?
3. Will it need to change its business model in any way?
4. After the coronavirus crisis should the firm continue with its market stall and local pub/restaurant deliveries? Are there any tensions between these three market segments?

A RISK MANAGEMENT FRAMEWORK FOR KNOWN RISKS

You cannot start a new venture without taking risks and risk often goes hand in hand with return. The higher the returns a business offers, the higher the risks that it is likely to face. By launching a business the entrepreneur is inherently making a judgement – explicitly or implicitly – that they can overcome any risks that they might face. However, all too often they fail to even attempt to identify them, never mind attempting to put together contingency plans or strategic options should they materialise. There are many 'known' risks. Although we may not know precisely where they will strike, earthquakes are a 'known' risk often associated with particular regions, and buildings can be strengthened accordingly. Even the coronavirus pandemic of 2020/21 was a 'known' risk (see Case insight 13.7).

> *It's easy to take a risk when it's just a couple of founders working from a garage; risk taking is part of a start-up's DNA. When your business grows, you still need to take risks, except there's a lot more at stake.*
>
> Adam Schwab, founder, Aussie Commerce Group, *The Sydney Morning Herald*, 28 April 2014

If the risks facing a business can be identified, contingency plans can then be generated to deal with them and options about changes in strategic direction developed (Chapter 17). Any potential financier reading a business plan will expect potential risks to be identified, contingencies planned for and strategic options considered. So, just as financiers will evaluate financial projections (and the likelihood of achieving them) they will also evaluate the risks facing the business and its ability to deal with them. Risk is inherent in business. While it cannot be avoided, with knowledge and information, it can be managed. This might involve putting in place appropriate controls or at least monitoring early warning of potential problems materialising. If risks can be avoided, then less time is spent 'fire-fighting' when they materialise.

Risk management for known risks is a four-stage process:

1. Identify the risks that might be faced.
2. Assess the likelihood, impact and controllability of those risks.
3. Decide on how the risks can be mitigated (reduced or avoided).
4. Deciding what early warning signs need to be monitored to identify when the risks start materialising.

IDENTIFYING RISKS

The first step is to identify what the risks might be. Risks can relate to a specific project (called 'project risk') or for the business as a whole (called 'corporate risk'). For most start-ups these are the same – if the project fails so too will the business. But once the business is established then they need to be considered separately. Risk can take a number of forms. The corporate risks an organisation faces may come from:

- **External incidents** (e.g. flood, fire, pandemic illness etc.): These can be difficult to predict and the probability of occurrence might be low. However, the possible impact might be so great – for example loss of life – such that contingency plans are needed to deal with them. Some of these risks will be generic risk to an industry, for example, the reaction of competitors.
- **Internal incidents** (e.g. loss of sources of supply, malfunction of a major machine, product contamination etc.): These can be many and varied, depending on the operations of the business. A good place to start looking for possibilities is in the key operating activities of the business.

Simply brainstorming the risks faced is one approach but another that can be useful is scenario planning (Chapter 4). Based on the threats an organisation faces, scenarios can be explored about the results of these threats materialising. Table 13.1 provides a checklist of possible risks facing a start-up. It is unlikely to be comprehensive and is in no particular order of priority. However, no matter how thorough the analysis, it will probably be impossible to identify every possible risk. The only two certain things in life are death and taxes, and some multinationals are working to reduce the latter.

If we are looking at a technology-based start-up we might say there are four key risks:

- Technology risk – Will it work?
- Market risk – Will anybody buy it (if it works)?

Table 13.1 Risks checklist

RISKS CHECKLIST	
* IP – is it secure?	* Productivity – are targets being met?
* Pre-launch delays – are any of the pre-launch key activities likely to cause delays?	* Administration – are processes and procedures working well?
* Competitors – what are they doing and are you monitoring them?	* Brand identity – is it being established?
* Competitive advantage – is it being eroded and what is your reaction?	* Technology – how are changes affecting you?
* Market – how is it changing and can you spread risk across different markets?	* Investment – does business need more and what do you need to do to secure it?
* Customer value proposition – is it being monitored and delivered?	* Stocks/inventory – are they adequate or too much?
* Product/service quality – is it adequate?	* Merchandising – is it under control?
* Customer service – are they satisfied?	* Debtors/receivable – are they under control?
* Cash flow – is it adequate and can you secure further funding if needed?	* Interest rates – how will changes affect the business and can you secure against changes?
* Sales – are targets being met?	* Exchange rates – how will changes affect the business and can you secure against changes?
* Profits – are targets being met?	* Management – is the team in place and managing well?
* Operations – are key activities under control?	

» Financing risk – Will anybody finance it until it generates a positive cash flow?

» Business risk – Is there a management team able to operationalise the business model and make this into a sustainable business?

ASSESSING RISKS

Identifying risks is only the start of the process of risk management, because not all risks are the same. Equally important is trying to assess the probability and impact of the risk materialising. If the probability is very low, is there any point in preparing contingency plans? The answer may be 'yes' – if the impact on the business was large. Risk management is about prioritisation. Ideally the risks with the highest probability of occurrence and the greatest loss to the organisation are handled first and those with the lowest probability of occurrence and the smallest loss are dealt with last. However, superimposed on this is the issue of whether the risks are controllable or not – whether they can be mitigated or reduced in some way. Generally, the less the risk can be controlled or influenced, the greater the danger it poses.

Figure 13.1 shows how project or business risks can be classified in these three dimensions to form a risk matrix. This is a three-dimensional Rubik's cube measuring risk probability, impact and controllability. The first two dimensions are probability and impact. Any risks that have a major impact on the business are undesirable, but those which are very likely to happen pose the greatest risk (quadrant I). By way of contrast, risks with a low impact and a low likelihood of occurrence (quadrant A) pose the least threat. The third dimension is controllability. It may be possible to control or influence some risks; others might be completely out of the firm's control. Therefore the risks posing the greatest danger are those in quadrant Q – highest impact, highest probability but least controllability. These risks cannot be mitigated but must be closely monitored. The risks that have the highest probability of occurrence and have a major impact on the firm but can be controlled (quadrant I) will be the focus of action to mitigate and reduce them.

> *Mapping the risks and opportunities for your business early on can make all the difference.*
>
> Richard Branson, founder of Virgin Group, *The Guardian Media Planet*, May 2015

Case insight 13.3 Food-ATM

Identifying operational risks

Ayesha Khan was a cooking enthusiast who worked for the government of UAE as an IT professional. When she tried out new recipes she would often bring them to her office and let the cleaners and other support staff try them. Realising how much they appreciated this and how much they saved from their salaries by not spending on meals she decided to do this on a more regular basis. This continued for some ten years at which point she decided that she would set up a food centre for the needy on a more permanent basis. She contacted her local authority who explained that she would need to have premises where the food was prepared and cooked, packed and distributed that met food hygiene regulations and could be could be inspected regularly. To raise funds she sold off her house in India and, in 2019, Food-ATM was launched.

Food-ATM already has a number of corporate clients, and provides three meals a day to blue-collar workers employed in Dubai, Sharjah and Ajman. For this it charges these organisations a minimum amount of AED15 (about £3) per person. Most organisations do not charge employees for the meals, seeing it as part of their social responsibilities, while others see it as saving money. Food-ATM also distributes some 100 free meals to labour camps and construction sites in the area and has received an award for social responsibilities from the Ajman Chamber of Commerce.

This daily process can be complicated as the company has to deal with some 700 food parcels each day. Menus need to be planned in advance so that ingredients can be bought in – some ingredients are fresh and others can be stored for longer periods. Cooking and packing takes time and deliveries need to be coordinated. Quality and hygiene standards need to be maintained. Food-ATM is contracted to ensure that each worker receives their food parcel. In order to do this each worker is issued with a smartcard which is loaded with meal counts (topped up at the beginning of every month) which are swiped using a conventional card reader machine at each meal dispensing.

The company intends to go further and provide hot meals by 2021. To enable it to do this it has ordered 12 hot-food vending machines from a company in India. Each machine costs AED 37,500 (about £7,500) and will be installed at various client locations in 2020. The machines will replace conventional card readers and the process should be more cost-effective as it will reduce time spent in food distribution and manual card swiping.

Khan understands that food preparation and distribution are time-critical processes, and delivering freshly cooked meals three times a day to many people at different locations can become a nightmare. The whole process of buying ingredients, cooking, packing and delivering requires careful planning. The correct sequencing of activities is critical and disruption in any one part might endanger the timing of the food delivery. The operation is currently running successfully at a smaller level, but Khan plans to expand to other cities in the UAE and this will create additional pressures.

'Now, our mission is to serve more people with daily free meals to support their families and provide education to their children. Food-ATM is not only a business for me but also an integral part of my life that I always want to live until I exist.'

Access the *Digital Links* booklet to visit the business website and to watch videos telling the Food-ATM story and showing how it operates.

Questions:

1. List the key operations involved once the hot-food machines are installed and draw a simple Gantt chart for delivery of food to the machines. How complex is coordination?
2. What are the operational risks facing the business and what are the critical success factors?
3. What other factors will determine the success of this venture?

This case was contributed by Dr Tahseen Arshi, American University of Ras Al Khaimah, UAE.

In reality it is often very difficult to quantify the probability of a risk materialising beyond the simple low (A = 1), medium (B = 2) or high (C = 3) shown in Figure 13.1. The monetary impact of the risk materialising might be just as difficult to establish beyond a similar low (A = 1), medium (D = 2) or high (G = 3). The composite risk factor is defined as the probability of occurrence multiplied by the impact of the risk event. Using the simple classifications above, the highest composite risk factor is therefore 9 in quadrant I (3 × 3), the lowest is 1 in quadrant A (1 × 1). This 1–9 scale can then be reclassified as low (1–3), medium (4–6) and high (7–9). This low/medium/high classification is called a risk index. The higher the index number, the greater the impact and the probability of the risk happening.

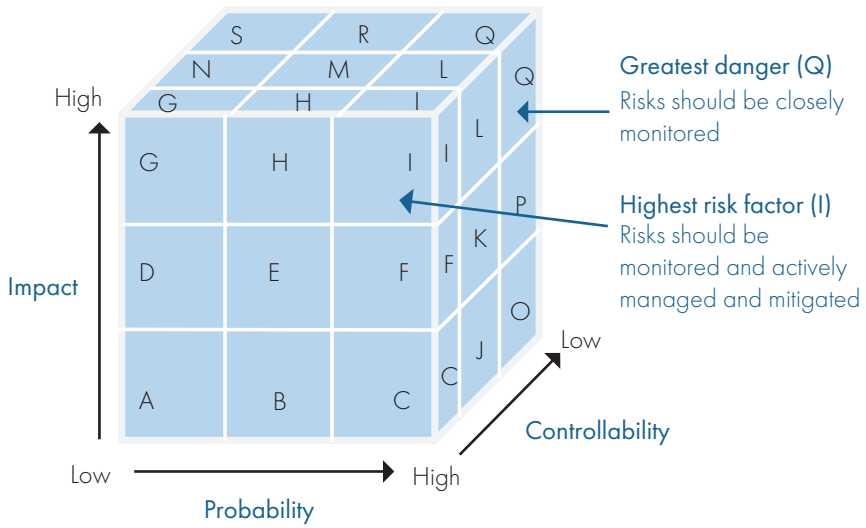


Figure 13.1 Risk classification

The dimension of controllability can be added by reversing the simple 1–3 scale (1 = high, 3 = low controllability) e.g. A = 1, O = 3. A danger factor can be calculated by multiplying the risk factor (1–9) by the controllability factor (1–3). The lowest danger factor is 1 in quadrant A (1 × 1 × 1). The highest is 27 in quadrant Q (3 × 3 × 3); high impact, high probability and low controllability. This can be reduced to a danger index by reclassifying the danger as low (1–9), medium (10–18) and high 19–27).

Let us consider the situation faced by a start-up with a high level of borrowing (called 'gearing'). The identified risk is an increase in interest rates. The probability of this depends on the general economic conditions at any time. This is out of the control of any individual business. The impact of an interest rate increase depends on the level of interest payments (a fixed cost) compared to profit. This is called 'interest cover', a term explained in Chapter 15. High interest payments (compared to profit) could easily become a quadrant S risk in Figure 13.1. If turnover goes down, profit is reduced but interest payments remain fixed. Indeed, sometimes interest rates, and therefore interest payments, can go up when turnover, and therefore profit, are already reducing because of macro-economic factors. This is the classic situation that is created when interest rates are increased by government so as to reduce overall demand in the economy. The result is that small firms are squeezed by facing both higher interest costs and reducing sales or turnover.

Sometimes firms just do not identify all the risks they face (how many firms identified a coronavirus pandemic), despite the fact they might have a high impact. One of the key strengths of SMEs generally is their flexibility and their ability to switch strategies or business models quickly. This is called 'pivoting' and is discussed in Chapter 17.

> *We take risks – but they're always calculated.*
>
> Emma Elston, founder of UK Container Maintenance, *The Sunday Times*, 29 June 2014

MITIGATING RISKS

Once a risk index is established (for projects or for the business as a whole), decisions can be made about how to manage and mitigate those risks, depending on their likelihood of occurrence, impact and controllability. There are four options:

1. Attempt to eliminate the risk – An entrepreneur might decide to withdraw completely from the area of activity that generates the risk – an unlikely course of action initially for an entrepreneur. However, they need to at least continue to monitor the risks because at some point in the future they might change this decision.

2. Attempt to reduce the risk – An entrepreneur might attempt to reduce the risk by selecting lower risk strategic alternatives within a business model, for example by using different distribution channels or partnering with others. They might also reduce risks by increasing internal controls, staff training or supervision, depending on the nature of the risk. Understanding the nature of the risk and putting in place the effective risk management processes outlined in this chapter will go a long way towards this.
3. Transfer and/or sharing the risk – There are many useful techniques that can be used to transfer both internal and external risks such as insurance, foreign exchange or interest rate hedging. For example, companies constantly 'insure' against currency fluctuations – a risk they neither control nor influence – by buying forward in the currency market. As we have observed, partnering in all its forms (e.g. subcontracting, outsourcing, franchising etc.) is an extremely effective way of transferring risk. For example, when developing a new product/service the firm might spread its risk by finding a strategic partner or forming a strategic alliance. This can help a company avoid over commitment to any one project and can bring it new skills and capabilities. The Virgin Group operate in this way with a holding company that owns, or partly owns, over 300 subsidiaries, each one set up in partnership with another company with different skills and capabilities.
4. Accept the risk – The entrepreneur might simply decide to accept a risk (e.g. because it falls into quadrant A). If they accept a risk completely, they still need to manage it and put in place early-

Case insight 13.4 TechHub

Risk assessment

TechHub is a commercial accelerator/incubator for technology start-ups (see Chapter 6). It was founded in 2010 by Elizabeth Varley and Mike Butcher and offers many of the benefits associated with these incubators without seeking to take equity in the start-up. Instead it offers supported workspaces paid for by rents based on leases as short as three months. This proved very popular. Its first workspace was based in London's 'Silicon Roundabout' (in Shoreditch), where it became the heart of the UK's start-up ecosystem and home to hundreds of start-ups, producing a string of innovative companies such as DeepMind, Monzo and Deliveroo. It subsequently opened workspaces around the world, many in partnership with Google, and supported some 750 start-ups with members raising over $1 billion in venture funding. In 2020 the London-based company went into administration.

The reason for TechHub's success is the same as the reason for its failure – its business model. While a short lease was attractive to start-ups, TechHub London itself was locked into a lease running up to 2024, with regular monthly payments. The lockdown which resulted from the 2020/21 coronavirus pandemic caused three-quarters of TechHub's income to disappear overnight as members were prevented from using the space. The landlord, Intercontinental Exchange, refused a restructuring plan and as a result the founders put the company into administration. However, even before this there were growing problems. TechHub's attractiveness to start-ups had originally been based partly on the cheap leases it was able to offer because of its location. However, over the ten years of its existence property prices and leases in that area had risen by a factor of ten, causing start-ups to look further east for cheaper leases. Despite the wealth created around it, TechHub itself never became a big business. TechHub in London may still emerge as a going concern – that is in the hands of the administrators – but there are other TechHubs in Riga (Latvia), Bucharest (Rumania) and Swansea (Wales). These will not be affected by the London office going into administration as they are owned independently.

Access the *Digital Links* booklet to visit the company's Swansea website and to watch a video showing what TechHub in Shoreditch (East London) had to offer.

Questions:

1. Could this risk have been identified? If so, how might it have been mitigated?
2. Is there a future for TechHub, Shoreditch? Explain.
3. How important is low cost/price to TechHub's business model compared to the other benefits of an accelerator/incubator for a start-up? What does this tell you about the location of these units and how they are structured?

warning indicators of it materialising – although this might be uneconomic if the impact on the firm is low. Many industries have inherent risks that need to be accepted if the entrepreneur decides to operate in that sector.

Options 1 to 3 are most appropriate for those risks that pose the greatest danger (quadrant Q in Figure 13.1); high impact, high probability and low controllability. If the entrepreneur decides to accept a high-danger risk it is vital that they monitor it so they can take corrective action if it materialises. This is probably the situation they will face with competitors if their business idea is really successful, so they need to have contingency plans and strategic options readily available.

> *If there are some obvious risks to your business model from the start, put in place some strategies to mitigate them.*
>
> Richard Branson, founder of Virgin Group, The Guardian Media Planet, May 2015

MONITORING RISKS

All organisations have to accept some residual risk associated with their operations. However, they still need to monitor those risks, particularly those that are least controllable. They need to identify parameters or events that indicate an increased likelihood of the risk materialising – called key risk indicators. And this is where the information gathered by networking with customers, suppliers and other professionals is of vital importance. This can give it foreknowledge of risks materialising. These need to be monitored on a regular basis so that remedial action based on contingency plans can be taken.

To be effective, key risk indicators must be easy to monitor as part of the firm's regular activity, highlighting when corrective action is needed and providing guidance on what action is needed. Cash flow is an obvious example of a potential key risk indicator. The risk is bankruptcy – a firm needs cash to pay its bills – and cash flow measures its ability to do this. Inadequate cash flow is a major cause of failure in start-ups. Cash flow therefore needs to be monitored on a regular and frequent basis. We show how this can be done in Chapter 15. If the reaction of competitors is a major risk to a firm, it needs to develop a risk indicator that will measure this and put in place activities to ensure that it is monitored. For example, supermarkets regularly and routinely monitor the prices competitors charge for a typical basket of products. Without doing this they risk being uncompetitive and losing customers to rivals.

The marketing and operations plan should be interlinked and consistent – linked to plans to identify, assess, mitigate and monitor associated risks. For example, if the generic business model adopted by a firm involves low price, it is likely that the operational imperatives involve ensuring low costs. This means that the operations plan must somehow ensure this is the case. If this involves sourcing materials from a distance with geographically long supply lines then one of the risks is that these supply lines might be disrupted – whether through controllable or uncontrollable factors. This can be a risk facing both retail and manufacturing businesses. As was seen during the coronavirus pandemic of 2020/21 this can have disastrous consequences for firms, causing many to close, albeit temporarily. As we saw in the last chapter, the risk associated with long supply lines can be mitigated by holding buffer stocks, although this involves additional costs. In some cases the risks involved in having long supply lines may be judged too high to follow this operating strategy. After the pandemic, firms tried to make their supply lines more resilient to this sort of disruption.

Explore further 13.1

Compiling a risk register

Access the *Digital Links* booklet to watch a video explaining how to compile a risk register.

Case insight 13.5 Eurostar

Risk management

By necessity the operations of a railway will be bureaucratic and you would be correct to think that they take risk management very seriously. Eurostar is high-speed rail services that run between England and France under the English Channel. It has identified the risks it faces and has a business continuity plan for use when disruption occurs. Every Eurostar department has helped establish the risk register. Examples of risks on the register range from losing the main offices because of fire to bomb scares, train derailment, computer systems failure and even financial catastrophe. Using the techniques outlined in the text, Eurostar has developed a risk matrix showing the impact of a risk and its likelihood of occurrence that allows it to calculate a composite risk factor and consider what actions might mitigate those risks with a high impact. For example, Eurostar has a telephone contact centre at Ashford in England that handles sales, ticketing and customer service. In the event of a serious fire, the company would lose much of its booking capacity with a resulting impact on revenue and reputation. Risk is mitigated through fire alarms, trip switches on electrical circuits, fire procedures and, ultimately, back-up locations that can be activated so that operations can be continued if the fire happens despite the other mitigations. The company has even carried out exercises using different locations in its own offices to simulate these actions. Eurostar rescores the composite risk factor after considering the mitigations that have been implemented until an acceptable level is reached. It revisits the risk matrix every six months just to check that the risks have not changed and that the mitigating activities are working as planned.

Eurostar has a business continuity department, but implementing the continuity plan is firmly the responsibility of line management. Every line department has a business continuity champion. They are responsible for: assessing business impact, assessing the risk of the events, identifying who is responsible for ensuring that mitigating actions are carried out, considering what further mitigations might be possible, coordinating business continuity within the department, investigating failures and departmental risk training. Eurostar has a full training programme of exercises that simulate various 'disasters'. These might involve simple round-table discussions or practical simulations. For example, it has carried out major evacuation exercises in the Channel Tunnel with Eurotunnel and the emergency services and is constructing its own tunnel evacuation training simulator.



Source: Pharaoh_EZYPT from Pixabay

Questions:

1. What are the business risks to Eurostar to not having a comprehensive risk management system?
2. Using the format shown below (see Figure 13.1), list the major risks that you think Eurostar faces and, on a scale of 1 (low) to 3 (high), estimate the impact that risk materialising might have on the business and the probability of it happening. Calculate the risk index. Evaluate the controllability of these risks, reversing the scale of 1 (high controllability) to 3 (low) and calculate the danger index. What do the results tell you and what might you do with this information?

Risk	Impact (1–3)	Probability (1–3)	Risk index (1–9)	Controllability (1–3, reversed)	Danger index
1.					
2.					
3.					
4.					
5.					

FINANCING RISK

Any start-up faces both commercial risk – arising from the nature of the project and the commercial environment it operates in – and financing risk – arising from how it is financed. Using external funds of any sort brings new risks and constraints. Entrepreneurs tend to keep the use of external funds – both loans and equity – to a minimum. This may be because of their inability to borrow or unwillingness to give up control. They may alter their business model so as to minimise the need for external funding.

One way of minimising the use of external finance and avoiding risk is by using other people's resources as much as possible – called 'bootstrapping'. You do not have to own a resource to be able to use it. This is true for human assets as well as physical assets, particularly if the entrepreneur has understanding friends, family and/or a wide network of contacts. Entrepreneurs also tend to keep capital investment and fixed costs as low as possible, sometimes renting or leasing assets rather than purchasing them, often subcontracting some activities. They might hire temporary, rather than part- or full-time, staff. Entrepreneurs prefer to commit costs to a project only after the opportunity has proved to be commercially viable – part of the approach called affordable loss mentioned earlier.

Nevertheless, if the opportunity proves to be commercially viable they may then have to find external funds to finance the project and at some stage an entrepreneur will need to borrow money and borrowed money means that interest will have to be paid – whether the business is making profit or not. The higher the borrowings in a business, the higher the interest payments it must make. This is a fixed cost, payable whether the project is generating income or not and therefore increases the breakeven and risk of the business (Chapter 15), although the actual rate of interest may vary as part of the loan agreement. And if the business should fail, it may be that the entrepreneur will have to repay the borrowings from their own personal funds. Therefore if a business can minimise its commitment of resources for as long as possible, it also minimises its funding requirement and the risky fixed costs involved in borrowing. Lenders are usually unwilling to lend for the development of more innovative longer term projects, where the return is uncertain and does not materialise until some way in the future, and sometimes entrepreneurs must turn to equity finance. While this is less risky for the business (dividends are only paid when the firm makes them available), the entrepreneur must surrender ownership and control of their business. We will look at funding options in Chapter 19.

CRITICAL SUCCESS FACTORS AND STRATEGIC OPTIONS

The risk management framework outlined here can be applied to any key operating activities with procedures incorporated or put alongside them to monitor and mitigate the risks. Critical success factors (CSFs) should be the key activities needed to address the risks falling into quadrants I and Q in Figure 13.1 – high risk and greatest danger. If they are controllable, action plans need to be prepared, such as what actions are required, who is responsible for undertaking them and establishing timelines for their completion. Strategic options – the options available if these critical factors do not go according to plan – also need to be prepared. Creating strategic options is about contingency planning. The more strategic options available, the lower the impact of the risks should they materialise. Having options improves strategic flexibility and speed of response, should strategic pivoting be necessary. This is particularly the case for CSFs over which the entrepreneur has little or no control, for example with competitive reaction. Preparing scenarios of 'worst-possible' cases in advance of them happening allows an entrepreneur to prepare contingency plans and strategic options rather than trying to react after the event. It is about creating as many options for future courses of action as possible so as to better deal with an uncertain and rapidly changing commercial environment.

This risk management framework can be used to highlight the downside risks facing both launch and growth strategies for a business. However, it can also be turned on its head and used to assess upside opportunities (Chapter 4) and strategic options (Chapters 6 and 16). Using this opportunity framework, you are seeking to identify those with the *highest* impact (profit), *highest* probability (of success) and *highest* controllability. In this business opportunity framework quadrant I in Figure 13.1 becomes the most attractive, controllable opportunity. Once more, action plans need to be prepared, CSFs identified and strategic options developed. The Gantt chart technique, outlined in the previous chapter, can help with detailed planning. The whole process is a continuous one that involves 'strategising' – the process

Case insight 13.6 Flying Tiger Copenhagen (3)

Developing an operating model and identifying risks



We looked at Flying Tiger's business model in Case insight 9.5 and its growth and expansion model in Case insight 11.4. The company's ambitious growth targets are facilitated by its investment in what it calls its 'scalable corporate backbone', which aims to simplify operation and support future rapid growth. The operations model for the business units is anchored in a centralised, proactive management team that monitors and reviews the operational and financial performance of operating units. The team aim to take advantage of local or seasonal marketing opportunities and address problems which show up through under performance. Flying Tiger is investing substantial sums in a common IT system (using a Microsoft Dynamics AX ERP platform) so as to streamline its business processes and ensure a greater level of standardisation. Not only does this increase efficiency but it also makes it easier to scale-up operations quickly.

Because it operates a low-cost business model, it is important for Flying Tiger that costs are kept as low as possible. That means it needs to have efficient supply chain operations and processes. Most Flying Tiger products are produced by external suppliers. Flying Tiger aims to minimise lead times from purchase to sale by making the sales forecasting process as efficient as possible. This minimises working capital requirements as well as freeing up capital for further store expansion and future partner buy-outs. Suppliers agree to Flying Tiger's code of conduct and often, because Flying Tiger has a hand in the design of many of the products, work under the company's supervision. Most logistics is subcontracted to external operators, minimising the investment in assets and making it easier to scale-up operations quickly. Warehousing was reorganised in 2015 to reduce lead times to stores, minimise transportation costs and increase capacity. While the company has its own warehouse in Greve (Denmark), the warehouses in Barcelona (Spain), Raunds (UK) and New Jersey (USA) are all operated by external partners. Transport is provided by freight forwarders.

Flying Tiger has highlighted nine areas of risk that it monitors and put in place mitigation policies for:

1. Financial risk – mainly foreign exchange and interest rate. This is mitigated by hedging foreign currency risk for 80% of expected procurement for 12 months ahead, on a half-yearly basis. It also hedges its exposure to interest rate fluctuations by maintaining a mix between fixed and floating rate borrowings.
2. Liquidity risk – which is mitigated by monitoring its cash flow.
3. Competition risk – which is mitigated by investment in the business model. Initiatives include continued strengthening of creative capabilities within category management, product design and innovation, visual merchandising, marketing and branding as well as training of the store staff.
4. Expansion risk – mainly performance issues in local markets. This is monitored by business reviews and controls which aim to identify and then proactively address any potential disruptions in local markets.
5. Sourcing and supply chain risk – which is monitored on an ongoing basis. This is mitigated by the company's investment policy which aims to strengthen sourcing and supply chain systems, processes and capabilities so as to minimise disruption in supplies. Suppliers must adhere to the company's code of conduct and the company has a supplier audit programme.
6. Products, trademarks and legal risk – which are mitigated by having dedicated teams who focus on legal and compliance matters across the different legal jurisdictions the company operates in.
7. Partner collaboration and buy-out risk – which is mitigated by the partner business model which entails a 'put' or a 'call' notice of one year. This allows the company to develop a detailed plan to transfer ownership and operations of the stores alongside the partner.
8. Infrastructure risk – mainly implementation of the company's new IT systems. This is mitigated by the strengthening of the company's project organisation and project management capabilities, which is now monitored by the Executive Management.

9. People risk – which is about attracting, motivating and retaining qualified employees. This is mitigated through the work of Flying Tiger's HR function, which supports the local operating companies and has rolled out various recruitment and training initiatives, including a recruitment kit designed to assist in local recruitment.

Questions:

1. What do you think of Flying Tiger's analysis of the risk it faces?
2. Update Tiger's business model from Case insight 11.4 with the information in this case.
3. What might be Flying Tiger's strategic options.
4. Are the risks faced by Flying Tiger partners the same as those faced by the company?

outlined in Chapter 3 that involves the continuous development of strategy by assessing strategic options about how to make the most of opportunities or avoid risks as they arise.

The success of a start-up will depend on its ability to manage and mitigate both the commercialisation and more general business risks it faces – both pre- and post-launch. The key risks a business faces should be highlighted in its business model and business plan alongside CSFs and strategic options. These should be underpinned by detailed action plans. Successfully dealing with these CSFs are key milestones for a business. They are things to be celebrated when they are dealt with.

COGNITIVE REACTIONS TO RISK MANAGEMENT

We observed in Chapter 3 that most people do not approach complex decision-making logically by analysing all the options and can easily be influenced by many things that introduce bias into their final decision (Kahneman, 2012). The mind deals primarily with 'know-knowns' and rarely considers 'known-unknowns', let alone 'unknown-unknowns' - creating an illusion of control. Entrepreneurs, in particular, often base their decisions upon cognitive heuristics and past experience, which can be just as liable to bias as anything else. What is more, entrepreneurs seem averse to formal planning anyway (Sarasvathy, 2001). Entrepreneurs are unlikely, therefore, to be inclined to approach the management of risk in the systematic way outlined in this chapter. Nevertheless, they do seem to invest more certainty in their decisions than most people, whether or not the risks have been analysed. Realistically many entrepreneurs will need strong encouragement to undertake this analysis and that might only come from another stakeholder such as the provider of finance.

There is a further significant danger. Chapter 3 also highlighted another important conclusion arising out of Kahneman's work: that most people are risk-seeking for losses – they prefer to gamble and avoid the certainty of loss. This means that people are generally willing to gamble when it comes to dealing with downside risks – even when that risk is significant and the impact severe. We also observed how, if a known risk does not materialise even if there were 'near-misses', most people are strengthened in their belief that it is unlikely to do so again. It is almost as if we are willing to gamble with disaster and are unwilling to allow our brains to contemplate high-impact risks. Ord (2020) observed that: 'Even when experts estimate a significant probability for an unprecedented event we have great difficulty believing it until we see it.' The obvious example is climate change, which the vast majority of scientists believe is happening through manmade actions and could have catastrophic effects across the globe, but actions to mitigate the risk are proving difficult to implement. Since the typical entrepreneurial character is more inclined to take risks, it is reasonable to assume that this tendency to gamble when it comes to dealing with downside risks is amplified for them. Their extensive use of cognitive heuristics may amplify this further.

What all this means for the entrepreneurial firm is that, even if the risk management framework outlined in this chapter is implemented, people, and the entrepreneur in particular, will have a tendency to ignore it or not take it seriously so that monitoring and mitigating plans are not actioned. What is often needed to galvanise change in the minds of people is some form of crisis. Even then, as we shall see in Chapter 17, implementing change can be slow and ponderous and requires strong leadership. But if we always wait for the crisis to hit we risk the possibility that we react too late and that could be disastrous for the business.

Case insight 13.7 Covid-19 pandemic

Monitoring and mitigating identified risks

Worldwide pandemics are nothing new: SARS in 2002 (another form of coronavirus); swine flu (H1N1/09 virus) in 2009; MERS in 2012; Ebola in 2013. After these many experts predicted a global pandemic was almost certain to break out at some point in the near future. Even Bill Gates predicted one in a 2015 Ted talk. It was a 'known-unknown'. So why was the UK so unprepared for the Covid-19 pandemic in 2020?

In 2009 a UK parliamentary committee concerned about the swine flu epidemic questioned the government's health secretary about its readiness. The health department had just issued a document suggesting that the National Health Service (NHS) could double its critical or intensive care capacity during a lethal pandemic, at the same time acknowledging that 'there may be ten times as many patients requiring mechanical ventilator support as the number of beds available'. The health secretary later conceded that, under a worst-case scenario, 'intensive care capacity may well be inadequate'. Two years earlier a pandemic had been classified the number one UK national security risk – a threat with 'level five' impact and a probability of occurrence of between one-in-20 and one-in-two. The only other threat with that level of impact severity was a large-scale biological or nuclear attack and that was deemed to have a probability of occurrence of less than one-in-200. Other risks such as cyberattacks on infrastructure or widespread flooding were all considered *both* less likely *and* with less impact than a pandemic. It remained the number one security risk right up to 2020, when the threat materialised.

The UK government has been 'planning' for a pandemic outbreak since 2005. Indeed, the UK was ranked second in the world (after the USA) in 2019 by the Global Health Security (GHS) Index, for its capability to prevent and mitigate pandemics. This despite the fact that at least two NHS preparedness audits had highlighted both a shortage of personal protective equipment (PPE) and insufficient ventilators within intensive care units for such an outbreak. According to the *Sunday Telegraph* (28 March 2020), the NHS 'failed' a 2016 exercise to test its ability to handle a pandemic with a similar mortality rate to coronavirus. The exercise showed, again, that the NHS would be overwhelmed with a lack of intensive care beds with respiratory support, PPE and morgue capacity. These deficiencies were never remedied and the UK went into its number one identified risk facing severe shortages of intensive care beds, ventilators and PPE. Additional ventilators had never been purchased and stocks of PPE had actually been run down since 2016. Did successive governments believe the risk would not materialise? There had been four pandemics since 2002, but none affected the UK badly. Did they think they could not afford the cost of the equipment? It has been estimated that the cost of the 50,000 ventilators that should have been bought would have been one-tenth of the amount it spent on a pair of aircraft carriers in 2011 to counter the less likely threat of attack (*New Statesman*, 3–23 April 2020).

There is another lesson to be learned from the pandemic – that the UK planned for the wrong sort of pandemic and then only reluctantly changed its plans, despite mounting evidence. All of the planning documentation refers to 'influenza', which is a type of flu, not a coronavirus. There are crucial differences. Because of its ability to transfer easily and its short incubation period flu is considered impractical to contain. The UK government's early strategy was based on an influenza pandemic that, ultimately, could not be contained only delayed – a point made by the chief medical advisor and repeated by his deputy in mid-March 2020. Early modelling of the spread was also based upon this assumption. The more deadly Covid-19 does not transit as easily but, crucially, had already been effectively contained through testing and tracing in a number of other countries, thus saving lives. However, the UK government stuck to its formal influenza strategy, which caused it to shut down public places far later than other countries, allowing the virus to spread with deadly consequences. Why did the UK government, and more particularly their senior medical advisors, adhere to this strategy for so long?

The UK government was advised by a group of eminent scientists – clinical academics and modellers, crucially not frontline experts on infectious diseases or public health. When minutes of their meetings were belatedly published in May, many scientists disagreed with their assumptions and analysis. Matthew Syed believes the government advisors were subject to 'groupthink'. Their advice and the government's decisions were framed by the pandemic strategy which was based upon incorrect assumptions about the type of virus. Nobody questioned this because it was the 'dominant logic' of this group. Only when other scientists from other backgrounds looked at their logic was it questioned.

> *'The UK government has excellent advisors, but even experts are vulnerable to biases. Groupthink was doubtless reinforced by a lack of diversity in thought and experience.' (Matthew Syed,* The Sunday Times, *17 May 2020)*

Questions:

1. Having identified and assessed a pandemic to be the number one risk facing the UK, why were actions not taken to mitigate and monitor that risk by stockpiling more PPE and respirators?
2. Was a coronavirus pandemic really an 'unknown-unknown'? If so, why were other countries better prepared? If not, how do you stop 'dominant logic' or 'groupthink' from affecting the planning and response?

SUMMARY

- The 'unknown-unknowns' are where the risks cannot be identified (they are unknown). These are best dealt with using the 'lean start-up' and 'affordable loss' methodologies outlined in Chapter 6. These set budgeted expenditure ('affordable loss') to develop an MVP which, over a number of predetermined stages, yields more information about the commercial viability of the project or start-up.
- The 'known-unknowns' are where risks can be identified (they are known). For these a risk management framework involves a five stage process:
  - Identifying the risks (internal or external) associated with an action;
  - Evaluating the probability of the risk materialising;
  - Evaluating the effects of that risk materialising;
  - Mitigating the risk in whatever way possible;
  - Monitoring the risk so as to ensure early warning, should the risk materialise.
- This framework is most appropriate for projects or start-ups developing incremental product/service innovation.
- Other generic risk management strategies include partnering, minimising fixed costs and maximising margins and generating strategic options.
- Risk can be evaluated by developing a risk index – multiplying the probability of occurrence by the scale of impact – and then deciding on its controllability. The riskiest situation is where there is a high probability of occurrence with a high impact in a situation but where there is little control (high danger). These can derive from internal factors or the external environment.
- Where risks can be identified it is important to monitor key risk indicators that give early warning signs of the risks materialising. Where a risk can be controlled it should be mitigated.
- There are four ways of dealing with risk: attempt to eliminate it; attempt to reduce it; transfer or share it; accept it.
- Financing risk arises from how a project or start-up is financed. Bootstrapping attempts to minimise the use of external resources. Using external funds of any sort brings risks and/or constraints but borrowing involves the risk of making a commitment to pay interest (a fixed cost), whether the project or start-up is profitable or not.
- Critical success factors (CSFs) can emerge out of the analysis of risks and what needs to be done to manage them. Strategic options are the contingency plans that are available should the risks materialise.
- The risk management framework outlined in this chapter can be used to manage downside risks or, by turning it on its head, to manage upside opportunities.
- Entrepreneurs are unlikely to be inclined to approach risk management systematically. They are also more inclined to gamble when it comes to dealing with downside risks – even when that risk is significant and the impact severe. These are dangerous characteristics.

GROUP DISCUSSION TOPICS

1. If you focus too much on risk you will ignore opportunities. Discuss.
2. What sort of risks fall into the category of 'unknown-unknowns'?
3. Could a firm have predicted the coronavirus pandemic of 2020?
4. What sort of risks might appear on a risk register for a country that do not appear on the risk register for a company?
5. Should climate change appear on the risk register of firms?
6. Can you deal with unknown risks? If so, how? Give examples.
7. Can you really predict the risks a business will face?
8. If you cannot predict a risk, you cannot manage it. Discuss.
9. Do entrepreneurs ignore risk? If not, how do they deal with it?
10. Setting an 'affordable loss' is a little too much like gambling – all or nothing. What is really needed is a way of gauging how much and when to invest. Discuss.
11. Are large companies doomed to always favour low-risk project opportunities?
12. Entrepreneurs are willing to take greater risks than most people. But most people are willing to gamble to avoid downside losses. What are the implications of this for an entrepreneur-led business?
13. Does high risk always go with high returns? If not, what other factors affect profit?
14. What are the risks associated with global warming? Do they present any business opportunities?
15. The easiest way to avoid financing risks is to avoid using external finance. Discuss.
16. If innovative start-ups face high risks they are bound to face high capital costs. High capital costs just increase the risk these companies face. Discuss.

STUDENT ACTIVITIES

1. Describe the risks facing an organisation of which you have experience (it might be your university). Classify them using the risk cube in Figure 13.1 and indicate what key risk indicators would need monitoring.
2. List the risks you face in selecting a company to work for when you leave university. Classify them using the risk cube in Figure 13.1 and indicate what key risk indicators you would need to monitor.

START-UP ACTIVITIES

1. Identify the risks you face pre- and post-launch. Apply the risk management framework to them by calculating their risk index (1–9) and identifying the key risk indicators.
2. Identify your CSFs and develop strategic options.

14

RECRUITING AND MANAGING PEOPLE

Contents

- People, people, people
- Recruiting people
- Attracting a venture team
- Shared cognition in the venture team
- Using professional advisors
- Selecting the venture team
- Developing the venture team
- Organisational structure: Spider's web
- Organisational structure: Hierarchy
- Hierarchy and control
- Control, autonomy and motivation
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: Getty Images/Joshua Hodge Photography

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand the different ways of employing people and how to go about recruiting them;
- Draw up a job description and person specification;
- Understand the benefits of using different types of professional advisors;
- Understand how to go about recruiting and selecting a venture management team;
- Understand the advantages and disadvantages of different organisational structures;
- Understand the balance needed between control, autonomy and motivation.

Case insights

14.1 Darktrace
14.2 Specsavers (2)
14.3 BP and Deepwater Horizon

Explore further links

14.1 Employment laws and regulations
14.2 Business consultants
14.3 Personality tests
14.4 Autonomy, purpose, mastery and task execution

PEOPLE, PEOPLE, PEOPLE

The one thing every business needs if it is to grow is people – competent, committed people. Nevertheless, many entrepreneurs try to minimise the cost of hiring people by doing as many things as possible themselves. This despite the fact that this is not always a good idea as they may not always have the necessary expertise. People cannot be purchased in the same way as other assets. They have to be attracted to join the business as employees or partners. Of course many new ventures do not employ anybody to start with, preferring instead to subcontract as many operations as possible. However, the only way a business will grow is by recruiting appropriate staff, including managers, to deliver their product/services to more and more customers.

For both leaders and managers, business is primarily about people. Selecting, developing and managing staff will become a key activity – but something many entrepreneurs find difficult. When there is more than one founder, the issue of working with the other partners so as to become an effective management team can be just as challenging. And as we have seen, the founder (or founding partners) needs to adapt and change the way they lead and manage the business as it grows. These changes need to be properly managed alongside the day-to-day delivery of customer service. It is little wonder that so few firms grow to any size. Some entrepreneurs even decide not to grow their business because they realise they cannot manage these changes or because they prefer to move on to another start-up. This chapter is about finding, attracting and organising the appropriate people to work with as partners, staff and advisors.

> *In the early days it's all about your enthusiasm, but very quickly it's just about people, people, people ... The rest will look after itself.*
>
> Ben Meldrum, founder of Professor Puzzle, *The Sunday Times*, 7 May 2017

RECRUITING PEOPLE

> *People are the lifeblood of the business. Focus on your employees and your customers and everything else will fall into place.*
>
> Tom Molnar, founder of Gail's Artisan Bakery, *The Sunday Times*, 20 April 2014

Recruiting the right people to work with is crucial to the success of a business – the bigger the start-up, the more important the team. Team members can bring a range of skills, capabilities, knowledge and networks that complement and leverage the founder's experience. Industry experience can be vital in a new venture, particularly if the experience comes from recruiting someone from a competitor. It might take time to attract everyone needed and the business may have to be launched with some key posts unfilled, but it is important that the best people are appointed, so any skills gaps may have to be plugged with temporary appointments or by subcontracting certain operations. Attracting the right staff is likely to involve advertising posts, but for many SMEs most appointments will originate with personal networks and recommendations – particularly at specialist and managerial level.

While a business may be able to subcontract some activities or partner with other businesses, sooner or later it will need to recruit people to work directly for it. People can be recruited to work on a number of different bases:

- Full/part time – Not all people want to work full time and, for a start-up, each full-time employee can represent a large increase in fixed costs. So, employing part-time staff can be attractive, particularly if they are willing to work shifts and in-fill to meet customer demand, in which case you can specify the number of hours they work.
- Regular hours/shift work – Office workers might expect to work regular 'nine-to-five' hours, but in many industries, such as hospitality, shift working is the norm and part-time work is common. The determinant factor here is what is required to provide the necessary customer service.
- Zero-hours contracts – Some companies employ staff on a contract that is totally flexible, not specifying when they work nor guaranteeing any hours (they are called 'gig-workers'). This may be attractive to some employees but gives the employer the greatest flexibility and lowest risk. However, the legality of this form of employment needs to be checked from industry to industry.
- Fixed-wage or salary/commission/piecework – Employing full-time, fixed-wage or salaried employees increases the fixed costs of a business and therefore the risk it faces. While this may be necessary to attract the 'right' sort of person – particularly in management positions – many types of jobs or even industries have different ways of working. Salespeople expect part of their remuneration to come from commission or bonuses based upon meeting their sales targets – the more they sell, the more they earn. Some workers expect to be paid on a piecework basis – they are paid for the volume they produce.

The next steps revolve around understanding the skills gaps in the business, specifying how they might be filled and the sort of person that might fill them. Finally, the nature of their employment can be specified.

> *Organizations are struggling to satisfy their younger employees' demands for job flexibility, improved work/life balance and opportunities to be creative.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 18 August 2019

The skills profile

The process starts by developing a skills profile for the business and identifying where the gaps exist. These are operational skills needed and therefore depend on the nature of your business. However, the core functional disciplines of business – sales, marketing, accounting etc. – will also need to be covered. A business may also need specific market or industry skills. A skills profile should be undertaken pre-launch but, as the business grows, more staff and new skills will be needed as gaps emerge, so it is wise to plan for recruitment in advance. 'Making do' at start-up is not good enough if the business proves to be successful. Depending on the size of the start-up, a founder may have to be flexible and live with a degree of overlap and indeed cope with some gaps, at least in the short term. It is therefore useful to classify the skills in the profile as 'key', 'important' or 'desirable'. Recruiting appropriate people with key skills, particularly pre-launch, may be a CSF (Chapter 12).

The job description

The next task is to draw up a job description for each employee listing the things they have to do and what they will be held accountable for in this role. This can problematic in a small, growing business where the nature of the tasks to be undertaken can change day to day and over time. Job descriptions can be made flexible. However, in some countries employees expect quite detailed and specific job descriptions. For example, the Swedish home furnishing store IKEA does not give employees job titles or precise job descriptions and this caused it a major problem when it first launched in the USA, where employees are used to clear roles and responsibilities. The resulting high staff turnover rates caused IKEA to change its recruitment processes so as to highlight the company's culture and values. Prospective employees who were not comfortable with this could therefore withdraw during the process.

The person specification

Based upon the list of duties in the job description, a person specification listing the criteria on which to base selection of the person can be drawn up. This is an important document against which the suitability of a candidate for a post can be assessed. Table 14.1 gives a checklist of characteristics that might be included in this document. These can be split into 'essential' and 'desirable'. In most countries employees are expected to be given a contract of employment which outlines their terms and conditions of employment. In the UK this must be done within two months. What goes into this contract is prescribed by law. There are also a plethora of regulations and laws that regulate how you recruit, employ and dismiss employees.

Table 14.1 Person specification checklist

* Educational attainment * Experience (e.g. retail sales etc.) * Knowledge (e.g. marketing etc.) * Skills/abilities (e.g. teamworking etc.)	* Personal attributes (e.g. flexibility etc.) * Personal characteristics (e.g. friendly etc.) * Personal circumstances (e.g. able to work evenings)



Explore further 14.1

Employment laws and regulations



Access the *Digital Links* booklet for web links to UK government sites that provide information and advice.

ATTRACTING A VENTURE TEAM

> *The ability to find and hire the right people can make or break your business. It is as plain as that ... The right people in the right jobs are instrumental to a company's success.*
>
> Michael Dell, founder of Dell Corporation, (1999), *Direct from Dell: Strategies that Revolutionized an Industry*, New York: Harper Business

> *I very much look at personality and give that more weight than skills. You can always develop ability but you can't change someone's personality.*
>
> Rob Pollard, Director of Lightbox, *The Times*, 25 February 2014

Attracting employees can be difficult enough. The posts will need to be advertised, applicants who meet the person specification(s) shortlisted and then interviewed. However, finding and attracting a new venture team – people of managerial level who have key skills and knowledge that the start-up lacks – can be altogether more difficult. Why should they join a risky start-up, particularly if they have a secure job in an established company? The answer lies in part with the persuasive power of the entrepreneur but also with the remuneration package they offer them. The entrepreneur may be short of cash to start with, but if they are successful there should be plenty of money to go around later on. So the answer may be to offer incentives such as target-linked bonuses, shares or share options – effectively making them partners in the business and sharing in its success. Most of the really successful start-ups, particularly risky tech start-ups, have distributed shares to key managers early in their development.

Sometimes the new venture team will share the ownership of the business between them from the start. The share each has might reflect the cash, IP or simply the time and effort they have put in to get the business off the ground – called 'sweat equity'. The terms of a shareholders' agreement should specify how this is done, as well as anticipating future issues facing the founders. A shareholders' agreement only applies to those signing it, while the articles of association govern all future shareholders. Typical topics included in such an agreement are shown in Table 14.2.

Whatever the package put together looks like, the founding entrepreneur will need to actively seek out their potential team. The entrepreneur's network of contacts is always a good starting point – family, friends and professional contacts. They may need to advertise. However, social media can be an important source of contacts. The entrepreneur can use their Facebook or LinkedIn account to broadcast to friends and contacts that they are setting up a new venture team and what skills, capabilities and knowledge they are looking for – and the package on offer. Some companies use Twitter for recruiting. Applicants can then be shortlisted against the person specification(s) and their suitability assessed. Meetings and interviews can take many forms, but the more senior the appointments, the more important it is to make sure they are the right ones – particularly if they are to become shareholding partners. If the team being put together is small it is always better to meet suitable candidates more than once. And it is important to realise that it is not just their skills that need to 'fit' with the company, but also their personality.

Table 14.2 Topics in a typical shareholders' agreement

* Nature of the business
* Identity, role and title of founders
* Legal form of business
* Distribution of shares between founders
* Consideration paid for shares or ownership share of each founder (for cash or other consideration)
* Intellectual property signed over to company by founders
* Rights to appoint and remove directors
* Dividend policy
* Terms to protect minority shareholders
* Terms regulating the raising of capital (to avoid diluting existing shareholding)
* Conditions affecting founders regarding the valuation and disposal of shares, including buy-back clauses
* Other limitations on directors' and/or shareholders' freedom of action
* Resolution of disputes between shareholders

SHARED COGNITION IN THE VENTURE TEAM

There has been considerable research into what makes a successful partnership or venture team where ownership is shared. This has repeatedly shown the importance of cohesion and 'shared cognitions' – shared goals and effective communications and transfer of knowledge between partners. 'Shared cognition' improves collective understanding within a group, and helps individuals with different functional backgrounds to reach consensus. This can improve decision-making quality and the general performance of the business (Smith et al., 2005; West, 2007). It is therefore important that the new venture team share the same values and beliefs and sign up to the same mission and vision for the business.

Shared cognition can also help cut down on conflict within the partnership group (Burgers et al., 2009) and increase partners' 'reciprocal credibility and coordination' (Zheng, 2012), both positively effecting performance. Conflict generally takes two forms – relationship conflict and task conflict (Jehn and Bendersky, 2003). While conflicts over tasks can sometimes be productive and beneficial, relationship conflicts are rarely beneficial and may erode cohesion within the team, negatively affecting performance (Gelfand et al., 2008). It is therefore important that the team have sufficient emotional intelligence to get on together. The Thomas-Kilmann Conflict Mode Instrument, outlined in Chapter 16, can help explore how the team might handle conflict. In most cases building a cohesive team involves building consensus towards the goals of the firm – which is perhaps easier between partners – while balancing multiple viewpoints and demands. However, too great a reliance on achieving consensus can lead to slow decision-making, so a balance is needed that will strain the interpersonal skills of the leader.

The challenge is to select the team and then to build cohesion and motivation. Cohesive teams have been linked to greater coordination during teamworking as well as improved satisfaction and productivity (Mach et al., 2010). The need for a cohesive team is particularly true for the partnership team in a new venture as it has been shown to lead to superior business performance – providing a more stable and solid foundation of interpersonal relationships that produces synergistic behaviour and improves coordination (Ensley et al., 2002; Lechler, 2001; Thye et al., 2002). These studies underline the importance of being very careful in selecting partners and basing decisions not just on task competencies but also on shared beliefs and good interpersonal relationships that can make for a cohesive partnership team. In the best entrepreneurial firms, leadership seems to work almost by infection. The management team seems to be infected by the philosophies and attitudes of the founder and readily buy into the goals set for the firm, something that is helped if they share in its success.

> *Most successful businesses are started by teams. Solo entrepreneurs certainly succeed ... but they are very much the minority. Even those who we think of as great individual entrepreneurs ... all had co-founder partners in the early years.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 21 May 2017

> *You start out with a mission or dream and then you have to work out how you are going to get there. Any time that you choose to partner with anybody you make that choice to accelerate your growth, with the impact that has in some degree on your independence.*
>
> Kristian Segerstråle, co-founder of Playfish, *The Sunday Times*, 22 November 2009

USING PROFESSIONAL ADVISORS

It is not always necessary to 'own' resources to be able to use them. Entrepreneurs often use their network of personal contacts to support their business in different ways that help them avoid the costs and risk associated with full-time employment. Professional jobs can be contracted out. Functions can be outsourced. Sometimes, no matter how hard they have tried, a founder may be unable to find the 'right' people for their key senior roles. In these cases it may be possible to 'buy in' these roles through professional advisors, at least temporarily. Professional advisors can be an invaluable source of knowledge, skills and advice as well as providing an additional network of contacts for the founder. Over time they may even be persuaded to join the start-up. Many founders make use of friends and family on an informal basis, willing to help because of the relationship with the founder. They might relish the challenge of helping a start-up. Professional advisors can also be hired or, in some cases, paid for by other bodies such as government. There are four types of professional advisors you might employ.

Accountants

Accountants can help produce financial forecasts, the regular financial statements for the business, and then help analyse and interpret them (Chapter 15). Often they have access to industry financial norms that can be used to benchmark performance. Indeed, the whole financial administration of a business

can be subcontracted, including the issuing of sales invoices and collection of cash, the payment of purchase invoices and payroll administration. Accountants also offer tax advice and will handle the filing of information with appropriate bodies, such as Companies House. They usually have a network of contacts that can help with finance and funding, from loan to equity capital. Every business needs to succeed financially to remain viable and having reliable accounting information is vital. The more ambitious the aims for a venture, the more likely it is to need good financial advice early on.

Lawyers/attorneys

Lawyers can help with anything involving the law (Chapter 11). They can advise on the legal requirements of establishing a business and on the various business licences or permits it might need. They can advise on safeguarding a business idea – patents, copyright etc. They can draw up legal contracts with staff, partners, suppliers or customers. They can be invaluable in drawing up a shareholders' agreement for the venture team. Often, like accountants, they have a network of contacts that can help with finance, from loan to equity capital, and sometimes they offer tax services. However, also like accountants, good lawyers can prove to be expensive, so it is always best to understand how they charge their fees before they start any work.

Business consultants

General business consultants can offer advice on marketing or strategic planning. They can help draw up a business plan, which may be required to obtain finance. Often they can provide access to other sources of help and advice, particularly at a local level, including specialist advice on specific industries or topics such as exporting. Local consultants can also provide invaluable access to local networks of other owner-managers and providers of capital. Some consultants might be 'free', paid for by government to help small firms. Most Western countries have services offering help and support to SMEs.

Explore further 14.2

Business consultants

Access the *Digital Links* booklet for web links to UK organisations providing help and advice. In the USA it is provided by the Small Business Administration through its Small Business Development Centers.

Recruitment consultants

Recruitment consultants can help find specialist/technical or experienced managerial staff quickly. These are areas which may be most relevant to high-tech start-ups. However, they can be expensive.

> *Have great advisers and listen to them. You don't have to take their advice but it's valuable to have other voices.*
>
> Sara Murray, founder of Confused.com, *The Sunday Times*, 1 February 2009

Any start-up benefits by surrounding itself with high-quality advisors. They add to the credibility of the management team and this can help persuade providers of finance to invest. They can also provide an invaluable network of high-level contacts. The more ambitious the start-up, the more important this is. Using advisors on a 'pay-as-you-go' basis can offer an attractive way of accessing a range of knowledge, skills and networks that a new venture might not be able to afford to employ on a full-time basis. It allows firms to simplify their structures focusing on their core activities. The relationship with these advisors might be informal or formal (relying on a contract for service). Skills gaps can also be addressed through the board of directors, different forms of partnership or equity investors, such as business angels. Non-executive directors can be particularly useful when it comes to networking but can also add enormously to the credibility of the firm (see Chapter 11). The range of different ways of meeting skills and knowledge needs are summarised in Figure 14.1.

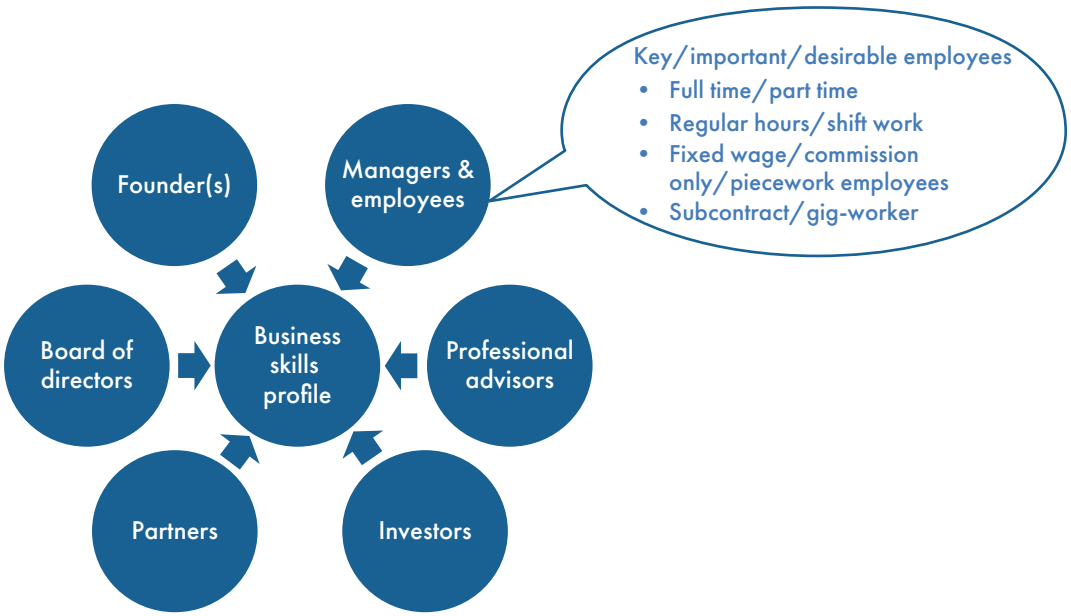


Figure 14.1 Meeting skills needs

SELECTING THE VENTURE TEAM

The ability to work effectively as a team is important – at any level. Team members bring with them information and experiences, as well as technical and management knowledge. Selecting an effective team will therefore depend upon the skills profiles and individual job descriptions and person specifications you develop. However, research suggests that demographic diversity such as age, gender and functional background is not as important for entrepreneurial team effectiveness as team process variables – how the team functions and their commitment to achieving overall goals (Chowdhury, 2005). The personal chemistry between members of the team is important. For a team to be effective, individuals need to have the right mix of a certain set of personal characteristics.

Belbin team roles

Meredith Belbin (1981) identified three 'personal orientations' – thinking, people and action – each of which translates into three 'team roles'. Each team role has positive qualities and allowable weaknesses. Individuals are naturally suited to two or three of these roles, yet all nine elements need to be present in a team for it to work effectively.

Thinking orientation

1. *Plant* – This is the team's vital spark and chief source of new ideas – creative, imaginative and often unorthodox. However, they can be distant and uncommunicative and sometimes their ideas can seem a little impractical.
2. *Monitor evaluator* – This is the team's rock – introvert, sober, strategic and discerning. They explore all options and are capable of deep analysis of huge amounts of data. They are rarely wrong. However, they can lack drive and are unlikely to inspire or excite others.
3. *Specialist* – This is the team's chief source of technical knowledge or skill – single-minded, self-starting and dedicated. However, they tend to contribute on a narrow front.

People orientation

4. *Coordinator* – This is the team's natural chair – mature, confident and trusting. They clarify goals and promote decision-making. They are calm with strong interpersonal skills. However, they can be perceived as a little manipulative.

5. *Teamworker* – This is the team's counsellor or conciliator – mild-mannered and social, perceptive and aware of problems or undercurrents, accommodating and good listeners. They promote harmony and are particularly valuable at times of crisis. However, they can be indecisive.
6. *Resource investigator* – This is 'the fixer' – extrovert, amiable, six phones on the go, with a wealth of contacts. They pick other people's brains and explore opportunities. However, they can be a bit undisciplined and can lose interest quickly once initial enthusiasm has passed.

Action orientation

7. *Shaper* – This is usually the self-elected task leader with lots of nervous energy – extrovert, dynamic, outgoing, highly strung, argumentative, pressurises seeking ways around obstacles. They do have a tendency to bully and are not always liked. However, they generate action and thrive under pressure.
8. *Implementer* – This is the team's workhorse – disciplined, reliable and conservative. They turn ideas into practical actions and get on with the job logically and loyally. However, they can be inflexible and slow to change.
9. *Completer-finisher* – This is the team's worry-guts, making sure things get finished – sticklers for detail, deadlines and schedules. They have relentless follow-through, picking up any errors or omissions as they go. However, they sometimes just cannot let go and are reluctant to delegate.

> *It takes real team spirit to take on challenges and win, and it also builds true camaraderie. It is this togetherness, above and beyond any other factor, that set great businesses apart from the also-rans.*
>
> Richard Branson, founder of Virgin Group, *The Sunday Times*, 7 December 2014

Belbin's work underlines the appeal of teamworking. It is impossible for one person to have all nine 'orientations', and it implies that, to be effective, teams need to comprise about four people. Chell (2001) suggested that the 'prototypical entrepreneur' might be a mix of three Belbin roles: plant (creative, ideas person), shaper (dynamism, full of drive and energy) and resource investigator (enthusiastically explores opportunities). She then suggested that the first team member to be recruited should be an implementer (reliable, efficient and able to turn ideas into practical action). The implementer will need a completer-finisher (conscientious, delivers on time), a teamworker (cooperative and unchallenging) and possibly a specialist (with particular knowledge or skills) working under them.

Five-Factor personality test

The Five-Factor personality test outlined in Chapter 3 has implications for general behaviour, not just the inclination to start up a business. The five dimensions of openness, conscientiousness, extraversion, agreeableness and neuroticism is one way of better understanding an individual's character traits and provides clues as to how team members might behave. We noted that individuals who were inclined to start up a business were likely to exhibit a high degree of openness, conscientiousness, extraversion and a low degree of agreeableness and neuroticism. High degrees of both openness and conscientiousness are generally associated with innovative behaviour. Leaders generally are likely to exhibit a high degree of openness, a low degree of neuroticism and balanced levels of conscientiousness and extraversion.

Although a good deal about the link between personality tests and job performance is disputed, in much of the literature a high degree of conscientiousness is considered to be the best predictor of overall job performance, followed by extraversion, with a high degree of neuroticism negatively associated with all forms of work role performance. However, high degrees of agreeableness and conscientiousness have been associated with intentional 'counterproductive' workplace behaviour by individuals.

For a team start-up the challenge is to select an appropriate team with balanced skills and personal character traits and then to build cohesion and motivation. A cohesive team works together effectively because of its collective commitment to an agreed goal. There may be different views about how that goal is achieved and this involves analysing the options and building a consensus while balancing multiple viewpoints and demands. However, too great a reliance on achieving consensus can lead to slow decision-making, so a balance is needed that may strain the interpersonal skills of the team leader – the founder of the business.

Herrmann Brain Dominance Instrument (HBDI)

Chapter 4 explained the Herrmann Brain Dominance Instrument (HBDI). This has implications in a group context, not only for creativity but also for whether and how creative ideas might get implemented. Ideally a venture team will have a mix of thinking types (Type A: analytical; Type B: sequential; Type

C: interpersonal; Type D: imaginative), each complementing the other in the same way as in the Belbin team roles. While Type D are the highly creative thinkers, Type A are the more analytical thinkers, likely to highlight problems and risks, Type B are the ones who will work well solving problems and implementing good ideas, while Type C will bring the team together through their interpersonal skills.

For example, the innovations department of a major UK high-street retailer was frustrated that many of the good ideas they were coming up with were not being implemented. As part of a training programme on creativity, staff were asked to take the HBDI. The results are shown in Figure 14.2. Individual results are represented by the large dots and the overall result profile by the solid line. As can be seen, the department is strongly skewed towards Type D imaginative thinkers – which you would expect to be good for an innovations department. However, the profile is also skewed away from Type B sequential thinkers, who are the ones who are good at organising work and implementing ideas. This analysis made the retail chain consider whether the problem lay within the department rather than outside and what would be needed to develop more 'implementers' to get the team to work more effectively.

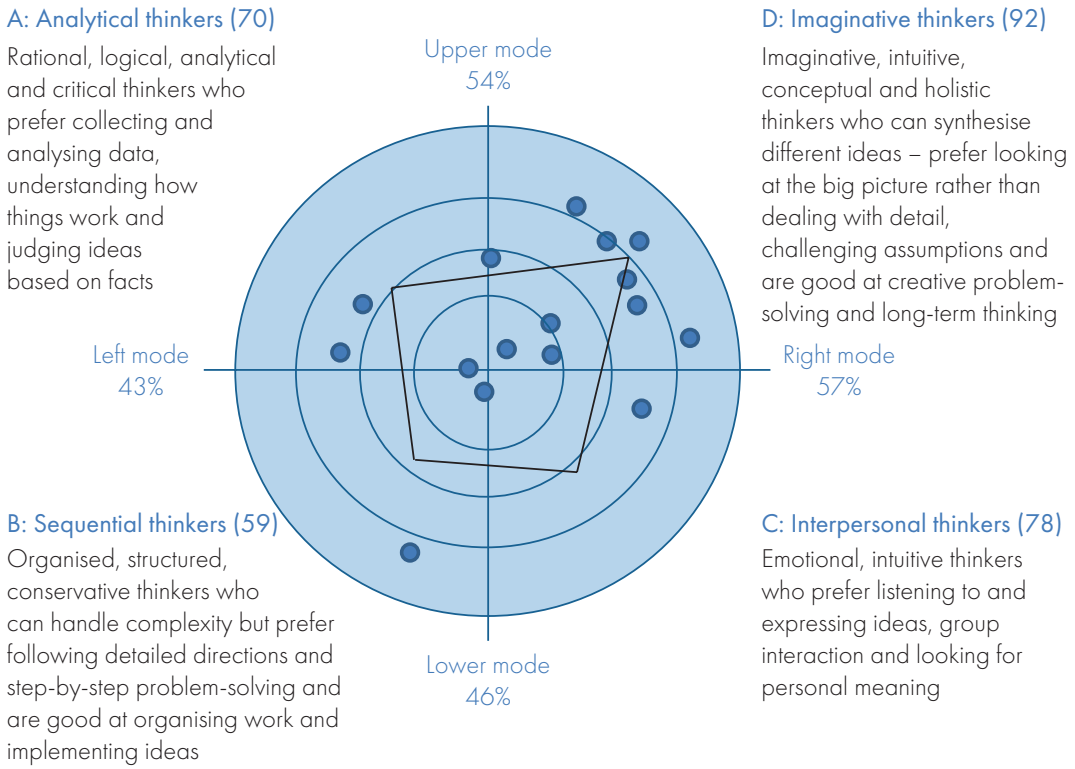


Figure 14.2 HBDI mapping for innovation team

Combining these three tests should provide an insight into both how and why team members interact in certain ways. Understanding this, as a team, can help build communication, enhance creative follow-through and resolve conflict.

Explore further 14.3

Personality tests

Access the *Digital Links* booklet to:

- Watch a short video explaining the nine Belbin team roles.
- Access the Belbin team roles questionnaire.
- Take the Five-Factor personality test.
- Access the Herrmann Brain Dominance Instrument (HBDI).

DEVELOPING THE VENTURE TEAM

All personal relationships are based upon trust – it is the cornerstone of a good team. It binds them together. This involves being open and spontaneous, honest and direct, being supportive of other individuals and having their interests at heart. But trust needs to be earned, it does not come as of right and therefore needs to be built up between individual members of the team over time. It needs to be demonstrated with real outcomes, but can be lost very quickly by careless words or actions and then takes even longer to rebuild. Effective teams do not just happen, they have to be developed, and that can take time. Teams go through a development process, shown in Figure 14.3:

Phase 1: The group tests relationships. Individuals are polite, impersonal, watchful and guarded.

Phase 2: Infighting starts in the group and controlling the conflict is important. However, while some individuals might be confrontational others might opt out and avoid the conflict altogether. Neither approach is good. Collaboration is best. This is a dangerous phase from which some groups never emerge.

Case insight 14.1 Darktrace

Start-up venture teams

Founded in 2013, Darktrace is one of the UK's 'unicorns', being valued at £1.3 billion at the last venture funding round, and plans to launch on the UK stock exchange in 2021. With headquarters in Cambridge and San Francisco, it already has 44 offices around the world and employs over 1,200 people.

Darktrace provides governments and companies with tools to repel cyberattacks. What makes the company unique is its innovative use of artificial intelligence and probabilistic mathematics. At the core of all its software is its Enterprise Immune System, an unsupervised machine learning technology that learns from analysing vast amounts of data about computer usage within an organisation without human intervention, and can adapt to the changing needs of a business. It then uses probabilistic mathematics to determine how likely an attack might be based upon unusual computer usage. At this point the company's appropriate Antigena software interventions are triggered. In 2016 it won the award of Best Security Company in the Info Security Global Excellence Awards.

But how does such a high-tech company come about? Darktrace was founded by a diverse venture team comprising Cambridge University mathematicians, computer machine learning specialists, intelligence experts from the UK's MI5 and GCHQ and business- people. Founder Poppy Gustafsson (chief executive officer) has a background in accounting and finance. Nichole Eagan (chief strategy officer) has a background in marketing. Jack Stockdale (chief technology officer) has a background in software development. Nick Trim (chief revenue officer) has a security background. Dave Palmer (director of technology) has a background in mathematics and Emily Orton (chief marketing officer) has a background in marketing. Gustafsson's role with the founders was to 'stitch the two sides together and make it



Source: Markus Spiske on Unsplash

cohesive'. The company has links in 'high places'. Its advisory board includes a former chief information officerof the CIA, a former director-general of MI5 and a former UK home secretary. Twelve of the company's 20 directors used to work for the Cambridge-based Autonomy before it was purchased by Hewlett-Packard in 2011. The founder of Autonomy, Mike Lynch, is one of the Darktrace investors. In 2021 it went public with an IPO valuing the company at some £3.8 billion.

Access the *Digital Links* booklet to visit the company website and to watch a video explaining the work of Darktrace undertakes.

Questions:

1. Could this business have been started by an individual rather than a team of founders? Explain.
2. What is the role of the entrepreneur in the team?
3. How important is their network of contacts for the founders and the company? Explain.

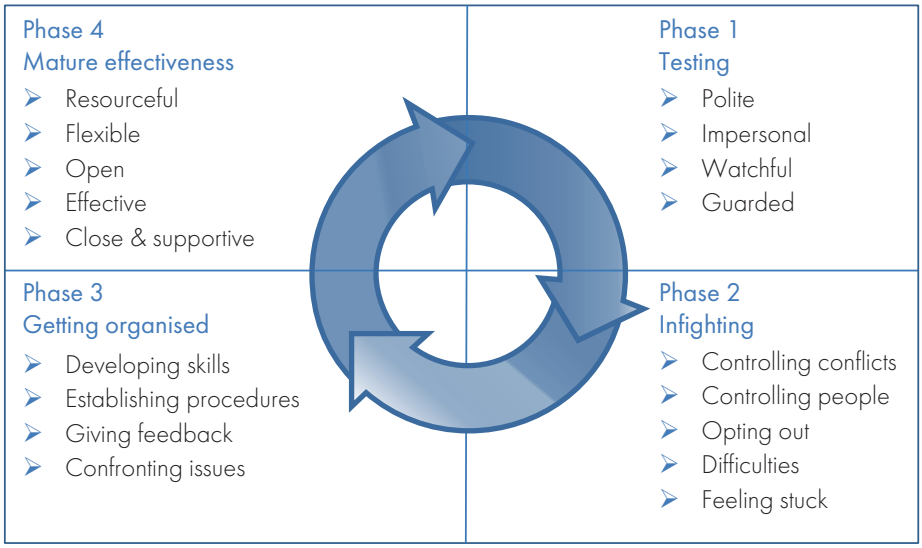


Figure 14.3 Team development wheel

Phase 3: The group starts to get organised; developing skills, establishing procedures, giving feedback, confronting issues.

Phase 4: The group becomes mature and effective, working flexibly and closely, making the most of resources and being close-knit and supportive.

The whole process of team formation and development has been likened to courtship and marriage, involving decisions based partly on emotion rather than logic. For that reason it is important that the venture team shares the same values and is committed to the same goals. They may disagree on tactics but they all agree on the destination and how they are going to get there. It is also important that team roles are clearly defined, although, given the uncertainty involved with rapid growth, it is also important that flexibility is maintained. An effective team will generate team norms of behaviour and that can be a powerful force for conformity and suggests skill-ful handling.

> *The best teams stand-out because they are teams, because the individual members have been so truly integrated that the team functions with a single spirit. There is a constant flow of mutual support among the players, enabling them to feed off strengths and compensate for weaknesses.*
>
> Alex Ferguson, Manager of Manchester United FC, 1999

ORGANISATIONAL STRUCTURE: SPIDER'S WEB

How organisations are structured is a key issue, but probably only once the business starts to grow. Entrepreneurs tend to manage staff through their strong personal relationships, rather than through hierarchy and structure. They prefer informal organisation structures and the power of influence rather than rigid rules and job definitions. They often persuade and cajole staff, showing them how to do things on a one-to-one basis rather than having prescribed tasks. This reflects itself in the culture in the organisation.

The typical organisation structure seen in a small-scale start-up is the spider's web, shown in Figure 14.4. The founder sits at the centre of the web with each new member of staff reporting to them. This is a very efficient structure that can respond quickly and flexibly to change. The uncertainty and rapid pace of change in a start-up probably means that rigid rules and structures would be out of date quickly. What is more, in a small firm everybody has to be prepared to do other people's jobs because there is no cover, no slack in the system if, for example, someone goes off sick.

The web is perfectly flat and therefore efficient – overheads are reduced. It is responsive – communication times are minimised. It works quite well up to about 20 employees. There are two reasons for this. The first reason is to do with the character of the entrepreneur themselves. Their high internal locus of control means that they tend to want to meddle and do things themselves. Even when they try to delegate and introduce new staff who report to existing members of

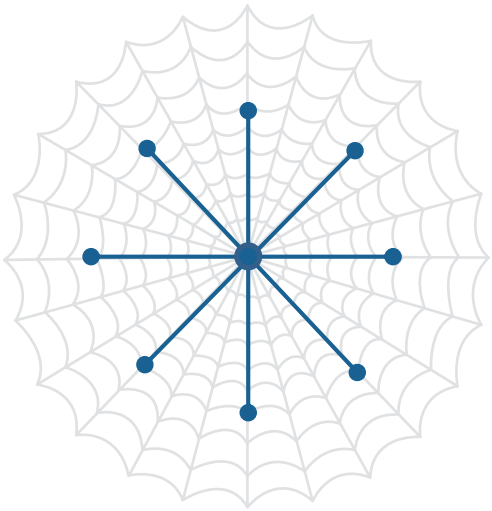


Figure 14.4 A typical spider's web structure

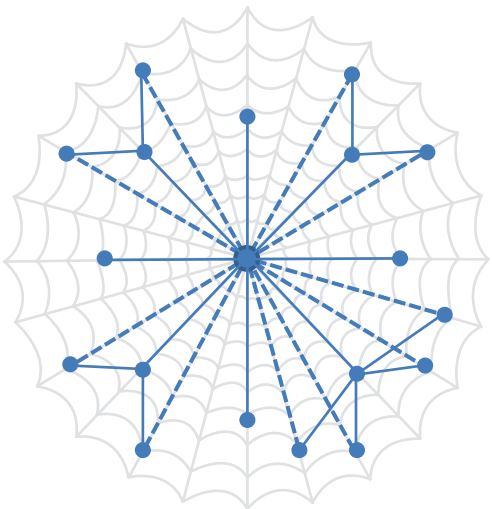


Figure 14.5 An expanded spider's web structure with informal reporting lines to the entrepreneur (dotted)

staff, entrepreneurs meddle and the new employees soon find an informal reporting line to the entrepreneur, short- circuiting the manager or supervisor they are supposed to report to, as in Figure 14.5. It is no wonder that this creates frustration, resentment and an unwillingness to accept responsibility in the manager. Why should they take responsibility when their decisions are likely to be questioned or reversed, or when staff supposedly reporting to them are constantly being checked up on by the entrepreneur?

The second reason is that communication simply becomes more complicated, with greater opportunity for misunderstanding and conflict, as the number of people interacting increases. Figure 14.6 shows the number of interactions possible with groups of two, three, four and five people. The number of interactions is represented by the mathematical formula:

$$n \times \left[\frac{n-1}{2} \right]$$ where n represents the number of people.

Thus, 5 people generate 10 interactions, 10 people generate 45 and 15 people generate 105. Postulated by Northcote Parkinson, 'Parkinson's Coefficient of Inefficiency' proposes that the optimum *inefficient* number for a group is 21, at which point group interaction becomes impossible.

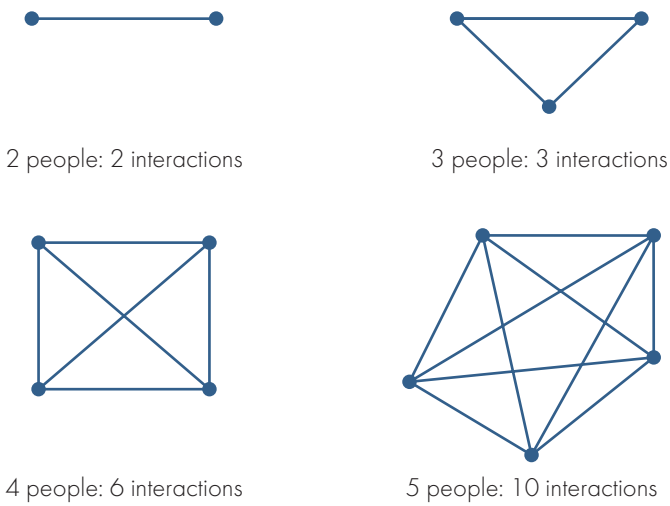


Figure 14.6 People and number of interactions

ORGANISATIONAL STRUCTURE: HIERARCHY

The larger an organisation, the greater the need for a hierarchical structure. It creates order and allows coordination of complex tasks. Hierarchy is the fundamental feature of organisational structure, not only for humans, but for all complex systems. It gives managers confidence that they have the authority to manage and allows coordination, cooperation and specialisation. Figure 14.7 shows a simple five-person hierarchical structure with four interactions. This can be contrasted to a self-organising structure without hierarchy in Figure 14.6, where there are ten interactions. Simple hierarchy offers fewer interactions and relationships to manage. However, while this may be efficient it says nothing about the quality of the interactions and the hierarchy structure can discourage collaboration and sharing of knowledge.

As an organisation grows, it needs structure to avoid this sort of chaos. Figure 14.8 shows a classic hierarchy involving departments (e.g. marketing, production, accounting etc.), functions within the departments (e.g. sales, advertising etc.) and individuals. Each level of hierarchy might represent a particular grouping or sub-grouping within the organisation. This fosters stability and encourages efficient, rule-driven operation. It shows individuals that there is a career path within their department. When a business grows beyond a certain size there is a tendency for it to adopt a divisional structure – representing different product or market groupings. Each division might then have its own departmental structure within it. Divisions might be legally separate companies.

There is no one 'best' structure. Some hierarchies might be 'tall' structures – with more managers each having a narrower span of control (fewer people reporting to them). Others might be 'flat' structures – with fewer managers each having a wider span of control (more people reporting to them). Flat structures require fewer managers and there has been a tendency to 'delayer' – to flatten structures and widen managers' span of control – thereby reducing managerial costs. This has been a continuing trend, facilitated by improvements in communication technology. Associated with this trend is decentralisation – pushing down decision-making in the organisation. Google, for example, has a flat structure with each manager having about 20 people reporting to them. Some Japanese manufacturing companies have only four layers of management; top, plant, departmental and section management. The founder of a business needs to decide on the structure of their start-up and that, primarily, will depend on the number of people they want to employ. However, they may well decide to change the structure as the business grows.

Matrix structure

In its simplest form, the traditional hierarchical structure is mechanistic, bureaucratic and rigid. It has been called a 'machine bureaucracy' because it is most appropriate where the organisation (or

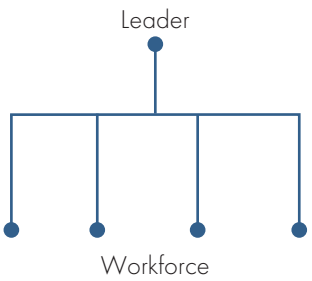


Figure 14.7 Simple hierarchy

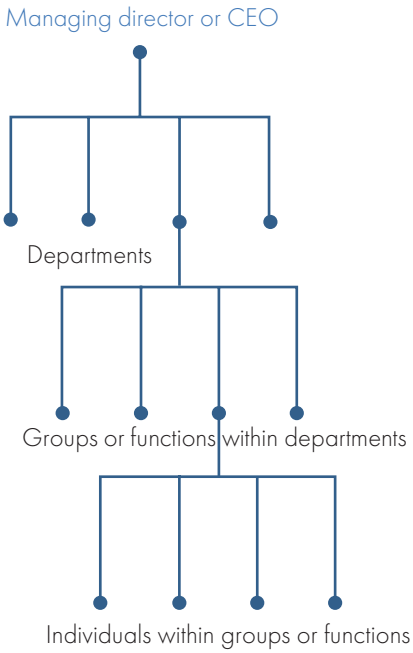


Figure 14.8 Hierarchical structure

sub-organisation) is tackling simple tasks with extensive standardisation, in stable environments, and/or where security is important and where plans and programmes need to be followed carefully. Well-developed information systems reporting on production/processing activity need to exist for it to be effective. Staff must conform to set rules and power is concentrated in the top management. It is more concerned with production than marketing and is good at producing high volumes and achieving efficiency in production and distribution – minimising costs. As such, it is most appropriate for highly automated line and, to a lesser extent, batch manufacturing and service businesses and/or when a product is in the mature phase of its life cycle and is being 'milked' for profit as a 'Cash Cow' (Chapter 18). For example, at the restaurant level, McDonald's is highly bureaucratised with high levels of job specialisation and formal systems emphasising rules and procedures. It is designed to stifle individual initiative and promote standardisation and efficiency. However, how its management operates at a higher level across restaurant sites is very different. Two examples of modifications to simple hierarchical structures are the matrix and organic structures.

A business that has multiple products, functions or geographic locations still needs to coordinate activities across all these dimensions. In this context, one of the problems with a simple hierarchy is that individuals increasingly perform multiple roles within an organisation and can answer to different managers. The organisational structure used to aid this is the matrix structure, shown in Figure 14.9. It is essentially an overlay on what is still a bureaucratic structure with hierarchical distributed power and decision-making. People have multiple reporting lines – to their functional manager (e.g. sales or accounting) and their geographic or product manager. This was popular among large organisations in the 1960s and 1970s but has become far less popular as their excessive complexity and slow responsiveness to change became apparent. Nevertheless, Starbucks still uses a matrix structure, combining functional and product-based divisions, with employees reporting to two managers.

Organic structure

This matrix structure is the blueprint for small project teams used by large companies. These organic structures bring together individuals with different functional skills from different departments, divisions or geographic parts of an organisation to work on innovation projects. Team members therefore usually have multiple roles but, unlike the matrix structure, they have clearly defined goals with delegated authority and resources to achieve them. There is usually a team leader. Figure 14.10

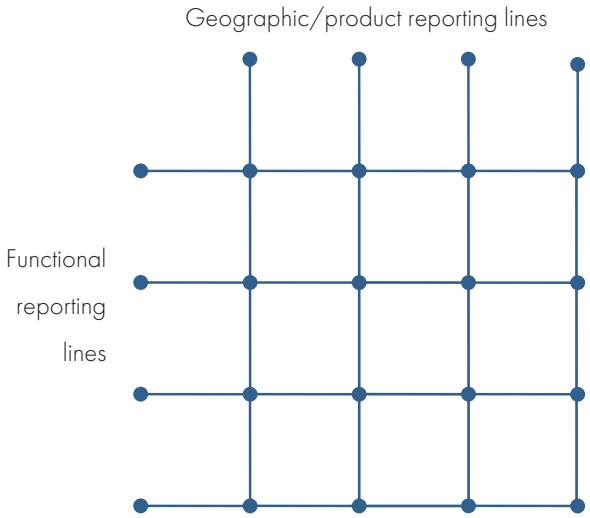


Figure 14.9 Matrix structure

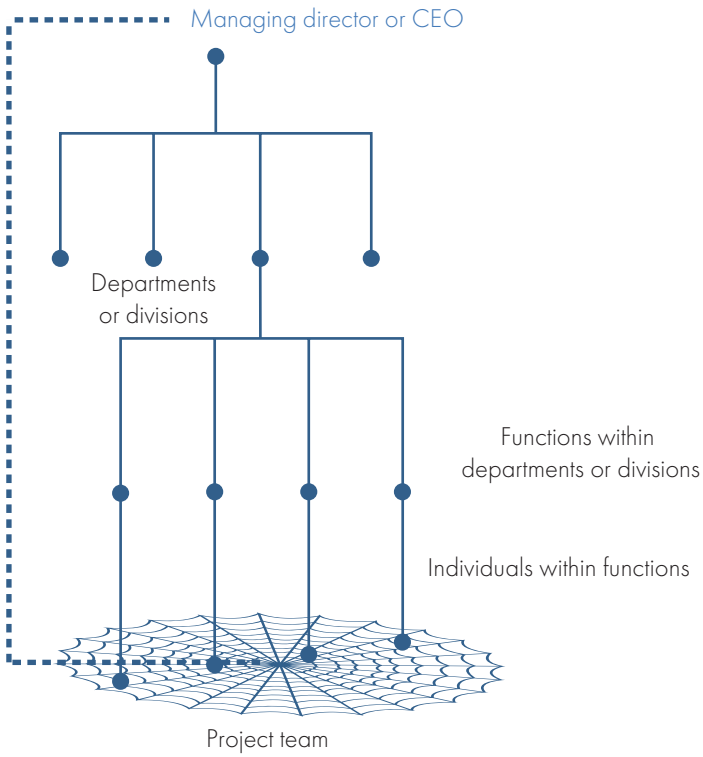


Figure 14.10 Organic multi-functional project teams

shows what an organisation using these project teams might look like. Sometimes called 'venture teams', they are used extensively in businesses that seek to encourage innovation, particularly in technology-based firms like Apple and Google. The reason for this is the same as the reason why most entrepreneurs use this organisational form – they are flat, flexible and foster rapid communication. They are part of the organisational architecture that encourages intrapreneurship (Chapter 22).

Covin and Slevin (1989) have argued that entrepreneurial behaviour within an organisation was positively correlated with performance when structures are more 'organic'. They characterise this as a structure that is highly flexible and changing, with limited hierarchy; one that places greater emphasis on personal relationships and interactions than on structures; one in which power is decentralised and authority is linked to expertise, with few bureaucratic rules or standard procedures. In fact this is exactly how most entrepreneurs manage. The challenge is replicating it as an organisation grows in size and complexity.

> *I believe in as flat a management structure as possible ... in leading without title ... I most certainly try to lead by example and I'm very much a big believer in making my mistakes public so that other people feel confident and comfortable to be able to air their own mistakes.*
>
> Shaa Wasmund, founder of Mykindaplace and Brightstone Ventures, *Management Today* (www.managementtoday.co.uk), 18 July 2008

HIERARCHY AND CONTROL

As we have seen, the more staff employed, the greater the need for hierarchy and formalised control. Informality and a lack of organisational structure just does not work beyond a certain point. Most organisational control systems are aimed at minimising risk and uncertainty and promoting efficiency and effectiveness. However, the beliefs and values of the entrepreneur will also influence the structures imposed, as should the business model on which the business is based. The most appropriate structure for an organisation depends upon the nature of the task staff are undertaking and the environmental or situational uncertainty faced by them. Galbraith (1995) observed how task complexity increased with environmental uncertainty and the amount of information that needs to be processed by the decision-maker. Tasks involving cognitive skills can be complex. If the situation faced by individuals in completing these tasks is changing, the task becomes even more difficult. These two factors – task complexity and environmental or situational uncertainty – have implications for both organisational structure and management style.

The principles are straightforward. The simpler and more repetitive the task, the easier it is to impose control and the less the need for initiative. Similarly, the more stable the environment, the less the need for initiative. But rigid control stifles initiative (and inhibits entrepreneurship), and therefore the more complex the task, the greater the need for flexibility and autonomy of action. Similarly, the more change or uncertainty in the environment – or the situation facing an individual – the greater the need for flexibility and autonomy in decision-making. This is shown in Figure 14.11.

Quadrant 1

This is the machine bureaucracy with hierarchical structures and tight controls described earlier. It is most appropriate where the organisation is tackling simple tasks with extensive standardisation, in stable environments, and/or where security is important and where plans and programmes need to be followed carefully (e.g. in a McDonald's restaurant). Well-developed information systems reporting on the production/processing activity need to exist for it to be effective. Power is centralised and employees given little discretion. Staffing levels are tightly controlled. It is more concerned with production than marketing and is good at producing high volumes and achieving the efficiency in production and distribution needed for a low-cost/price business model. By definition, a highly efficient organisation has no slack. Everything is tightly controlled, every penny accounted for, all jobs are defined and individuals made to conform. This structure is most appropriate for continuous and most line production businesses.

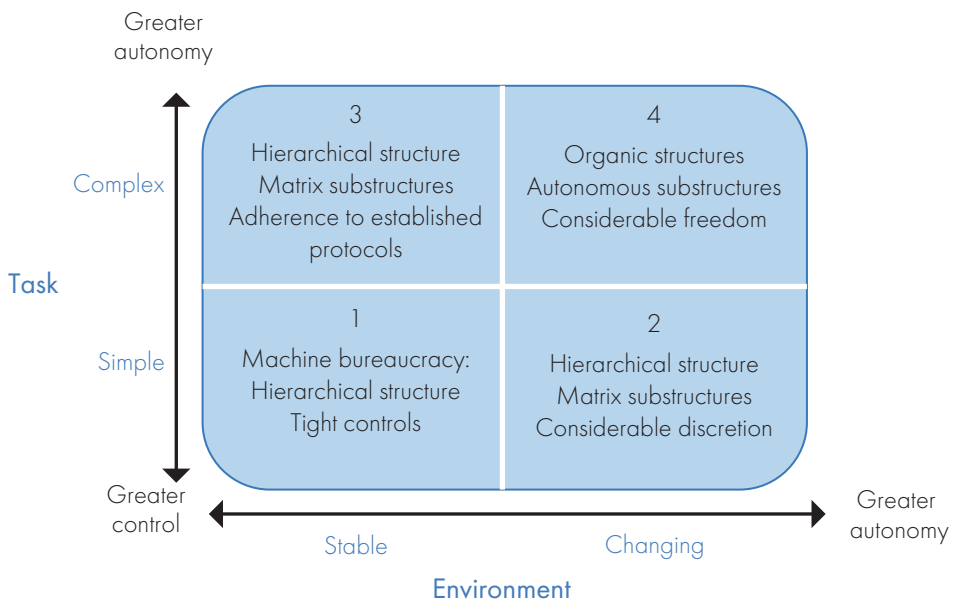


Figure 14.11 Structure, task and environment

Quadrant 2

As the environment becomes more changeable, standardisation becomes less viable and responsibility for coping with unexpected changes needs to be pushed down the hierarchy. Staff usually have more autonomy, although within guidelines. The structure needs to be responsive to change – although hierarchical, it is relatively flat with few middle-management positions. A matrix substructure (teams) can be used to tackle unexpected projects. Culture is important because the workforce needs to be motivated to make frequent changes to their work practices. It is appropriate for most jobbing and batch-production businesses (e.g. a team of skilled craftsman).

Quadrant 3

Complex tasks performed in stable environments mean that it becomes worthwhile to develop standard skills to tackle the complexities. The matrix can be an effective substructure within a hierarchical organisation. The matrix team can work on their complex tasks within set protocols, as they do, for example, in a surgical operation. In a changing environment the matrix team must have a higher degree of autonomy because established protocols may be inappropriate to the changing circumstances, even for the simple tasks they face. It is appropriate for most jobbing and batch-production businesses (e.g. the kitchen of a high-end restaurant).

Quadrant 4

In a changing environment where there is high task complexity, organic structures are most appropriate. Teamworking is likely to be the norm to help deal with these complex situations, and matrix-type structures across different functional specialities may facilitate this. Staff autonomy needs to be high with authority for decision-making delegated down to enable staff to deal with changing circumstances. Clear job definitions should never lead to a narrowing of responsibilities so that people ignore the new tasks that emerge. In many ways, far more important than the formal organisation structure for a firm of this sort is the culture that tells people what needs to be done and motivates them to do it. It is most appropriate for project-based production businesses, where tasks can be complex and specifications may change. It might also be appropriate in batch-production businesses where customer relations are vital. One of the characteristics of less hierarchical structures (such as teamworking) is that they rely on coordination by mutual adjustment rather than control through hierarchy. Individuals within them often have multiple roles and more freedom of action (e.g. a consultancy firm).

Figure 14.11 shows that the more complex the tasks facing employees and the less predictable their environment or situation, the greater their need for autonomy in decision-making. While this principle may seem straightforward, its application in practice can be more difficult, particularly in the context of a growing business. Which tasks are complex and which environments are uncertain? Both manual and cognitive tasks can have varying degrees of complexity. Innovation is a cognitive task that can be both complex and undertaken in an uncertain environment; however, that complexity can vary enormously. Innovation can be radical or incremental, continuous or discontinuous. Technological innovation is different to market innovation. Innovation in the pharmaceutical industry is of a different nature to that in the furniture industry. And all parts of an organisation may not be involved in innovation to the same degree – indeed some may involve simple repetitive tasks in a stable environment. So, different parts of an organisation may require different structures and controls to others – a problem that faces most businesses as they grow. As with most areas of management, there are no set rules and judgement needs to be applied in determining the 'balance' between control and autonomy. Nevertheless, hierarchy can hinder innovation and 'control by letting go' is generally seen as more effective than tight controls if innovation is to be encouraged (Kanter, 2008). Less hierarchy allows organisations to create value by making decisions faster than competitors (Blenko et al., 2010) and individual autonomy is a key element in this. Management control in these situations should be light and exercised more through the culture in the organisation than its structures – a topic we shall return to in the context of leadership and organisational architecture (Chapters 16 and 22).

Case insight 14.2 Specsavers (2)

Recruiting and selecting staff

We looked at the joint venture partnership model that Specsavers has in Case insight 11.3. Here we shall look at how it defines some of these roles in its retail outlets. As we saw, there are typically two business owners for each store: an optometry director and a retail director. A typical Specsavers store has a hierarchical structure, with layers of employees reporting up the hierarchy. The directors delegate responsibility for different tasks to managers lower down. However, to ensure consistency across these joint venture partnerships and safeguard its brand reputation, many of the Specsavers personnel policies and procedures are highly systematised and dictated by head office.

Specsavers stores typically have a flat management structure with a wide span of control, designed to facilitate communication between the retail and the clinical sides of the business. Store managers play an essential part in making sure that the store meets commercial objectives and targets for customer service. They are also responsible for recruiting, motivating, training and developing the store team. Each member of staff has a personal development plan developed with and monitored by the manager.

The larger the store, the greater the span of control of each manager. For example, in a large Specsavers store a store manager might have as many as 50 – 60 full- and part-time, appropriately trained optical assistants reporting to them. Optical assistants have delegated authority to deal with customer enquiries and make recommendations for selecting frames. Their job description includes: customer assistance; knowledge of products and treatments; understanding visual perception and basic visual defects; analysing prescriptions accurately and dispensing lenses accordingly; facilitating customer collections; and working to specified service standards.

There will also be several optometrists, dispensing opticians and laboratory assistants reporting to the directors. Optometrists have the responsibility for making sure that customers' eyes are tested and for recommending the appropriate type of lenses are provided for the customer. Laboratory assistants are responsible for making spectacles to customers' prescriptions on time and to the correct standard. They may report to a laboratory manager.

Specsavers puts great emphasis on recruiting and training highly motivated staff. Every job has a job description (e.g. for an optometrist these include: conducting full eye examinations; communicating the results to customers; providing dispensing advice; maintaining customer records; and maintaining cleanliness of test rooms and equipment). Based upon this, it draws up a person specification that sets out the skills required and the behaviours expected of employees in the specific roles. This enables Specsavers to match candidates to the relevant qualifications and entry requirements for each job, as well as identifying their potential for career development. Staff are set targets and standards to meet (e.g. optometrists are set targets for numbers of eye tests and resulting spectacle sales).

Individuals can join Specsavers at any level and there is plenty of opportunity for career development. For example, some staff who started as optical assistants are now business owners in their own stores. Specsavers say they also offer above-average pay scales and benefits such as free eye tests and discounted spectacles.

Questions:

1. What are the advantages and disadvantages of this form of highly systematised policies and procedures?
2. Are they appropriate for all businesses? Explain.

CONTROL, AUTONOMY AND MOTIVATION

Balancing control and autonomy in a small-scale start-up can often be achieved at the individual member of staff level. Somebody packing goods for delivery can be treated differently to the marketing manager. However, as the business grows this informality will disappear. Generally growing, entrepreneurial firms need looser control (or staff with greater autonomy), with tighter accountability for meeting targets and objectives. As the business grows, it can then afford to establish operating divisions or subsidiaries with different structures, different degrees of control and different cultures. But these principles also have some important implications for creative and high-tech businesses of any size.

It turns out that autonomy can be a great motivator for staff undertaking cognitive tasks where initiative and creativity are important. Many authors have emphasised the need for autonomy in promoting creative and entrepreneurial behaviour (e.g. Amabile, 1997; Isaksen and Ekvall, 2010) and others have found links between job autonomy and innovative behaviour (e.g. Burcharth et al., 2017; De

Spiegelaere et al., 2014). Staff enjoy the challenge of undertaking something that they find challenging but psychologically rewarding and use autonomy constructively. Pink (2011) quoted a number of studies across different countries which showed that, while monetary reward was a motivator for individuals undertaking mechanical tasks, it was not a motivator for individuals undertaking cognitive tasks involving complexity or creativity. This conclusion was reinforced by Phadke and Vyakarnam (2017) in their study of some 300 science and technology-based firms, many of which were high growth. They concluded that the links between organisational performance and employee rewards were generally weak. Both sets of authors concluded that once monetary reward was sufficient to be 'taken off the table', other less tangible factors were far greater motivators and led to greater personal satisfaction and better performance. In particular, Pink (2011) highlighted self-direction and autonomy as important motivators if you want people to be innovative, engaged with their tasks and proactive rather than just compliant. For employees undertaking creative tasks there were three key motivators:

1. **Autonomy** – freedom of action and self-direction, not being told what to do or how to do it, which encourages people to enjoy what they are doing (e.g. Google allows staff to spend up to 20 per cent of their time on innovation projects).
2. **Purpose** – a reason for doing something based not upon monetary remuneration but upon a wider vision of what the organisation can achieve (e.g. from CSR policies).
3. **Mastery** – the challenge of completing a complex or creative task. Pink (2011) cites Wikipedia and Linux as initiatives that have engaged highly skilled people in creative tasks without monetary remuneration.

The reason for this can be found in the literature on psychological ownership in organisations. Psychological ownership is when an individual 'feels' that they own the organisation or part of it, even if they do not. And it is promoted by the three factors outlined above. Pierce et al. (2001) see autonomy or loss of control as important because it provides feelings of 'efficacy' and 'effectance'. They argue that it is also promoted by investing time, ideas and energy and acquiring an intimate knowledge of the task – which is all part of mastery. What is more, psychological ownership creates a sense of responsibility in the individual which is evidenced as stewardship and a sense of social responsibility – or purpose – for the organisation.

So if autonomy is a strong motivator for staff undertaking cognitive tasks, the dilemma is the amount of autonomy to give them. Too much, and anarchy or worse might result. Too little, and creativity, innovation and initiative will be stifled. Foster and Kaplan (2001) advocated a minimalist approach to control:

> Control what you must, not what you can: control when you must, not when you can. If a control procedure is not essential, eliminate it … [Encouraging creativity] requires control through selection and motivation of employees rather than through control of people's actions; ample resources, including time, to achieve results; knowing what to measure and when to measure it; and genuine respect for others' capabilities and potential.

> *I'm mindful that if people ask for a pay rise, then we haven't been doing our job correctly.*
>
> Rob Jupp, Founder of Brightstar Financial, *The Sunday Times*, 23 February 2020

Explore further 14.4

Autonomy, purpose, mastery and task execution

Access the *Digital Links* booklet to watch the following videos:

- A Royal Society of Arts (RSA) animation explaining how autonomy, purpose and mastery can be strong motivators for tasks requiring cognitive skills.
- A *Harvard Business Review* animation about balancing task execution (control) with autonomy.
- An animation about how to increase creativity in the workplace.

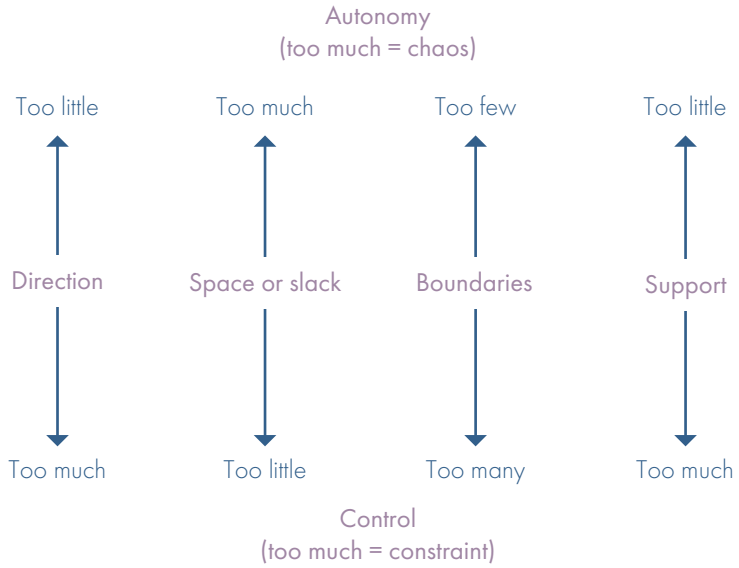


Figure 14.12 Control vs autonomy

> *Employees today should be encouraged to think for themselves. They should be cultivated to have an entrepreneurial, innovative spirit, and not just to implement orders.*
>
> Zhang Ruimin, CEO of Haier Group, *Strategy + Business*, Issue 77, Winter, 2014

More generally, Birkinshaw (2003) advocated the idea of 'balance'. He outlined the model used by BP to help guide and control entrepreneurial action: direction, 'space' or slack time, boundaries and support. All four need to be in balance. If they are not, either bureaucracy (constraint) or chaos might ensue. This is shown in Figure 14.12.

Direction

This is the company's broad strategy and goals. Managers should have scope to develop the strategy for their own operating unit, in line with the company's general direction, values and mission. Pink (2011) agrees, saying creative people need a strong sense of 'purpose' in their work, which is not just about making profit. Birkinshaw (2003) gave two pieces of advice on getting this balance right:

- Set broad direction and re-evaluate periodically as markets and the environment change;
- Let the company's strategy inform that of the operating unit (or the individual) and the unit's inform that of the company.

Space or slack

This is to do with the degree of looseness in resource availability – monetary budgets, physical space and supervision of time. In a tightly run, highly efficient organisation there is no time or other resources to think, experiment and innovate. Creative organisations require a degree of space or slack to allow experimentation. Garud and Van de Ven (1992) confirm that entrepreneurial activity in a large organisation is more likely to continue, despite negative outcomes, when there is slack in resource availability and a high degree of ambiguity about the outcomes. 3M allows researchers to spend 15 per cent of their time on their own projects. Google allows 20 per cent. However, if employees are given too much space they run the risk of losing focus on the day-to-day detail of the job and it can be wasteful. Birkinshaw's advice was:

- Goal setting should be carefully managed, clear and specific, but individuals should be given freedom in how the goals are to be achieved;
- Individuals should be allowed to learn from their own mistakes.

Boundaries

These are the legal, regulatory and moral limits within which the company operates. But rigid rules that are not shared beg to be circumvented. Boundaries should come from your values – which are shared

by your staff. Not having boundaries courts extreme danger, particularly if breaking them might lead to the failure of the organisation. Birkinshaw's advice was:

- Identify critical boundaries that, if crossed, threaten the survival of the organisation and control them rigorously;
- Manage other boundaries in a non-invasive way through training, induction, codes of conduct and so on.

Case insight 14.3 BP and Deepwater Horizon

Disaster management: Autonomy vs risk

You might think that BP proved an unfortunate example for Birkinshaw (2003) to use when he looked at this, given that the explosion in 2010 on the Deepwater Horizon offshore oil rig cost 11 lives and caused a vast oil spillage across the Gulf of Mexico. This disaster brought the concept of 'balance' into question when the risks faced were so great. Although financially very successful, at least until 2010, something clearly went wrong and BP took too many high-impact risks. In fact it had already demonstrated this with the explosion in the Texas City oil refinery in 2005 that cost 15 lives with 170 injuries and the Prudhoe Bay pipeline burst in 2006 for which it was fined $20 million. So what went wrong and why?

In the 1980s BP was seen as a cumbersome, bureaucratic organisation spread across too many lines of business. In the late 1990s BP slimmed down its range of activities and changed direction to focus its exploration activities on riskier, 'new frontiers' of oil and gas exploration that would also yield higher returns. It also flattened its organisation and decentralised in the way Birkinshaw described, reducing the size of its headquarters and establishing a number of business units, so as to encourage entrepreneurship and risk-taking. BP encouraged the use of self-managed teams as a way of organising the different layers of management and engineering, encouraging the horizontal rather than vertical flow of information. Heads of business units, which included managers of oil fields, were given more authority to run things the way they wanted to so long as they met performance targets, which in turn were linked to bonuses and rewards – loose control with tight accountability. As already observed, once targets were agreed they had 'free rein to deliver on their contract in whatever way they see fit, within a set of identified constraints'.

Birkinshaw's article was published in 2003, but BP's highly decentralised, entrepreneurial approach was reinforced when a new CEO, Tony Hayward, took over in 2007. He reorganised roles, reducing the number of senior executives from 650 to 500 (mainly in head office) and replacing almost a third. Despite the incidents in 2005 and 2007, he emphasised the need for operational efficiency and cost cutting in what was, essentially, a commodity supplier that needed maximum efficiency. The continued slimming down of BP's layers of management and specialist expertise was accompanied by increasing subcontracting of operational activities. In this model the self-managed teams, including subcontractors, were responsible for all aspects of project management from costs to safety, with the inevitable tensions and conflict of interests that creates. However, this model continued to deliver good profits. Although BP regularly said safety was its primary consideration, the team responsible for Deepwater Horizon (which included the subcontractor Halliburton who installed the cement casings and caps that ruptured) clearly got the balance wrong. But why?



Source: C. Morrison from Pixabay

Access the *Digital Links* booklet to visit the company website and watch an animation which gives a technical explanation for the blow out and a video which gives an overview of the accident.

Questions:

1. Given the reputational importance of safety at the corporate level and the high environmental impact of the spillage, was there sufficient 'direction' from head office at project level? Was there too much 'direction' given regarding the importance of cost efficiency? What does 'balance' mean in this context?
2. Was there any mechanism for resolving the conflict between safety and cost, within BP and with its subcontractors like Halliburton?
3. How can a company make judgements about the degree of direction, support, space and boundaries? Does this change at different levels in the organisation?

Support

This refers to the knowledge transfer systems and training and development programmes you provide to help managers do their job. Systems should encourage knowledge sharing and collaboration – a prerequisite for innovation. Training and career planning should be top down. Both should, however, be discretionary. The danger here is that knowledge will not be shared and there will be little collaboration, encouraging managers to go their own way. On the other hand, if there is too much support the manager will be 'spoon-fed' and initiative stifled. Birkinshaw's advice was:

- Put in place enough support systems to help managers and ensure they know where to go for help;
- Systems should encourage collaboration.

The broad conclusions are therefore that the greater the complexity of tasks and the more staff have to use their cognitive abilities – creativity and initiative – to undertake these tasks within the context of a changing environment, then the greater the need for autonomy. Autonomy is, however, not enough on its own. It needs to be combined with a sense of 'purpose' and the challenge of 'mastery' of that task. It can be influenced through giving individuals 'space' or 'slack' – looseness in resource availability which allows employees to 'borrow' time, expertise, research, materials, equipment and other resources as they develop new concepts – but with direction, boundaries and support. However, too much autonomy can become licence and it needs to be combined with a strong accountability. At the very least financial control systems must be aligned with structures so that departments, teams and/or individuals can be held accountable for their actions.

However, there is also the issue of risk and the impact some risks might have. Does greater autonomy mean greater risk? And should high-impact risks be delegated at all? In the case of BP, it is for you to conclude whether, in the light of the Deepwater Horizon oil spillage in 2010, the elements of control were in 'balance' or there was too much autonomy.

SUMMARY

- Any business is primarily about people and a business is only as good as the people that work within it. A start-up needs to develop a skills profile for the business as a whole – the skills, knowledge and networks that are needed to launch and operate it. These skills can come from a wide range of people; for example, founder(s), employees, partners, investors, professional advisors and the board of directors.
- Using skills profiles, job descriptions for key roles can be drawn up and, based on these, person specifications.
- Using professional advisors can be an attractive way of accessing a range of knowledge, skills and networks. By surrounding themselves with high-quality advisors the founder can help tackle the challenges of growth and add to the credibility of their start-up.
- Picking an effective management or venture team is about assembling the required skills but also about a mix of different personalities that can work together as a team. Belbin identified three orientations and nine team roles that are needed:
  - Thinking orientation: plant, monitor-evaluator and specialist.
  - People orientation: coordinator, teamworker and resource investigator.
  - Action orientation: shaper, implementer and completer-finisher.
- The management or venture team also need to have shared cognition – shared goals and effective communications and transfer of knowledge. This improves collective understanding within the group, and helps individuals with different functional backgrounds to reach consensus and avoid conflict.
- Structures create order but there is no single 'best' structure. The most appropriate structure for an organisation depends on the nature of the organisation, the strategies it employs, the tasks it undertakes, the culture it wishes to encourage, the environment it operates in and its size.
- As a firm grows in size it is likely to develop a more hierarchical organisation structure using organic matrix structures for small project teams. However, traditional hierarchical structures can be mechanistic, bureaucratic and rigid. It is most appropriate for simple tasks in stable environments.
- The greater the complexity of tasks and the more staff have to use their cognitive abilities to undertake these

tasks within the context of a changing environment, then the greater the need for autonomy. Autonomy is, however, not enough on its own. It needs to combine a sense of 'purpose' and the challenge of 'mastery' of that task. It can be influenced through giving individuals direction, slack time, boundaries and support. And finally, it needs to be combined with a strong accountability.

GROUP DISCUSSION TOPICS

1. Why does size matter for an organisation?
2. What are the advantages and disadvantages of using outsiders such as professional advisors in key roles?
3. What are the advantages and disadvantages of using only full- or part-time employees to fill roles within an organisation?
4. Why might the founder of a business seek partners?
5. Why is 'shared cognition' important?
6. What role do values and beliefs have in developing 'shared cognition'?
7. Why has the increasing importance of knowledge encouraged the growth of networks?
8. Why is organisational structure important?
9. What factors determine the 'best' size of an organisation and the 'best' way an organisation is structured?
10. Why does tight control stifle creativity, innovation and entrepreneurship?
11. Why, and in what circumstances, is autonomy important?
12. How do you determine the degree of control you should exercise over staff?
13. The concept of 'balance' between autonomy and control is of no practical use. Discuss.
14. How can you have loose control but tight accountability? Give examples.

STUDENT ACTIVITIES

1. Give some specific examples of an industry where a hierarchical, bureaucratic structure should be the 'best' way to organise. Select a company in this industry and investigate their organisational structure. Explain why their structure conforms or does not conform to your expectations, taking into account its relative commercial success.
2. List the type of organisations and market sectors that face high degrees of competition and turbulence. Select a particularly turbulent sector and research how the firms within it are structured and their relative success.

START-UP ACTIVITIES

1. Identify the skills needed for your business and how they might be met:
   a) List the skills, knowledge and competencies required for it and the job roles these translate into. Make sure all skills etc. are covered by these roles.
   b) Classify roles as 'key', 'important' or 'desirable'.
   c) Classify roles as 'full/part time' and 'regular/shift work' and note any special remuneration arrangements.
   d) Identify the roles the founder(s) will take and identify the resulting role gaps.
   e) Identify which roles or skill gaps might come from outsiders – professional advisors, partners, the board of directors and/or providers of finance.
   f) For the remaining role gaps, prepare a brief job description and person specification. Decide whether any of these roles should be filled by a partner or shareholder in the venture.
   g) List the areas where professional help and advice will be needed.
2. Decide on the organisation structure.
3. Decide on the terms of employment and job advertisements:
   a) Decide on remuneration levels (including bonuses and incentives) for all posts, including those occupied by founders.
   b) If the business is a limited company, decide which members of the management or venture team will become shareholders. Draft the main features of a shareholders' agreement. Remember that the advice of a lawyer must be sought before anything is signed.
   c) List their goals, performance measures and targets.
   d) Draft job advertisements for job gaps and decide how these will be advertised.
4. Take the Belbin team roles test and list the implications of this for you as the founder of the business.

15

FINANCIAL FORECASTS AND CONTROL

Contents

- Financial objectives
- Understanding profit
- Understanding the balance sheet
- Understanding cash flow
- Understanding breakeven
- Forecasting sales and costs
- Preparing financial forecasts
- Forecast bias
- Financial ratio analysis
- Setting and monitoring performance targets
- Key financial metrics
- Controlling performance as the business grows
- Using financial information for decision-making
- Summary
- Group discussion topics
- Student activity
- Start-up activities



Source: iStock.com/yevtony

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand the information contained in different measures of financial performance, including the difference between profit and cash flow;
- Understand how forecast and historic financial statements are drawn up and how they can be used to monitor performance – income statement, cash flow statement and balance sheet;
- Calculate breakeven point and understand its relevance and importance;
- Use contribution analysis to help with decision-making.

Case insights

15.1 Hays Travel

15.2 The English Pub* (2)

FINANCIAL OBJECTIVES

For any venture to survive and grow it needs to be financially viable and it needs to have good financial control. This can mean a number of different things. For it to be attractive to an equity investor – and the founder – it needs to be profitable and efficient. For it to survive it needs to be sufficiently liquid to enable it to pay its bills. Founders, investors and lenders are all interested in how risky the venture is. Assessing these things involves looking at a range of different concepts and measures, sometimes using a range of terminology (often UK vs US) for the same concept.

» Profitability – Profit is the difference between sales (also called turnover) and costs. A commercial business would normally want profits to be as high as possible. It measures how *all* the assets of the business have increased through trading activities – not just cash – and a firm may be profitable but short of cash – or vice versa. Profitability and how it is generated from sales and costs is shown in the income (or profit and loss) statement, which can be produced on a regular basis (usually monthly).

» Efficiency – Efficiency is about maximising the profits generated in a business from the minimum of assets. It is a measure of the *quality* of the profit generated and investors, including the founder, expect it to be as high as possible. If the financial return it makes (profit ÷ assets) is less than the going rate of interest, an investor (and founder) is better off putting their money in the bank to earn interest. Assets and liabilities are shown in the balance sheet of a firm. There are a number of measures of efficiency using a technique called 'ratio analysis', which is explained later. Notice, however, that since cash is also an asset, there is a tension between being highly efficient and highly liquid.

» Liquidity – Liquidity measures the ability of a business to meet routine, short-term financial obligations – its bills and wages. The most liquid of all assets is cash, and without a 'healthy' cash flow the firm might go out of business. The cash flow statement shows when cash comes into the business and where it comes from (e.g. sales and capital injections). It shows when cash expenditures take place and what those expenditures are for (e.g. wages, raw materials, other costs and capital investments such as buildings or plant and machinery). It shows the cash surplus (or deficit) at certain points of time (usually monthly).

» Risk – There are two sorts of risk measured in the financial statements. Operating risk is the level of risk a firm faces from the way it operates – the level of fixed costs that cannot be altered easily, compared to its profitability. This is usually measured by the breakeven point – the level of sales beyond which profits start to be made, The higher the breakeven point, the higher the risk, but what is really important is how far above this point are the sales of the business. Financial risk is the level of a firm's interest payments (which are also a fixed cost), compared to its profitability. This is usually measured by how many times its interest payments are covered by the profits it makes – called 'interest cover' – and the amount of borrowing it has compared to its total assets – called 'gearing' (UK) or 'leverage' (US). The higher the fixed operating and financing costs of a business, the higher its risk of making a loss, should sales fall below a certain level.

The financial objectives of a commercial business will usually involve being highly profitable and efficient, while maintaining adequate liquidity and minimising operating and financial risk. The challenge is quantifying these things and then achieving them. For a social enterprise with social objectives, profitability and efficiency may be constraints rather than elements to be maximised. However, whether it is a commercial or social enterprise start-up, the same financial statements will need to be drawn up and the principles of financial management remain the same.

> *The business side of any company starts and ends with hard-core analysis of its numbers. Whatever else you do, if you don't understand what's happening in your business factually and you're making decisions based on anecdotal or gut instinct, you'll eventually pay a big price.*
>
> Bill Gates, (1999), *Business @ the Speed of Thought*, New York: Time Warner

UNDERSTANDING PROFIT

Financial statements (whether forecasts or actual) comprise three elements. Each provides different, but consistent, information:

» Income statement;

» Balance sheet;

» Cash flow statement.

How a business actually performs is measured by its historical financial statements, usually produced annually. These are used as a basis for taxing the business. Companies in the UK must submit them to Companies House, where they are publicly available. Financial statements are also used to control the business, and most well-managed firms will produce monthly income statements and monitor their cash flow on an even more regular basis.

Profit is the difference between sales and costs over a period of time and results in an increase in the (net) assets of the business (not necessarily cash). Figure 15.1 shows how this process of making profit happens and what profit means. 'Money' (often called 'funds') comes in and goes out of the business as profits are made. This can take the form of cash but it can equally take the form of a 'promise-to-pay'. But at the same time 'money' might be spent on other things like assets or to pay taxes – but again this might be 'money' the firm owes rather than a cash payment. This 'money' is therefore not just cash, since it might owe 'money' or be owed it. It represents all the assets that the business owns or is owed, and this trading cycle is how 'money' (or funds) is created, accumulated and retained.

Start at 1 and work through the diagram in the sequence below:

1. A start-up needs to find capital in the form of cash. This could be a founder's own cash or, for a company, shareholders contributing share capital, both perhaps supplemented by bank borrowings.
2. This is now invested in assets to be used in the business. The assets will comprise long-term or fixed assets such as plant and machinery, office equipment, computers, vehicles and so on, and assets for use on a day-to-day basis. They will also include stocks (or inventories) of goods for resale, stocks of consumables to be used in the office, and, of course, cash to pay the bills. These are called 'current assets'. The initial investment of cash has now turned into other assets, but all this 'money' is still retained in the business.
3. The assets are then used to generate sales. Goods are resold, services are rendered – sometimes for cash, sometimes on credit. This is the first stage on the way to making profits.
4. Of course, making sales is not enough to guarantee profits. Sales might be high, but if day-to-day business costs (paid for in cash or on credit) are higher, then a loss rather than a profit will emerge. So there is a need for management to control day-to-day costs and produce an operating profit. There are also fixed costs or overheads that need to be controlled (see Chapter 9). Other non-routine costs, such as loan interest, might also have to be deducted. All this 'money' leaves the business.

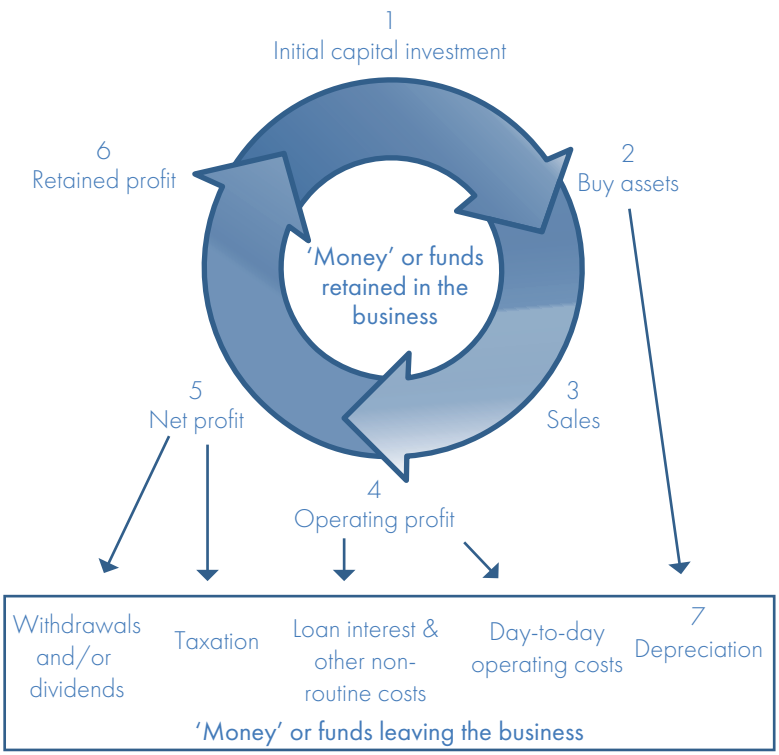


Figure 15.1 The 'money' generation cycle

5. The result is net profit. This is still not, necessarily, cash because customers might have not paid in cash or the firm might not have paid all its bills. However, it does represent an increase in the total assets of the business. If the business is established as a sole trader, cash may now be withdrawn. If the business is a limited company, corporation tax is paid and then dividends may be paid to shareholders. Sole traders pay income tax on the profits of the business and shareholders pay income tax on their dividends.
6. The balance of retained profits represents an increase in the capital of the business. However, this capital is still not, necessarily, cash. It can take the form of any assets. This is important as a business will need a constant flow of capital to replace existing assets which are used up and to expand and grow.

Information from items numbered 1 to 6 in Figure 15.1 are all reported in the financial statements – 3, 4, 5 and 6 in the income statement and 1 and 2 in the balance sheet. The cash flow statement tells you only how one asset within the balance sheet – cash (reported on in 2) – has changed over the period.

The income statement, therefore, does not tell you about new capital that might have been introduced into the business nor the assets the firm might own in order to generate profit. It tells you about how the business goes about trading to increase the assets it has. If those assets in box 2 are being used in the business the profit statement needs to recognise that there is a cost associated with this. For assets that are traded (stock/inventory) this is simply a cost to be charged against the sale. But for a fixed asset that has a life of a number of years the cost is allocated using a method called 'depreciation'. Whereas the cash cost of an asset is recognised in the cash flow statement when the cash is spent, the cost of the asset needs to be somehow allocated over its life to the profit statement as a cost of doing business.

7. Depreciation is a way of allocating the cost of an asset over its life in the profit statement. It is a major difference between profit and cash flow. The simplest method of calculating depreciation is called 'straight-line', which writes off the asset in equal amounts over its life. For example, if the asset cost $10,000 and has a working life of five years, at which time it can be sold off for $2,000, the annual depreciation would be:

$$\frac{\text{Initial cost} - \text{final residual value}}{\text{Life of fixed asset}} = \frac{\$10{,}000 - 2{,}000}{5} = \$1{,}600 \text{ per annum}$$

As shown in Figure 15.2, the value of the asset would go down by $1,600 each year. At the end of year one it would have a value of $8,400, year two $6,800 and so on, until year five when it would be $2,000. Each year the depreciation expense of $1,600 would be reported in the income statement. Although this is 'money' leaving the business, it does not represent any cash expenditure – that takes place when the asset is purchased.

$1,600	Written-off the value of the asset in year 1 as depreciation expense
$1,600	Written-off the value of the asset in year 2 as depreciation expense
$1,600	Written-off the value of the asset in year 3 as depreciation expense
$1,600	Written-off the value of the asset in year 4 as depreciation expense
$1,600	Written-off the value of the asset in year 5 as depreciation expense
$2,000	Residual value of asset

Figure 15.2 Asset depreciation

Tech start-ups often face high development costs and it is controversial whether or not these should be shown as expenses when they are incurred or as an asset that can be depreciated or written off over some timescale – a timescale that is becoming increasingly short as technological development accelerates. There are three approaches. The 'prudent' approach would be to write these costs off immediately. Less prudent would be to write them off over a specified time period (e.g. five years), or, finally, to try to predict sales and allocate a development cost to each unit sold (very difficult).

Normally, firms sell their goods or services for more than they cost to produce – income exceeds costs – and the income statement therefore shows how all the assets of the business have grown through trading. Profit is not an exact figure since it involves elements of judgement, for example in the calculation of depreciation or an estimated liability. A sole trader can charge whatever they want for their services (shown as 'drawings' in the income statement) and even allow other family members to draw a salary, whether reasonable or not (although they still face taxes). Founders of limited liability companies can pay themselves either by way of salary or dividend. Profit can therefore be manipulated.

Finally, it is worth pointing out that the income statement on its own does not tell you how well a firm is doing. If the firm makes a profit of $5,000 from a capital investment of $250,000 it is making a return of only 2% ($5,000 divided by $250,000) and would probably be better off putting the capital in a bank to earn interest at no risk. This is measured by another financial ratio – the return on capital.

UNDERSTANDING THE BALANCE SHEET

The balance sheet lists the assets the business owns alongside its liabilities and capital. It is a snapshot at a point of time. A balance sheet lists two things that ought to come to the same value:

1. The assets that the business owns (whether paid for or not):
   - Cash;
   - Debtors (UK) or receivables (US) – amounts owed to the firm from sales to customers;
   - Stock (UK) or inventory (US) – raw materials, work-in-progress and stocks/inventory of finished goods;
   - Fixed assets – things the business means to keep over a number of years such as equipment, machinery, vehicles, premises etc. The net 'value' of these are shown after depreciation has been charged to the income statement.
2. Where the funds for these assets came from and therefore what might be owed to other people or belong to the shareholders:
   - Overdraft and loans;
   - Creditors (UK) or payables (US) – amounts the firm owes to suppliers of goods and services;
   - Share capital invested in the business by shareholders;
   - Profits for the period and accumulated profits from previous years (or losses), which belong to the shareholders. Remember, profits/losses measure how the net assets (assets – liabilities) of the business have increased/decreased.

There are two sides to the balance sheet and, as depicted in Figure 15.3, they always balance. This is an ancient method of financial control called 'double-entry' bookkeeping. As long as you have a record of 'money' coming in and going out of the business – the transactions taking place – you should therefore know the assets that the business should have. If any assets 'go missing', the balance sheet will not balance and you know something is wrong.

Let us look at a series of simple transactions to see how this works. If you drew up a balance sheet when you invest $10,000 capital in a new venture (as a company) it would show two things: cash $10,000 and share capital $10,000. If you went on to purchase assets with the $10,000 of cash, those

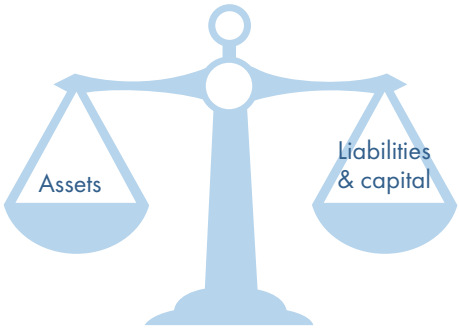


Figure 15.3 The balance sheet

assets would be listed together with their purchase price, and the other side of the balance sheet would remain the same, showing where the funds of $10,000 for these assets came from. If you can secure more funds or credit, this would be shown in the balance sheet as a liability, with the assets purchased on the other side of the balance sheet as assets. In this way, stock (or inventory) purchased on credit for $5,000 would be shown on one side of the balance sheet as a creditor (or payable), with the stock (or inventory) shown on the other side as an asset.

Assets	$10,000		Creditors/payables	$5,000
Stock/inventory	$5,000		Share capital	$10,000
	$15,000			$15,000

Once the business starts trading and making a profit by charging a higher price for the product than the cost of production, the assets of the business will start to grow. If it sold this stock for $10,000 (on credit rather than for cash), making a (accumulated) profit of $5,000, the balance sheet would change, but it would still balance.

Assets	$10,000		Creditors/payables	$5,000
Stock/inventory	0		Share capital	$10,000
Debtors/receivables	$10,000		Accumulated profit	$5,000
	$20,000			$20,000

UNDERSTANDING CASH FLOW

Cash flow is about how quickly a firm can convert the 'money' in the cycle in Figure 15.1 into cash. Convert it quickly and its cash flow improves, slowly and it deteriorates. The better a firm's cash flow, the more cash it has available for other purposes such as investment or unexpected events. The cash 'burn' rate is the rate per month at which a business uses up its cash reserves – the monthly excess of cash payments over cash receipts.

This is the notorious Death Valley for a start-up where cash flow dries up, and external finance is needed (Figure 15.4a). Without external finance the start-up would be unable to pay its creditors/payables and may not survive. The length and depth of Death Valley depends on how quickly the firm pays cash out (e.g. to creditors/payables) and how quickly it collects it in (e.g. from debtors/receivables). Its depth determines how much the firm needs to borrow (maximum borrowing requirement) and its length determines how long it will need to borrow for (borrowing period). The shape of the valley can vary from industry to industry and the negotiating power of suppliers and/or customers. It can also be affected by the economic cycle, for example, customers might take extended credit in an economic downturn. And the faster the growth of a business, the deeper and longer Death Valley is likely to be. For a start-up, if actual sales exceed forecast sales (shown as Profit 2 in Figure 15.4b), cash flow is likely to worsen and Death Valley will lengthen – despite increased profitability (shown as Cash flow 2 in

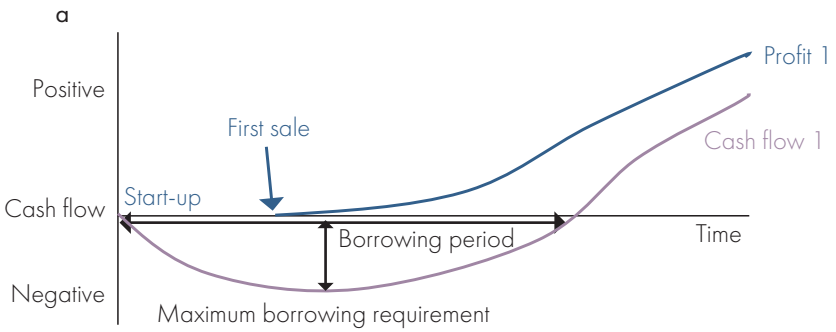


Figure 15.4a Cash flow and Death Valley

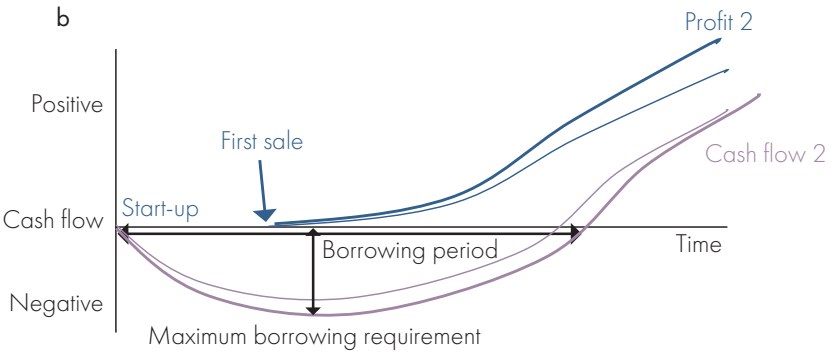


Figure 15.4b Cash flow and Death Valley when sales are better than expected

Figure 15.4b). Even a profitable company experiencing unexpected rapid growth can run out of cash – it is called overtrading. So, be warned – success breeds danger and many firms do not survive long enough to come through Death Valley.

For any start-up Death Valley needs to be mapped out and plans made for how it is to be navigated. That means preparing a cash flow statement or forecast. This shows when cash comes into or goes out of the business and where it comes from or goes to:

Cash flow in any period = Total cash receipts – Total cash payments

Only this will tell the founders how much finance they might need to launch their business. By altering the assumptions on which the cash flow model is based, they can see the effects on Death Valley. A good model should allow them to understand how they might reduce the depth and length of Death Valley.

To illustrate the difference between cash flow and profit we shall take the example in Table 9.2 (reproduced as Table 15.1) and introduce one additional piece of information. To recap, this is the sale of Lego figures for $3 a box at a car boot sale that costs $10 for the pitch (a fixed cost, paid in cash). These boxes are purchased for $1 each. The new piece of information is that they must be purchased in batches of ten boxes at a cash cost of $10. The resulting cash flow (shaded area) looks very different to the profit reported. If you sell only one box you have a cash deficit of $17 but show an accounting loss of only $8. The reason for this is because, to calculate (full-cost) profit/loss, the cost of the pitch plus the cost of the number of Lego boxes actually sold (not all ten purchased) is allocated against the income – costs are 'matched' against income in each period. The nine unsold Lego boxes are then recorded as an asset, valued at $9. Accounting profit/loss ($–8) represents the increase (or decrease) in net assets – in this case an increase in stock/inventory of $9 and a decrease in cash of $17 ($9 – $17 = $–8). Only when all ten boxes are sold and there are therefore no other assets, is cash equal to profit at $10.

> *We have always very carefully managed growth against profitability. Cash is king.*
>
> Eileen Gittins, founder of Blurb, *BBC News Business*, 11 December 2012

Table 15.1 Cost, profit and cash flow example

BOXES SOLD	1	2	3	4	5	6	7	8	9	10
Income (cash) [A]	$3	$6	$9	$12	$15	$18	$21	$24	$27	$30
Cost of boxes	$1	$2	$3	$4	$5	$6	$7	$8	$9	$10
Profit	$2	$4	$6	$8	$10	$12	$14	$16	$18	$20
Pitch cost [B]	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10
Net profit/ (loss)	$(8)	$(6)	$(4)	$(2)	$nil	$2	$4	$6	$8	$10
Batch cash cost [C]	$10	$10	$10	$10	$10	$10	$10	$10	$10	$10
Cash flow [A – B – C]	$(17)	$(14)	$(11)	$(8)	$(5)	$(2)	$1	$4	$7	$10

UNDERSTANDING BREAKEVEN

The breakeven point is an important piece of financial information. It is the point where a business stops making a loss and starts making a profit – where sales revenues are equal to the total costs. Some costs, often called 'overhead costs', are fixed – they do not change with the volume of activity or sales (at least up to a certain level of output) – for example, property lease/rental costs or fixed wages and salaries. These fixed costs are represented by the dotted horizontal line AB in Figure 15.5. Producing the product or delivering the service will mean incurring additional variable costs – costs that vary with volume like materials and direct, piecework labour costs. Every time an additional unit is produced and sold, an additional cost is incurred. Line AC therefore represents the total cost of producing the product or delivering the service – the fixed cost plus the variable cost. Over large volumes, this line may curve downwards as the effects of economies of scale are felt. Line LM represents the revenue generated by total sales (or turnover) – sales volume multiplied by unit price. At volume X all costs are covered by revenue. This is the breakeven point. If target sales volume is Y, this will generate the profit represented by the distance between lines LM and AC (total sales – total costs).

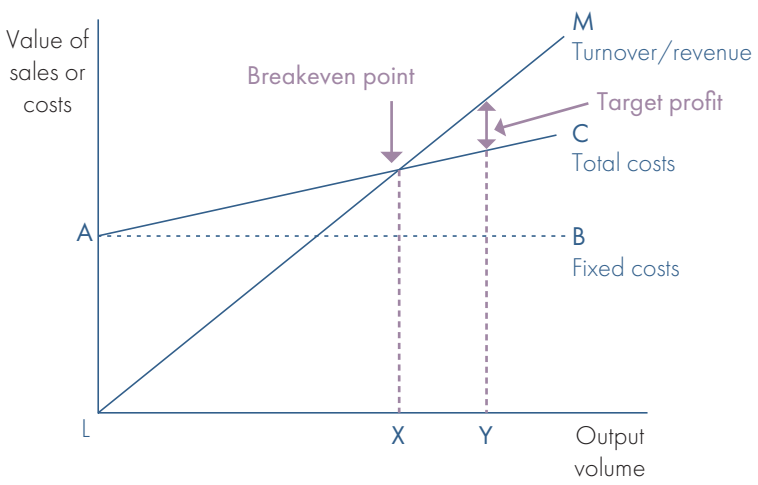


Figure 15.5 Breakeven point

The higher the breakeven point, the more sales needed before a firm makes a profit and therefore the higher the risk it faces. The lower the breakeven point, the less risk it faces. Indeed, if the breakeven point cannot, reasonably, be expected to be achieved then a venture is probably not viable.

The breakeven point can be easily calculated without a diagram using the formula:

$$\text{Breakeven point (expressed in \$ turnover)} = \frac{\text{Fixed costs}}{\text{Contribution margin}}$$

Contribution per unit is the difference between the sales price and the variable cost of each unit sold. Total contribution is the difference between total sales (turnover) and total variable costs. Contribution margin can be calculated per unit or based on totals and can be expressed as a decimal or, more usually, as a percentage:

Contribution margin = Contribution per unit ÷ Unit sales price

or = Total contribution ÷ Total sales or turnover

Referring back to the Lego figures example in Table 15.1, the contribution margin was 0.67[1]or 67%. The breakeven point was therefore \$15 (\$10 ÷ 0.67 = \$15). Once above that breakeven point, each \$1 of sales contributes \$1 (67%[1]) to profits. If you start with a profit rather than a sales target you can use the breakeven point to work out the level of sales you need to achieve this. Dividing your profit target by your contribution margin tells you how much above the breakeven point you need to be. Using the Lego example, if the profit target was \$10, the sales would have to be \$15 *above breakeven* (\$10 ÷ 0.67[1] = \$15), that is \$30 (\$15 + \$15) or nine boxes. If the profit target was \$8, the sales would have to be \$12 *above breakeven* (\$8 ÷ 0.67[1] = \$12), that is \$27 (\$15 + \$12), or nine units.

This works the other way round. So long as you know the breakeven point and contribution margin, it can be a useful tool for estimating profitability based simply upon the sales in any period:

Profit = (Actual sales – Breakeven sales) × Contribution margin

Continuing with the Lego example, if sales were \$30, profit would be \$10 ([\$30 – \$15] x 0.67[1]). If sales were \$27, profit would be \$8 ([\$27 – \$15] x 0.67[1]).

Even if a firm keeps its fixed costs low at start-up, they are bound to creep up as the business grows. As fixed costs increase, the breakeven point will also drift up and what is really important is the relationship of the breakeven point to total sales or turnover – how far above breakeven the business is able to trade. This is measured by the margin of safety:

$$\text{Margin of safety (normally expressed as \%)} = \frac{\text{Turnover} - \text{Breakeven}}{\text{Turnover}}$$

Returning to the Lego example, if sales were \$30, the margin of safety would be 50% ([\$30 – \$15] ÷ \$30). If sales were \$27, the margin of safety would be 44% ([\$27 – \$15] ÷ \$27).

The higher the margin of safety, the lower the operating risk facing the business. This reflects a number of factors: level of sales (the higher the better), contribution margin (the higher the better) and fixed costs (the lower the better). It is therefore a simple but powerful piece of information that can be used to monitor operating risk and control a business as it grows. If the margin of safety can be maintained (or increased) as a business grows, despite the increase in fixed costs, it shows that the operating risks of the business are under control.

1 There is a rounding up error here that effects calculations: \$2 ÷ \$3 = 0.66 reoccurring.

Case insight 15.1 Hays Travel

Cash flow and breakeven

Hays Travel is a Sunderland-based family business run by John and Irene Hays. It bought the travel operator Thomas Cook out of liquidation in October 2019, taking over 550 retail locations and more than 2,000 employees. There were a number of reasons for the collapse of Thomas Cook, but unlike that company Hays does not operate as an airline, merely as a travel agent and tour operator. Travel agents can enjoy positive cash flow, taking advance deposits for flights and holidays and receiving full payment long before they eventually pay for flights or hotels. However, they still face significant fixed costs that can drain their cash reserves – costs of their call centres, retail shops and overseas representatives. The main costs are staff wages and salaries and shop rent and rates.

When the coronavirus pandemic first struck the UK in early 2020, with lockdowns and travel restrictions, Hays still believed it could weather the storm. It took on government call centre work and received government wage support. When travel restrictions were lifted in the middle of the year it saw a surge in bookings. But the travel restrictions were re-imposed within a couple of months and the company found that its deposit repayments and other normal cash-costs were draining some £400,000 a day. The company had never made anybody redundant in its history but in August 2020 it shed some 900 jobs from its workforce of 4,500. Other staff were required to take a pay cut. The fate of its 600 or more retail stores remains unclear but footfall in the UK's high streets has plummeted since the pandemic and many of the redundancies were focused on the exchange section of the company who are primarily store-based. The company is said to have a strong balance sheet and significant bookings for holidays for 2021 and has said that its shops, contact centres and homeworking division remain operating at full capacity.



Source: Getty Images/mbbirdy,Matjaz Boncina

The company was badly hit by the second Covid-19 national lockdown in November 2020. This was compounded by the sudden death of John Hays. The future for the company is uncertain.

Access the *Digital Links* booklet to visit the company website and to watch a series of short interviews with John and Irene Hays about the redundancies.

Questions:

1. Why does this sort of business have a high breakeven point? How might this be reduced?
2. Why does this sort of business usually have positive cash flow?
3. What are the business imperatives and critical success factors for this sort of business?
4. What has happened to Hays since this case was written? Could the company have done anything more to mitigate the events of 2020? What lessons do you learn?

FORECASTING SALES AND COSTS

Just as you can have historic financial statements that show how a business actually performed, you can also have predicted financial statements or financial forecasts that show how you believe it will perform in the future. Forecasting the financial results of a start-up can be tricky – essentially they are nothing more than a 'best guess'. However, they will be used, just like actual results, to evaluate the (forecast) performance of the business as part of the business plan. Financial forecasts in a business plan are typically for at least a three-year period – five years for larger projects where significant commercialisation risks, particular to the project, have not been resolved.

Financial forecasts can start either one of two ways:

» By forecasting sales or turnover and the costs needed to generate them – the result is the firm's profit in that period (this is the most usual approach);

> *Ensure you are realistic about the amount of time it will take to become financially viable.*
>
> Angie Coates, founder of Monkey Music, *The Sunday Times*, 30 November 2014

» By calculating the costs needed to set up the business and then working back to a level of sales that are needed to generate a target profit level.



Source: Scott Graham on Unsplash

Whichever approach is taken, a number of iterations – altering price, volumes and/or costs – will probably be necessary before a satisfactory profit target is calculated. Monthly sales forecasts will be needed for the first year – perhaps for longer where these significant commercialisation risks remain unresolved. Sales revenue in the income statement should be net, after deducting sales returns and allowances and any discounts.

Sales income for physical goods or services might come directly to a business from consumers (at retail price) or might be derived from its channels of distribution (at wholesale price) – both calculated simply as price x number of units sold. Related costs will be the cost of sales (materials, labour, factory overheads), and operating expenses: sales and marketing costs (reps, tradeshows, etc.), delivery and distribution costs, administration and so on.

Sales income for virtual goods or services might also be derived from direct sales to consumers (downloads from the firm's website), for which there will be the cost of making these sales over the web (e.g. the firm might use AdWords, emails or other incentives, or offer existing customers a monetary incentive for referring new customers), or through app stores, where there will be a fee (typically 30 per cent) – treated as selling and marketing costs. Other costs will include operating expenses and product development costs (which we deal with later).

Virtual goods or services might be offered free and income derived from advertising or click-throughs. Web advertising income is typically determined by the number of page views a product generates. The firm might also be able to sell-on its email list. Costs will include customer acquisition costs and other operating expenses as well as product development costs.

Realistic, achievable sales forecasts are the starting point for the rest of the financial forecasts, so it is important that they are more than just aspirations. However, as we observed in Chapter 4, the more radical the product/service innovation and/or market innovation, the more difficult it will be to forecast sales. Market research is unlikely to yield an insight into demand for this kind of new product/service or market because customers do not understand it. Often the only sure way of knowing whether the idea will make a lucrative business is to try it out – launch the business but minimise the risks of doing so (lean start-up). That means calculating the minimum costs needed to set up the business and then working back to the level of sales needed to generate a target profit level. After that it is about taking the leap of faith that Henry Ford and Steve Jobs did, but if a firm needs financial backers it will need a persuasive argument and very attractive profit targets.

For more incremental innovations in product/services or markets the sales forecasts need to be justified by demonstrating two conditions:

1. There is sufficient market demand – The firm might be able to do this by market research that demonstrates that there is a market need that is, as yet, unmet. This can take many forms but must be underpinned by a convincing understanding of customers, competitors and differential advantage. For example it might be possible to demonstrate from desk research that there are relatively few competitors within a certain geographic area, compared to market demand. It might be possible to establish the total size of the market (TAM and SAM) and it should certainly be able to show market growth (Chapter 5). Alternatively, if potential customers can be identified it might be possible to contact them directly to establish whether they might be willing to at least try the product/service. Before opening a new shop in a certain area, footfall (number of passers-by) in that area might be measured by simple observation – field research. Another approach is to demonstrate that the

market share aimed for in a particular market is so small that it is highly likely to be achieved (the SAM compared to the TAM). In this case the definition of this market needs careful attention. While a firm may not be able to prove there *certainly* is sufficient market demand, it should be able to establish that there *probably* is.

2. Targets are achievable, within the operating and cost parameters of the business – Forecasts need to be internally consistent. There is no point in convincingly forecasting sufficient demand if the associated costs are insufficient to meet demand. It is important to make clear the assumptions upon which sales forecasts are based. That means clearly stating selling prices and volumes and ensuring that the volumes predicted are consistent with costs. Some costs that need to be incurred to set up the business are fixed costs and will not change significantly if the sales forecast is inaccurate. These forecasts can only be 'reasonable estimates'. Some costs are variable costs that vary with sales volumes, for example materials or piecework labour costs. Every time an additional unit is produced and sold, an additional cost is incurred. These costs vary with the sales forecast, and can be calculated on a percentage of sales.

Investors will typically pay great attention to the assumptions underpinning the financial forecasts of a new venture, and if they feel they are unrealistic it may severely dent the credibility of the entire plan. They will often apply a range of pragmatic, common-sense tests. For example, predicted sales for a retail business could be divided by the selling space taken up. This can often be compared to industry norms. Alternatively, forecast sales per day might be calculated, divided by the expected average spend per customer to arrive at a figure for buyers per day which can then be compared to footfall and buyer conversion rates. In a bar or restaurant total sales estimates can be checked against the number of covers and the average spend per cover needed to achieve that target. Remember also that sales may come from different distribution channels, each with a different profit margin. However it is shown, investors will certainly want to know the volumes and price assumptions that underpin these estimates.

PREPARING FINANCIAL FORECASTS

Forecast income statement

Once estimates of sales and associated costs have been made, the profit forecast can be prepared. This is simply done by slotting the estimates into an accepted format for an income statement. The amount of detail entered into is a matter of judgement, but the larger the start-up, the greater the detail that will be expected.

Financial statements generally highlight the gross profit of a business. From this the operating costs (such as selling, marketing, administrative costs etc.) are deducted to arrive at the operating profit, and from this financing costs (interest) are deducted to arrive at net profit (before taxes and dividends).

Gross profit	= Sales (or turnover) – cost of sales (e.g. materials, labour etc.)
Operating profit	= Gross profit – operating costs
Net profit	= Operating profit – interest

The cost of sales is the cost of the goods sold, including sales commissions. This can include both variable and fixed costs. For a shop these costs represent the cost of the items sold – which indeed is a variable cost. For a service business, such as a consultancy, most costs, like salaries, will be fixed and very few costs will be variable.

For a manufacturing business, in addition to the cost of the raw materials there will also be labour costs involved in adding value to the goods. If workers are paid by the volume they produce – called 'piecework' – then this is a variable cost. However, most employees now expect to be paid a regular weekly wage – which is fixed. However, if volumes change beyond certain levels new employees might have to be recruited or existing employees made redundant. The cost of sales will also represent other fixed factory overheads (e.g. depreciation of machinery and equipment). Cost of sales for a manufacturing

business therefore might comprise material costs (variable), labour costs (variable and/or fixed) and factory overheads (fixed). To work out the cost of goods sold (and the value of the goods held in stock) the cost of each manufactured product needs to be known. That means undertaking a costing exercise so that the fixed costs can be spread over the volume of goods *produced* – not necessarily the same as goods sold (see Bonus Case: Xtreme SnoBoards (2)). This is the basis for what is called 'cost+ pricing' (Chapter 9). If a manufacturing business fails to sell everything it produces, the cost of the extra it produces is reflected in the valuation of the unsold stock or inventory. To summarise, the cost of sales is a variable cost for a shop, probably fixed for a service business (up to a certain level of output) and comprises both variable and fixed costs for a manufacturing business.

> *Keep your costs to a minimum. If you can work from home and do your own PR in the beginning this will give you the cash to develop the product.*
>
> Calypso Rose, founder of Clippy, *Daily Telegraph*, 6 February 2009

For a business selling virtual goods or services through virtual channels (e.g. apps or games), there are no physical 'goods'. As we have already discussed, how the development costs for technology products (including virtual products like apps and games) are treated is controversial. Prudently, the development costs for these could be treated as an expense in the year of development. This is usual for smaller developments (e.g. for apps) but larger development costs (e.g. for games) will be treated like depreciation and allocated over the life of that asset. These are disclosed as development costs, not cost of sales. However, there are likely to be other variable costs that relate directly to sales, such as commissions or app store charges. These are cost of sales. The major operating costs facing these businesses are labour costs, which will mainly be fixed overheads and are not a direct cost of sales.

Forecast cash flow statement

A cash flow forecast lists the expected cash receipts and payments for the business in the period they are expected to come in or go out. The cash a firm has in any period is calculated by adding (or, if negative, subtracting) the period cash flow to the cash balance brought forward from the last period. It can be prepared on a daily, weekly or, more normally, a monthly basis. It is a vital part of a start-up business plan as it shows the firm's liquidity – how much cash it has – or its borrowing requirements. Monthly sales and cost estimates must be converted into monthly cash receipts and payments. For example, if a firm's terms of a credit sale are payment within one month, it will show the cash receipt coming in one month after the sales estimate. Similarly, if it purchases assets on credit, it might expect to pay cash after, say, one month.

Total cash receipts for the month are netted off against total cash payments and the resulting balance (negative or positive) is carried forward to the next month. Remember that depreciation is not a cash expenditure. The process is repeated each month until the total for the year end is arrived at. This cash balance should agree with the amount shown in the balance sheet. As with sales, it is important that the assumptions on which it is based are clearly listed.

Forecast balance sheet

As we have observed, the balance sheet lists the assets the business owns (whether paid for or not) alongside its liabilities and the shareholders' capital. Fixed assets are shown net of accumulated charges of depreciation (for this and previous periods). Depreciation for this period is also shown as an expense in the income statement. The profit for any period is added to any retained or accumulated profits from previous periods.

Typical formats for the income statement, profit forecast and balance sheet are shown in the Xtreme SnoBoards (2) Bonus Case insight on the companion website.

FORECAST BIAS

Chapter 3 highlighted how entrepreneurs are generally seen as being optimistic, sometimes unrealistically so. You might argue that it goes with the job. In a review of the literature, Coelho (2010) concluded that entrepreneurial characteristics, such as emotional commitment to the project and a belief that it is controllable, and empirical research indicate that entrepreneurs are indeed *unrealistically* optimistic. Chen et al. (1998) argued that it is this self-efficacy – a belief in their own capabilities – that

motivates entrepreneurs and gives them the dogged determination to persist in the face of adversity, when others just give in. We also noted how entrepreneurs appear to make extensive use of cognitive heuristics (simplifying strategies). Delmar (2000) observes that this created 'bias' in their decision-making. Possibly because of this, they can be seen as 'overconfident' (Forbes, 2005), particularly with regard to predicting a future outcome, to the point of escalating their commitment (Baron, 1998; Gibson and Sanbonmatsu, 2004).

It seems likely therefore that this optimism will extend into the financial forecasts an entrepreneur will produce. However, since these forecasts are confidential and often commercially sensitive documents, there is little research into their accuracy. Nevertheless, using data from larger, venture-backed businesses, studies have generally concluded that entrepreneurs' income and profit forecasts tend to be over optimistic (Armstrong et al., 2006; Collewaert and Vanacker, 2011), although the studies are contradictory about whether this over optimism increases over extended forecast periods. One large-scale empirical study of the forecast performance of entrepreneurial start-ups concluded that industrial experience improved the accuracy of forecasts, particularly in tech firms, but contrary to general belief start-up experience as such did not improve forecast accuracy (Cassar, 2014).

FINANCIAL RATIO ANALYSIS

Performance metrics are frequently based upon financial indicators. Accounting systems usually produce this information routinely, so it is easily accessible. The performance of a business can be analysed using a technique called 'financial ratio analysis'. This measures the relationship between two financial indicators. If we start with the usual economic purpose of most businesses ('profit' maximisation) and then outline some of the most frequently used ratios, you can see that these ratios are designed to provide information for that purpose. You will also see how the ratios build to form a picture of why the company's financial situation is what it is.

Investors – and founders – usually want to maximise the return ('profit') they get on their investment. If they invest $100 and receive $10, they get a 10 per cent return which they can then compare to other investment opportunities. The founder (and perhaps others) invest money in the share capital of the company and become shareholders. Shareholders in the business own all the assets of the firm and typically might expect to maximise the return they receive on this investment. Therefore, the performance ratio that shareholders expect to be kept as high as possible is the 'return to shareholders':

$$\text{Return to shareholders} = \frac{\text{Net profit}}{\text{Shareholders' funds}} \left(\text{expressed as \%}\right)$$

To maximise this, operating profit should be as high as possible, interest should be as low as possible and shareholders' funds should also be as low as possible. And here lies the dilemma. One way of keeping shareholders' funds low is to borrow (shareholders' funds = total assets – liabilities), but this increases interest payments and reduces net profit. So the question is, how much to borrow? The answer is that it pays to borrow as much as possible, as long as the return on these borrowings exceeds the interest rate. For example, the founder puts $5,000 into the business and then obtains a bank loan of $5,000 with an interest rate of 10%. If the return on this investment is 25% then they will make an extra 15% on the bank loan – a total of $750 ($5,000 x 15%). This goes directly to the founder, on top of the $1,250 ($5,000 x 25%) from their own investment, giving a total of $2,000, equal to a return to shareholders of 40% ($2,000 ÷ $5,000 x 100). The downside of this is that the financial risk of the business increases with the higher level of borrowing. The business is obliged to pay interest of $500 whatever profit it makes and, if it were only able to make a 5% return on the $10,000 it borrowed, then all the money would go to pay interest ($10,000 x 5% = $500), leaving nothing for the shareholders, despite the fact that they had invested $5,000. The appropriate level of borrowing is the classic risk/return trade-off decision – it is a question of judgement. Bankers have some benchmark ratios to inform their lending decisions, as we shall see later in this section.

As far as the business is concerned, the critical performance ratio is the return on total assets. This measures the operating performance of the business (stripping out the effects of borrowing) and must be kept as high as possible:

$$\text{Return on total assets} = \frac{\text{Operating profit}}{\text{Shareholders' funds + loan capital}} \text{ (expressed as \%)}$$

where Shareholders' funds + Loan capital = Total assets – Current liabilities

However, be aware that founders take a salary, which is deducted when calculating the operating income, and therefore the ratio (and the return to shareholders) can be distorted if salaries are unrealistically low or high.

In seeking to be as efficient as possible a company will look to do two things:

1. Maximise its operating profit;
2. Minimise its total assets minus current liabilities.

Financial ratio analysis can help with an understanding of this by looking separately at profit management and asset management.

Profit management

Profits normally increase as turnover increases. Therefore, looking at profit in isolation tells you nothing about the operating efficiency of a business. You need to assess the profit as a proportion of sales/turnover. The operating profit margin measures overall profitability compared to sales/turnover. It reflects the price a firm is able to charge, compared to the costs it faces. The ratio should be as high as possible:

$$\text{Operating profit margin} = \frac{\text{Operating profit}}{\text{Sales/Turnover}} \left(\text{expressed as \%}\right)$$

The gross profit margin reflects how well the direct costs of the product/service – the cost of sales – are controlled. It should be as high as possible:

$$\text{Gross profit margin} = \frac{\text{Gross profit}}{\text{Sales/Turnover}} \left(\text{expressed as \%}\right)$$

Gross profit margin is different from the contribution margin – which reflects a firm's control of variable costs. Companies often break this ratio down further by looking at ratios of key direct costs such as materials or labour, compared to turnover/sales.

Asset management

Assets also normally increase as sales increase. Therefore, looking at asset levels in isolation tells you nothing about the operating efficiency of a business. The key ratios below measure the efficiency of asset usage compared to sales/turnover. They are all expressed as numbers and should be as high as possible:

$$\text{Total asset turnover} = \frac{\text{Sales/Turnover}}{\text{Total assets}}$$

$$\text{Debtor/receivables turnover} = \frac{\text{Sales/Turnover}}{\text{Debtors (receivables)}}$$

$$\text{Stock/inventory turnover} = \frac{\text{Sales/Turnover}}{\text{Stock (inventory)}}$$

Liquidity

Liquidity is concerned with the ability of a firm to pay its debts. There are two ratios that measure this. They are both expressed as numbers:

$$\text{Current ratio} = \frac{\text{Current assets}}{\text{Current liability}}$$

This is expected to be greater than 1, indicating that current assets exceed current liabilities.

$$\text{Quick ratio} = \frac{\text{Current assets excluding stock/inventory}}{\text{Current liabilities}}$$

This is expected to be near to 1, perhaps as low as 0.8.

Gearing

The level of borrowing is called gearing or leverage. Ratios that measure this are of particular interest to bankers. High gearing or leverage is risky.

$$\text{Gearing/leverage} = \frac{\text{All loans + overdraft}}{\text{Shareholders' funds}} \text{ (expressed as \%)}$$

Bankers like this ratio to be under 100 per cent, indicating that shareholders have put in more money than the banks. Frequently for growing firms this is not the case. Above 400 per cent is considered very high risk – the business is likely to fail. However, some management buy-outs have had gearing levels even above this. Often bankers will also look at the proportion of all the loans that are short term (due within one year). They are also interested in the security of their interest payments.

$$\text{Interest cover} = \frac{\text{Operating profit}}{\text{Interest}} \left(\text{expressed as a number}\right)$$

This measures how many times interest is covered by profit. For a lender, the higher this is, the safer their interest payments are should profits decline.

Ratios allow you to evaluate performance – both forecast and actual. They are useful because they measure one numerical indicator against another – they therefore allow for growth. So, for example, debtors/receivables are bound to increase as the business grows and sales increase, but what is important is not the absolute value of debtors/receivables but rather its relationship to sales, measured by debtor turnover. Similarly, there is no way of knowing whether a $2 million profit in one company is better than a $1 million profit in another unless you know how much was invested in each to achieve it. To obtain a high return to the shareholder, a firm needs effective profit management and efficient asset management. Put crudely, margins need to be as high as possible and assets should be kept as low as possible.

The exception to this rule may of course be the social enterprise, where maximising the financial return to the shareholders – or stakeholders – may not be the main objective of the undertaking. Here the financial return may be set at some 'satisfactory' level. The problem with this is that it becomes very difficult to benchmark performance and efficiency, particularly against pure commercial organisations. As we saw in Chapter 11, this is one reason why organisations with social objectives are often divided in legal terms into a commercial company, with profit maximising objectives, and a social or charitable organisation, with social objectives. The problem then remains how to measure attainment of the social objectives. It may be easy to measure the accumulation of financial capital, but it is almost impossible to measure the accumulation of social capital.

But even a social enterprise may want to operate efficiently – particularly if profits are to be ploughed back into the enterprise – and systematic calculation of ratios can provide clues about how profit might be increased and where assets might be reduced. Of course to do this you need some

benchmarks. One fundamental benchmark is the rate of interest. The return on total assets should never fall below this value – otherwise a firm is better off closing the company and putting the money in the bank. There are also industry norms that might both inform forecasts and help evaluate performance. Industry-based ratios, often based on published financial statements, are produced by a number of organisations (e.g. in the UK, Centre for Interfirm Comparison and ICC Business Ratios). These are important benchmarks against which to judge the realism of projections. If a firm's projected margins are higher than industry norms, how can it justify this? Founders and investors use these norms and ratios to validate a set of financial projections.

SETTING AND MONITORING PERFORMANCE TARGETS

Financial forecasts can be analysed using ratio analysis and these ratios can form the basis for setting performance targets. Actual performance can then be compared to these targets – with remedial action taken if appropriate. Over time trends in ratios may emerge. By comparing actual financial results to the forecast on a timely basis the entrepreneur can 'manage by exception', only intervening when performance deviates from forecasts. This can free up time to concentrate on other important business problems.

Many companies use computer-based accounting systems to provide the detailed financial information needed to monitor performance, normally on a monthly basis. However, many start-ups subcontract the production of financial information, and that can mean there are delays in obtaining the information. What is more, entrepreneurs are often uncomfortable with accounting information. They can become 'numbers-blind' – unable to see the important pieces of information because of the detail provided in financial statements. Financial ratios simplify this process. By setting performance targets, some of which will be based on financial ratios, the entrepreneur can monitor and evaluate the performance of their business, ensuring that any remedial action is then taken on a timely basis.

As we saw in Chapter 6, there are other non-financial metrics against which to measure performance. The appropriate operating metrics that may need to be highlighted in projections and then monitored will vary from business to business, depending on the nature of activities. Performance metrics used for control are not usually critical. However, sometimes continued poor performance in one metric can cause it to become critical. For example, continued shortages of cash can threaten the survival of a business and mean that this financial metric becomes critical. Establishing any performance metric involves firstly identifying the process that needs to be monitored and controlled; then establishing the quantifiable outputs of that process; and finally establishing the targets against which to judge that performance. For a start-up, critical performance metrics are likely to be contained in the business plan as key targets.

KEY FINANCIAL METRICS

Generally firms can be controlled by monitoring just six key financial metrics (plus any other industry-specific metrics). These are like the instruments on a car dashboard. They tell you different things about the engine of the business. Different pieces of information are important at different times and in different circumstances. On a road with a speed restriction you watch your speedometer. When changing gear at speed you watch your rev counter. When low on petrol your eye rarely strays from the fuel gauge. These six financial metrics tell you all you need to know about driving the business. They apply to any and every business. They can be reproduced on a single piece of paper and provide the headline information on how the business is doing. If they disclose a problem, more information will be needed to accurately diagnose the cause and decide on the appropriate corrective action. The six key financial metrics are:

1. Cash – Knowing a firm's cash balance and monitoring its cash flow (cash burn rate) is vital for survival. Early in the life of a business, as it negotiates Death Valley, it will probably need to monitor cash on a weekly basis. But if it is really short of cash it may have to monitor cash on a daily basis – it becomes *critical*.

2. Sales/turnover – This tells you about the volume of work going through the business. It drives all the other financial results. Early in the life of a business sales/turnover will probably need to monitored on a weekly, possibly even a daily, basis. The source of these sales by product or distribution channel may also be important to monitor (e.g. for a web/mobile product sold through web/mobile channels of distribution this may come from its own website either directly or by referral or through an app store). If a firm's sales exceed forecasts, does it have the resources to meet the increased demand? If it is behind forecasts, are there sufficient sales in the pipeline, or does it have to cut back on expenditure?
3. Profit margins – These tell you whether costs are in line with sales. Target margins will only be achieved if sales volume targets are met, at the appropriate prices, and costs are under control. The operating profit margin, gross margin and contribution margin each give you different information. As for sales, it may be important to monitor margins from different sources of income. Profit margins probably only need to be monitored monthly.
4. Margin of safety – This tells you about the operating risk of the business. A deteriorating margin of safety should sound warning bells. It means a firm is approaching breakeven point. That could mean sales volumes are going down, contribution margins are not being maintained (prices are being discounted, or variable costs are increasing) or fixed costs are out of control. If the deteriorating margin of safety is due to falling sales, then the firm might try to reduce fixed costs – particularly the ones that it has some discretionary control over.
5. Productivity – For most firms the single largest and most important expense they face is the cost of wages. It therefore needs to be controlled carefully. Wages are best measured in relation to the productivity that they generate and for many firms this is most easily measured by the simple percentage of wages to sales. Often there are industry norms to compare this to. For example, in the UK licensed trade, wages of bar staff should be about 20 per cent of sales. If higher, the bar is over staffed, if lower, it is under staffed – a crude but simple and effective measure that needs to be checked at least monthly. Of course, to achieve this benchmark staff need to work shifts, being brought in at peak periods.
6. Debtor/receivables turnover and/or stock/inventory turnover – Similarly most firms will have one important current asset on their balance sheet that represents over 50 per cent of their total assets. For a service business this will probably be debtors/receivables, for a retail business stock/inventory, and for a manufacturing business it is likely to be both. You can use debtors/receivables and stock/inventory turnover ratios to monitor this investment, again on a monthly basis.

> *My own businesses have always been very tightly controlled. I was able to sell my [first] business because the books were very clean, we had grown steadily, we never lost money and I knew where all the figures were month by month, if not day by day.*
>
> Mark Mason, serial entrepreneur and business angel, *The Sunday Times*, 2 June 2013

CONTROLLING PERFORMANCE AS THE BUSINESS GROWS

The process of setting and monitoring performance continues as a firm grows. Forecasts for an established firm are called 'budgets'. They can be prepared at the department as well as company level, consistent with how the business is structured. Budget responsibility and accountability can be delegated to other managers and then used to monitor their performance. An essential element in this process of making managers accountable is that each knows exactly what they are held responsible for, and each does indeed control this aspect of the firm's operations. Responsibility cannot be assigned without authority. A clear management structure is a fundamental necessity alongside this. The principle is to make every manager responsible for the costs and revenues they control, even if they, in turn, delegate responsibility down the line.

Of course, if managers are going to be held responsible for the costs and revenues they control, they are going to want to be involved in the budgeting process. This is consistent with a dispersed leadership style that involves managers in developing strategies for the business. Indeed, as the business grows, they should come to know more about the area they are responsible for than the founder. Involving managers in setting their own budgets means that budgets and targets need to be SMART. If budgets are to motivate staff generally, they have to 'buy into' them and believe that they are realistic and achievable. Once they accept the standards of performance against which they are to be judged, they

> *Think big right from the beginning, but spend small.*
>
> Jason Sayers, co-founder of Filta, *The Sunday Times*, 8 December 2019

will normally try hard to achieve them. Imposing budgets from above generally causes resentment and leads to a lack of commitment.

It is important also to identify, monitor and put in place procedures to mitigate the risks a firm might face in achieving their financial forecasts or budgets. The processes for doing this were covered in Chapter 13. Internal risks might include the ability to achieve the sales forecasts or maintain the margin of safety. External risks – many of which might be out of a firm's control – could include interest and exchange rate fluctuations. These risks and how a firm deals with them will be of particular interest to potential investors. Having effective monitoring and control processes in place for a venture will help the founder manage it. They help them delegate and control it. They will help them achieve the targets they set. And they add value to the business when they come to sell it.

Case insight 15.2 The English Pub*(2)

Monitoring performance

The founder of The English Pub was always hoping to establish a small chain of pubs and to sell them as a going concern to another pub chain or a brewery within ten years. Once he proved that his formula for filling the pub throughout the day really worked (Case insight 8.1), his attention shifted to finding new, large city-centre sites. But he also realised that to sell-on any pub chain he would have to prove that it was profitable and that it had good financial control – something that was notoriously difficult in a cash-handling business. He believed that rigorous, centrally applied financial controls were the key to profitable operation and a successful sell-on. One of the first things he did was appoint a finance director to provide the board with in-house financial management skills.

As part of the emphasis on control, the company ensured at five key financial metrics were monitored on a regular and timely basis. The first four metrics were linked to targets for individual pub managers and tied into their bonus scheme. The fifth was one that the founder used to monitor the risks he faced:

- Cash – Daily checks on cash takings and banking, carried out by telephone and direct computer input to the company's bank account.
- Sales and profit margins – Weekly sales and profit performance measured within 16 hours of each week ending. Results were reviewed immediately by management and priorities for action identified.
- Stocks – Weekly stocktaking to ensure there were no stock losses and gross margin targets were attained.
- Productivity – Labour costs, as a percentage of sales, monitored through monthly management accounts, mailed to all affected parties no later than ten working days after each period.
- Breakeven point and the margin of safety – The founder believed that any growing business needs to monitor these two important metrics. He monitored this data monthly. Above his desk he kept a graph showing sales against breakeven point (i.e. the margin of safety). It made interesting reading, showing the gradual improvement in the margin of safety because of the high margins and low fixed costs as The English Pub concept was rolled out across new sites.

Within ten years of being set up, The English Pub chain of licensed houses was sold to a brewer for an eight-figure sum!

Questions:

1. Why are strong financial controls important for a pub chain?
2. Why do strong financial controls add value to a business?

* The English Pub is a real company but the name is fictitious.

USING FINANCIAL INFORMATION FOR DECISION-MAKING

The contribution margin of a business is an important piece of information. It can be used to make some simple decisions quickly. Here are some examples.

Should I incur an additional expenditure?

Knowing the contribution margin can help a firm make business decisions about whether to incur additional expenditure by telling it how much additional sales it needs to generate to pay for, and hence justify, a fixed-cost expenditure. The decision still needs to be made – and this is a judgement call – but it does provide valuable information to help make it.

$$\text{The extra sales needed} = \frac{\text{Increase in fixed costs}}{\text{Contribution margin}}$$

So for example, if a firm is considering an increase in advertising expenditure of $10,000 and its contribution margin is 40%, the extra sales needed to justify the expenditure are:

$$\frac{\$10{,}000}{0.40} = \$25{,}000$$

Which are the most profitable product lines?

For any business producing more than one product or service, the question as to which is the more profitable, and therefore the one which is to have its sales 'pushed' hardest, is an interesting one, and one to which the answer is not as straightforward as you might think. However, it is a fundamental question in deciding upon the mix of sales.

Suppose a skateboard company can produce three versions: 'Standard', 'All-terrain' and 'Freestyle'. As shown in Table 15.2, the Freestyle board has the highest $ contribution, but the Standard board has the best contribution margin (%). So which is the one that the firm should encourage the sales of most? The answer depends on the market that the different products are selling to:

- If the products or markets are independent, that is, if the Freestyle board is sold to one customer, the Standard to another and the All-terrain to a third, *and selling one does not reduce the budget available for the others*, then it should 'push' sales of the board with the highest $ contribution: Freestyle first, All-terrain second and finally Standard. This will generate the highest profit.
- However, if the products or markets are *not* independent, meaning that the total $ budget to purchase these boards is fixed (for example because it is selling to one customer) and increasing the $ sales of one simply reduces the $ sales of the others by the same amount, then it should 'push' the sales of the Standard board. As can be seen in Table 15.2, for every $1,000 spent, the company will make a higher profit than from any other board.

Table 15.2 Profitability of different product lines

	STANDARD	ALL-TERRAIN	FREESTYLE
Price per board	$25	$32	$50
Variable cost per board	$10	$16	$30
Contribution per board	$15	$16	$20
Contribution margin (%)	60%	50%	40%
Contribution per $1,000 of sales	$600	$500	$400

Where should I focus my limited resource?

In the case of the customer with a limited budget, the firm has to take account of a limiting factor – the amount of money available to buy their products. In fact, many start-ups face some type of internal limiting factor, such as a lack of skilled labour, limited machine capacity, shortage of raw materials,

Table 15.3 Profitability with a limited resource

	STANDARD	ALL-TERRAIN	FREESTYLE
Price per board	$25	$32	$50
Variable cost per board	$10	$16	$30
Contribution per board	$15	$16	$20
Machine hours needed to produce 100 boards	1.0	0.5	2.0
Contribution per machine hour	$1,500	$3,200	$1,000

lack of management expertise, or shortage of money. This approach can be applied to making decisions about which product to 'push' in these circumstances. Retailers often regard available shelf space as being their main limiting factor, while for a fast-growing manufacturing business the limiting factor may well be the availability of cash to finance their working capital needs. Where a limiting factor exists, then a business will maximise its profits by making the best use of the limiting resource. For example, retailers need to make the best use of their available shelf space. And in these circumstances they should always 'push' the sales of the product making the highest $ contribution per limiting resource.

Assume that our skateboard company has a shortage of machinery which reflects itself in availability of machine hours. It needs to decide how to use the machine hours available to maximise its profits. As can be seen in Table 15.3, the contribution per machine hour is highest for the All-terrain board. It should therefore 'push' sales of the All-terrain board, followed by Standard and finally Freestyle.

As always, the real world doesn't behave quite like a mathematical formula. If a supermarket filled its shelves entirely with small, high-margin items it might find it had a lot of dissatisfied customers unable to find bread, sugar and washing powder. Similarly, a manufacturer may prefer to sell to reliable large customers rather than to take greater risks selling to small traders, even though the contribution per sale may be higher in the latter case.

What does breakeven mean when I have a portfolio of products?

One practical problem for a company with a portfolio of products, each with different contribution margins, is to interpret just what the breakeven calculation means in terms of the mix of sales. If you use the contribution margin calculation based on total sales and variable costs, the resulting breakeven point represents an identical mix of sales.

Using our skateboard company as an example again, Table 15.4 shows sales volumes (units) achieved for each board and the resulting total sales value of $464,000, variable costs of $232,000.

Table 15.4 Breakeven calculation

	STANDARD	ALL-TERRAIN	FREESTYLE	TOTAL $'000	
Sales volumes (units)	8,000	2,000	4,000		
Price per board	$25	$32	$50	Total sales value	464
Variable cost per board	$10	$16	$30	Total variable costs	232
Contribution per board	$15	$16	$20		
Total contribution	$120,000 (60%)	$32,000 (50%)	$80,000 (40%)	=	232 (50%)
				Fixed costs	190
				Total profit	42

This gives an average contribution margin of 50% (right-hand column). If fixed costs are $190,000 this would produce a profit of $42,000.

We could go on to calculate the breakeven point using the usual formula:

$$\text{Breakeven point} = \frac{\$190.000}{0.50} = \$380{,}000\,\text{per annum}$$

But what does this mean? The problem is that this breakeven point only holds if the mix of sales always remains the same; that is, for every eight Standard boards sold, we always sell two All-terrain boards and four Freestyle boards. This equates to Standard sales of $163,900 (contribution @ 60% = $98,300), All-terrain sales of $52,400 (contribution @ 50% = $26,200) and Freestyle sales of $163,700 (contribution @ 40% = $65,500), giving total sales of $380,000 with a contribution towards fixed costs of $190,000 (figures rounded to nearest 100). Should the mix change, then the breakeven point will change and a new calculation becomes necessary.

An understanding of which products, customers or markets generate the best contributions, and of the optimal way to utilise limited resources, can make a significant difference to the overall profitability of the business. A firm will be in a much better position to optimise the sales mix if it knows which products contribute the greatest profit. It is also essential to know the breakeven point, together with its limitations, and manage it in the appropriate way.



Bonus Case Xtreme SnoBoards (2)

Visit the companion website at bloombury.pub/burns-esb-5e to access this four-part bonus case that covers pricing, the preparation and evaluation of financial forecasts and an estimated company valuation.



SUMMARY

- For a new venture to survive and grow it needs to be financially viable. This means it needs to be profitable and efficient, sufficiently liquid to pay its bills, while minimising the risk that it faces.
- Profit is measured by sales or turnover minus total costs. It is represented by the increase through trading of all the assets owned by the company and is not the same as cash flow. A firm can be profitable but illiquid, without cash to pay its bills. Cash flow therefore needs to be planned and monitored carefully.
- The balance sheet is a snapshot at a point of time that shows the assets the business has and where the funds for these assets came from.
- Financial forecasts comprise income statements (including breakeven), cash flow forecasts and balance sheets. The cash flow forecast for a start-up will indicate the funding needed to launch the business.
- The breakeven point is an important benchmark that tells a firm about the operating risk a firm faces. The higher it is, the higher the risk. The margin of safety measures how far above breakeven the sales of a firm are.
- The contribution margin of a business is a key piece of information that can be used to help decision-making and even to estimate profit based simply on sales data.
- Financial ratio analysis is a technique used to evaluate the performance of a business: profitability, asset usage efficiency, liquidity and gearing or leverage.
- There are six key financial metrics that can be used to monitor and control the financial performance of a business: cash, sales, profit margins, margin of safety, productivity and debtor/receivables and/or stock/inventory control. They are quick and easy to calculate and monitor.
- Actual performance is normally compared to forecast performance or budgets. As a business grows, the preparation and monitoring of budgets on a decentralised basis can encourage delegation and help motivate and control the performance of managers.

GROUP DISCUSSION TOPICS

1. Why is cash not the same as profit?
2. What would you do to make sure a firm gets through Death Valley?
3. Profit is something that an accountant can manipulate. It is not objective and therefore means nothing. Discuss.
4. Can you really forecast sales? How might you go about doing it?
5. How important are the assumptions on which sales forecasts are based? Why is this? What can you do to test them?
6. Are fixed costs really fixed?
7. Are wages a fixed or a variable cost?
8. How easy is it to calculate contribution margin?
9. What are the limitations of breakeven analysis?
10. If a firm has a portfolio of products with different contribution margins, breakeven is a meaningless concept. Discuss.
11. Entrepreneurs make decisions based on instinct (right-brain), not by using financial analysis. Discuss.
12. Can you really control a business by monitoring only six financial metrics?
13. What would you do to maintain tight control of debtors/receivables?
14. How can budgets help an entrepreneur delegate? Why is this important?
15. Behind every successful entrepreneur there is an accountant. Discuss.
16. You cannot determine profit in an SME because there are just too many ways the owner-manager can manipulate it. Therefore, any form of financial analysis will not work. Discuss.

STUDENT ACTIVITY

1. Undertake a financial ratio analysis on the financial statements of an SME or social enterprise and prepare a report evaluating its performance.

START-UP ACTIVITIES

1. Prepare a sales forecast for your first year of business. List the assumptions on which this is based.
2. Estimate the costs associated with this level of sales and draw up a forecast income statement.
3. Estimate the breakeven point and margin of safety for the business.
4. Prepare a monthly cash flow forecast for your first year of business. List the assumptions on which it is based. What does this tell you about your borrowing requirements?
5. Prepare the forecast balance sheet at the end of the first year of business.
6. Undertake a financial ratio analysis on your financial statements. What does this tell you?

PART 3

GROWTH

This section covers issues of scaling and growth. Most start-ups will not grow to any size. Growth poses challenges and may result in crises for many businesses. It requires most entrepreneurs to change how they manage. However, it is something that can be planned and prepared for. Indeed, if external equity finance is being sought, growth and a realistic plan to deal with it will be expected.

Chapter 16 From entrepreneur to leader

This chapter explains how the entrepreneur needs to change from a manager to a leader as the business grows. It outlines what the role of leader involves and how leadership skills can be developed or enhanced. Most importantly, it provides a blueprint for becoming an entrepreneurial leader.

Chapter 17 Developing strategy and the business plan

This chapter looks at how strategy is developed in a growing firm, outlining the process of strategic review. It highlights how resulting changes in strategy can trigger crises for the firm and outlines how these might be dealt with. It also shows how to turn a business model into a business plan.

Chapter 18 Scaling and growth strategies

This chapter looks at growth strategies – both market and product/service development. It explores issues surrounding the management of a product/service portfolio and how diversification is central to the process of corporate evolution. It explains how diversification can actually create shareholder value as a firm becomes an entrepreneurial conglomerate.

Chapter 19 Financing the business

This chapter explains the different sources of finance available today, matching sources to uses, and outlining the advantages and disadvantages of different forms of both loan and equity, including crowdsourcing. It also shows how the business plan can be used to obtain finance.



MEET THE ENTREPRENEURS



Access the *Digital Links* booklet via the companion website to watch interviews with various entrepreneurs on how they grew their small business.

16

FROM ENTREPRENEUR TO LEADER



Source: Getty Images/Colin Anderson Productions

Contents

- The challenges of growth: Commercial enterprise
- The challenges of growth: Social enterprise
- Leadership and management
- Defining the role of leader
- Personal attributes of leaders
- Building shared organisational values
- The cultural web
- Measuring organisational culture
- Building a shared vision
- The role of storytelling
- Leadership style and contingency theory
- Leadership paradigms
- Entrepreneurial leadership
- Summary
- Group discussion topics
- Student activities
- Start-up activities

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand and explain the difference between management and leadership and the personal qualities needed by a leader;
- Describe the issues facing both commercial and social enterprises at different stages in their growth and, in the case of social enterprises, understand how social capital can be built up;
- Understand and explain how a leader might go about building a vision and shared organisational values;
- Understand and explain how leadership style can be tailored to different circumstances and evaluate your preferred leadership style;
- Critically analyse the theories of leadership and how they contribute to an understanding of situational leadership in an entrepreneurial context.

Case insights

16.1 Adrenaline Alley

16.2 James Dyson (2)

16.3 Amazon and meeting protocols

16.4 Steve Jobs and Apple

Explore further links

16.1 Emotional intelligence

16.2 Measuring organisational culture

16.3 Leadership style – task vs people

16.4 Leadership style – dealing with conflict

16.5 Leadership

THE CHALLENGES OF GROWTH: COMMERCIAL ENTERPRISE

Most start-ups involve only self-employment for the entrepreneur. Even if they grow, SMEs are likely to have few employees – and often these are family members. In these circumstances the managerial and leadership skills needed by the entrepreneur are minimal. The success of the business depends heavily on their personal operational and marketing skills. However, as the business grows this changes. Greiner (1972) was one of the earliest academics to point to the changing skills needed by the entrepreneur as their business grows. He popularised the idea of the stages model of growth shown in Figure 16.1. In the model there are four growth phases, each followed by a crisis that necessitates a change in the way the founder manages the business. If the subsequent crisis cannot be overcome then the business risks failure. The four crises are:

1. Leadership – Growth initially comes through creative opportunity seeking. However, this growth leads to a crisis of leadership as staff, financiers and even customers increasingly fail to understand the focus and direction of the business – where it is going and why it is doing things a certain way, why it makes and sells certain things but not others etc. Resources may become spread too thinly to follow through effectively on any single commercial opportunity. The challenge the entrepreneur faces is to give direction by effective leadership.
2. Autonomy – Entrepreneurs have a strong internal locus of control, which means that there is a danger they will try to do everything themselves. Not only do they delay recruiting staff, partly because they are careful in managing cash flow, but when they do, they find it difficult to delegate. The challenge the entrepreneur faces is to develop an effective management team, and delegate to them.
3. Control – There is a danger that over delegation becomes an abdication of responsibility and there is a loss of proper control. The challenge the entrepreneur faces is to coordinate decision-making through appropriate organisational mechanisms that balance the need for control with the need for delegated autonomy.
4. Bureaucracy – As the business becomes even larger, the danger is that it might become over-controlling and lose its entrepreneurial drive. The challenge the entrepreneur faces is to facilitate collaboration – making people work together through a sense of mission or purpose rather than by reference to a rule book, balancing the need for control and delegated autonomy while avoiding too much bureaucracy.

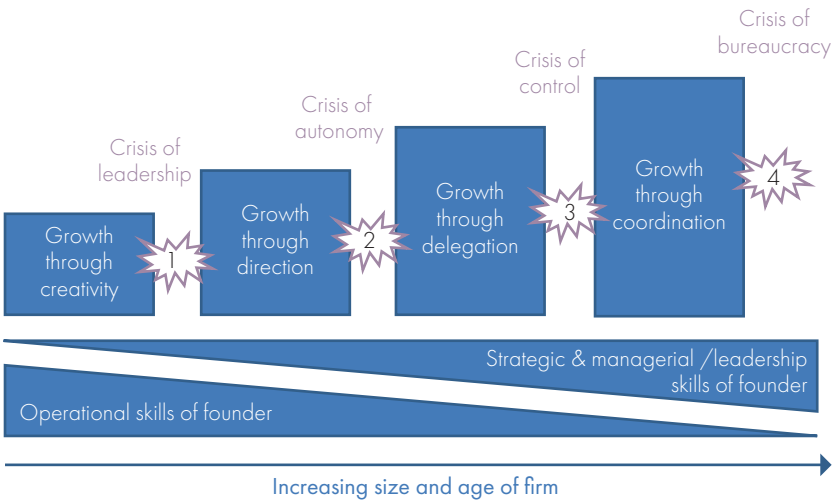


Figure 16.1 Growth stages of a firm

The length of time it takes to go through each growth phase depends on the industry in which the company operates. In fast-growing industries, they are relatively short; in slower growth industries they tend to be longer. Each growth phase requires a particular management/leadership style and/or emphasis. Figure 16.1 also shows the changing emphasis needed by the founder; from operational skills (a 'doer') to managerial/leadership and strategic skills.

The first of Greiner's crises is leadership. While the second two (autonomy and control) might be the responsibility of the leader, they are primarily a function of management (Chapter 14). We shall explore the difference between leadership and management later in this chapter. The company faces the final crisis of bureaucracy in later years and we will look at this in the final chapter of the book.

THE CHALLENGES OF GROWTH: SOCIAL ENTERPRISE

The challenges for a successful, growing social enterprise can be even more complicated than those facing a commercial enterprise. However, they still require many of the same leadership and management changes. A social enterprise usually combines some form of income-generating activity with a social goal. When it comes to reviewing operations and strategies it therefore has to review both sets of activities – commercial and social – and how it binds these together operationally. Leadbeater (1997) argued that entrepreneurial social organisations that grow can run into a range of problems that can stunt their growth or even lead to failure. He proposed the three-stage model shown in Figure 16.2. At each stage there are different imperatives and a need for different skills.

Stage 1

This sees the enterprise trying to establish itself. The key issue was to set the appropriate mission. But as the enterprise grows, this may have to be revisited as the scope of its activities expands. This needs to be handled sensitively with all the stakeholders. There is always the danger that one group of stakeholders may hijack the mission and revise it to meet its own ends, thus alienating others. This can be a risk for an enterprise that is short of funds and the funders therefore are able to set conditions that affect the mission. At the other extreme, too much influence by consumers may result in low prices and financial problems for the enterprise, and this can threaten its survival. These are issues of governance, which become more complex as the social enterprise grows.

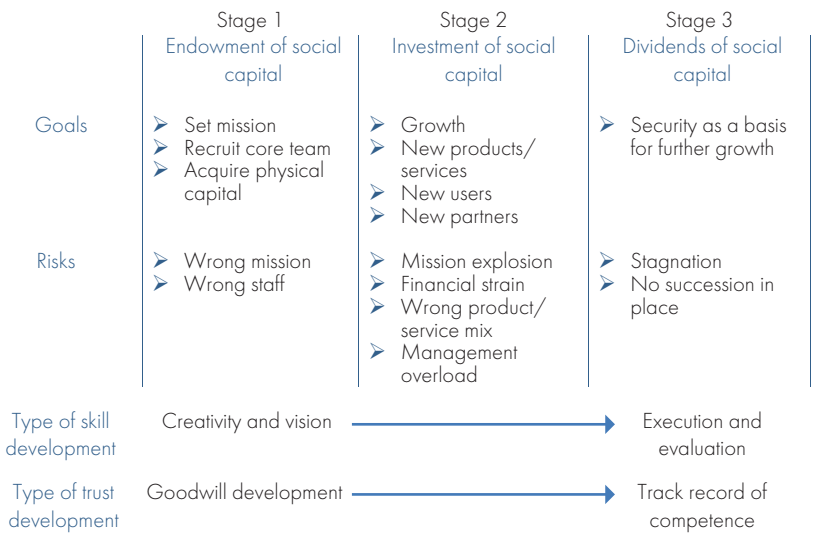


Figure 16.2 Growth stages of a social enterprise

Source: Leadbeater (1997).

Stage 2

As a social enterprise grows, it may have to change the products or services it offers because of changing social need. New products or services may displace existing ones and, without clear criteria for making these decisions, such as profit, the process can become political. This means that the enterprise needs to become very adept at evaluating the success of its work – developing appropriate measures of accountability is a significant issue in a not-for-profit organisation. At the same time, it needs to become more professional and the social entrepreneur needs to develop their entrepreneurial leadership skills. Effective, efficient delivery becomes increasingly important. The organisation needs to build a reputation based on its track record – in the commercial world it would be called 'developing a brand'.

Stage 3

By this stage, if it is to survive, the enterprise needs to be firmly established in its commercial and social environment. The final challenge is the same as for its family counterpart in the commercial world – how to manage succession (Chapter 21). However, unlike its commercial counterpart, many social enterprises have a number of stakeholders who can have a range of different, and often changing, priorities. It is not uncommon for a social enterprise to cease trading despite being successful because an important backer, such as the government, has pulled out because of a change in its policy priorities.

Leadbeater placed great store on the development of social capital during the life of the social enterprise. He called this the 'virtuous circle', shown in Figure 16.3. It starts with an endowment of social capital – 'a network of relationships and contracts, which are tied together by shared values and interests'. The trick for the social entrepreneur is to lever this up to gain access to more resources – firstly, physical capital such as buildings, and then financial capital to start the wheel turning and then human resources to start delivering the project. Organisational capital is then generated as the project starts delivering its objectives and further resources are attracted, but this will only be achieved with greater formalisation in structures and financial controls and a stronger set of relationships with partners. Finally the project starts to pay dividends, such as the creation of permanent physical infrastructure that can be used by the community – new community centres, hospices or sports facilities. And the increased trust and cooperation generated by a successful project can lead to a fresh injection of social capital as the network of relationships and contacts expands.

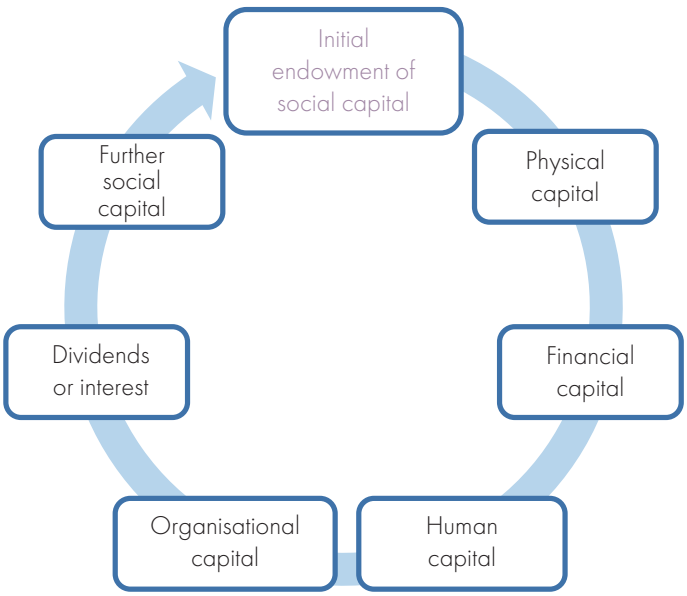


Figure 16.3 The virtuous circle of social capital development

Source: Leadbeater (1997).

Case insight 16.1 Adrenaline Alley

Challenges facing a social enterprise

Based in Corby in Northamptonshire in the UK, Adrenaline Alley is Europe's biggest urban sports park. Although it is run as a commercial business, it is a charitable social enterprise and a company limited by guarantee (see Chapter 11). It opened its doors in 2003 thanks to the efforts of Mandy Young, who, at the time, was an apprentice hairdresser. The spark that caused her to set up the social enterprise was a violent incident involving her terminally ill son. Mandy's son John, then aged 13, had struggled through childhood because of an undiagnosed brain tumour, which resulted in major surgery, radiotherapy and chemotherapy. In his teens he made friends with a group of local skateboarders with whom he felt less vulnerable, enjoying the sport and companionship. However, in 2001 Mandy found out that he had been attacked by some of those who knew about his health issues, taunting him with his illness as they attacked him. Mandy and her family were devastated, but were determined to turn the experience into a positive one. Talking with John and his friends it was apparent that not only was intimidation a major national problem for those undertaking 'extreme sports' but also there was a woeful lack of facilities. Mandy decided to try to do something about both problems.

In 2002 she set up the Corby Wheels Project and approached Ashley Pover, ex-CEO of Rockingham Motor Speedway, who donated land and the resources to build an outdoor park until an indoor facility became feasible. Corby Borough Council supported the venture with £15,000 of funding for equipment, and the Community Safety Partnership donated funds to help young people access the park by providing transport. In 2003 Adrenaline Alley opened, attracting some 13,000 visitors in the first 20 months. But Mandy was not happy with just this. She organised events and training at the park as well as continuing to fundraise. However, it became clear that renting a building for an indoor facility and sustaining the project would be difficult without further funding. Never daunted, in 2006 Mandy persuaded Bee Bee Developments to donate a building to the project, albeit a former chicken-processing factory, and with the help of scores of local helpers and £125,000 of partner funding Adrenaline Alley opened Building 1 – one of the biggest indoor ramp parks in the UK. Then Mandy secured funding to install the UK's only 'Resi Jump' box (a foam pit and bowl) followed by an extension housing rooms for outreach work, a café and other services such as equipment hire facilities and Europe's only 76 × 14 foot 'Resi/Vert' ramp.

In 2010 Mandy secured further funding from a range of local and national sources that allowed them to refurbish some offices, install new indoor ramps and outdoor dirt jumps, and develop a new skate-only area as well as adapting many facilities to enable disabled participation. In 2013 Bee Bee Developments donated another two adjacent buildings, and Mandy secured



Source: Getty Images/Daniel Milchev

further funding from a range of public and private sources enabling them to open Building 2 as a performance and event arena, and Building 3 as a scooter park, making Adrenaline Alley the biggest park in Europe. It also extended the range of youth work undertaken by opening a photography and media suite for those interested in acting, filming, script writing, directing, camerawork, lighting etc.

Adrenaline Alley has grown through the hard work of Mandy Young and the team she has drawn around her. While the project has grown incrementally, Mandy has always had a wider vision and cajoled people to push this through. It prides itself on being a safe environment with a warm and welcoming atmosphere. It also makes a point of partnering with other public and private, local and national organisations to help it achieve its ultimate goal, which is: 'to improve the lives of young people in Corby and Northamptonshire giving them a facility they have ownership over and can be proud of'. It charges for many of the services and facilities offered (entrance, equipment hire, coaching etc.), but as a social enterprise, all the generated income is ploughed back into the organisation. Here are the vision, mission and values of Adrenaline Alley:

Vision – To expand our thriving centre for urban sports and community use bringing change that makes a real difference to people's lives, and provide opportunities for other communities to develop social enterprises in the same way.

Mission – To provide safe, secure and manageable facilities addressing the needs of local communities and to be recognised as a leading provider of urban sports using a range of partnerships to become a sustainable social enterprise.

Values – Delivering our mission as a team, we strive to be:

- Approachable and honest – always willing to listen and learn;
- People focused – operating for the benefit of our community and participants;

- Accessible – willing to go the extra mile to ensure everyone can participate;
- Affordable – always striving to reduce costs;
- Versatile! – adapting the business to the needs of our customers.

Mandy's son, John, died in 2010 at the age of 24 years. Adrenaline Alley was her legacy from John to the local community.

Access the *Digital Links* booklet to visit the website and to watch a video about Adrenaline Alley.

Questions:

1. How important was Mandy Young to this project? Could it have worked without her?
2. Why is it a social enterprise? Is this the best form for the venture?
3. How important are partnerships to this venture?
4. How has strategy been developed?
5. Has Adrenaline Alley remained true to its vision, mission and values?
6. Which growth stage has Adrenaline Alley reached?

LEADERSHIP AND MANAGEMENT

Leadership and management are different and distinct terms, although the skills and competencies associated with each overlap are complementary. Most leaders have to manage as well as lead and many managers have to lead as well as manage. Management is about handling complexity in organisational processes and the efficient execution of work. It is about detail and logic and is concerned with detailed planning, organising, commanding, coordinating and controlling. As we have seen, none of these skills come easily to the typical entrepreneur who favours a more informal, relationship-based approach to management and Greiner's (1972) growth stages model highlighted how the skills of an entrepreneur need to change as the organisation grows.

Leadership is concerned with setting direction, communicating and motivating. It is about broad principles, emotion and less detail. If management is the head (left-brain), leadership is the heart (right-brain) of an organisation. It is therefore quite possible for an organisation to be over-managed but underled, or vice versa. However, any organisation needs both good leadership and good management. As Bennis (2009) said: 'Managers are people who do things right while leaders are those people who do the right thing'.

As with a manager, the role of leader is normally also based on some sort of authority but traditional views of leadership as a command-and-control function seem increasingly to be out of date. Authority can derive from role or status, tradition, legal position, expert skills or charismatic personality. Timmons (1999) believed that in successful entrepreneurial ventures leadership is based on knowledge and expertise rather than authority and many of the best-known entrepreneurs, like Richard Branson or the late Steve Jobs, clearly also have charisma. The characteristics of a good leader are not set in stone – they are situation specific. Some leaders are good in one situation but not in others. Leaders can have roller-coaster careers as they exhibit successful leadership characteristics at certain discrete times, in certain circumstances, with particular people, but these characteristics do not work when things change. They fail to adapt. Winston Churchill was widely acknowledged as a great wartime leader but a poor peacetime leader. Therefore entrepreneurs might be good leaders at start-up but poor leaders as the business grows.

One characteristic that separates leaders from other people is the obvious one that they have willing followers. They are leaders of a particular social group – a company, a country or a political party. Why is this? What is it about them that can persuade others in that group to follow them? The characteristics and personality traits of good leaders tell us a limited amount about good leadership. They seem to differ from leader to leader. While it is too simplistic just to say that leaders have certain enduring character traits, some individuals do seem to emerge as leaders across a variety of situations and tasks. As we shall see, this gives us some indications of the characteristics and particularly the behaviours needed to be a good leader.

However, leadership is primarily not about who you are. It is more about what you do with who you are, and how you form relationships with your followers. And this is very personal. Haslam et al. (2020) observed that an effective leader is seen as one of the group they are leading, not somebody separate from them. They work for the group and with the group to achieve what the group values. They enjoy a mutuality of interest and reflect the values and qualities that make the group distinctive. They reinforce the sense of an 'in-group'. Both leadership and managerial effectiveness are situation specific – tailored to the group, the task and the context faced.

We are beginning to better understand the importance of a leader's personal cognitive abilities and expertise, motivations, social and problem-solving skills. What emerges is a complex interaction of many factors that underline how good leadership (and management) is an art rather than a science and must be tailored to meet a specific situation. While we can isolate the main factors that influence it and point to good practice in particular situations, there is no magic formula.

DEFINING THE ROLE OF LEADER

Our traditional view of good leaders is that they are special people – often charismatic 'heroes' – who set direction, make key decisions and motivate staff, frequently prevailing against the odds at times of crisis and, rather than going with public opinion, they lead it. They have vision – something most entrepreneurs have aplenty. They create the culture within the organisation to reflect their priorities. Schein (1990) believed this to be the only important thing that leaders do. Leadership is more about guiding vision, culture and identity than it is about decision-making. Nevertheless, they are strategic thinkers and effective communicators. Most leaders also need to be good managers – or have good managers working with them. At the very least they need to be able to monitor and control performance. If there were ever a job description for a leader, therefore, it would probably include five elements.

» Having a vision for the organisation – This gives people a clear focus on the direction of the organisation, the values it stands for and the key issues and concerns it faces in achieving its goals. Visions are underpinned by the values of the organisation and the values are reflected in the culture (and even the brand) of the organisation.

» Being able to develop strategy – It is one thing the leader knowing where they want to go, it is quite another to know how to get there. The heart of leadership is about being able to chart a course for future development that steers the organisation towards the leader's vision. This is what strategy is about – linking various actions and tactics in a consistent way that forms a coherent plan. There is a wonderful Chinese proverb:

'Tactics without strategy is the noise before defeat.' – Not only does the proverb underline the need for coherent strategy, but also that without it miscellaneous tactics – delegated actions – will just cause 'noise' or confusion among followers about what to do, why they should be doing it and whose responsibility it is.

» Being able to communicate effectively, particularly the vision – There is no point in having a vision and a strategy unless it can be communicated effectively in a way that inspires and motivates staff. Staff need to understand how the vision will be achieved, and believe that they can achieve it, particularly in an uncertain world. They need to understand where the organisation is going and the strategies that are being adopted to take it there. To communicate this an entrepreneur needs strong interpersonal skills, based upon their ability to build relationships.

» Creating the culture for the organisation – The culture of an organisation is the cement that binds it together. It influences how people think and how they act. Creating an appropriate culture is probably the single most important thing a leader has to do – but it is not an easy task.

» Managing and monitoring performance – Leaders still have to manage. This may be a routine task, but in an entrepreneurial organisation there are special challenges such as dealing with rapid change, the balance between freedom and control, and managing risk.

> *If there is a spark of genius in the leadership function at all, it must lie in the transcending ability, a kind of magic, to assemble ... out of a variety of images, signals, forecasts and alternatives ... a clearly articulated vision of the future that is simple, clearly understood, clearly desirable, and energising.*
>
> Warren Bennis and Burt Nanus (1985) *Leaders: The Strategies for Taking Charge*, New York: Harper & Row

PERSONAL ATTRIBUTES OF LEADERS

Strategic thinker

A key mind-shift from manager to leader is to become a strategic thinker. Strategic thinkers are able to move away from day-to-day operational detail to see the broad, strategic, organisational perspective. This involves taking a longer term, holistic view of the organisation. Strategy sets a framework within which short-term actions can be judged. Leaders understand where they have come from – knowledge of the past – and how it affects the current situation, where they are going to and how to get there. They are also engaged in perpetually 'scanning' the environment, both for opportunities and risks, strategising and considering options. They therefore become strategic learners. This learning may involve looking at the big picture, trying to find patterns over time and looking for complex interactions so as to understand the underlying causes of problems (this is called the 'wheel of learning' and we shall return to it in Chapter 22). Based on this information, leaders can then envision a new and desirable future and reframe this new future in the context of the organisation. This is their vision and strategic intent. During the process they engage in both the analysis and synthesis of information and ideas.

Emotional intelligence

Leadership is also about persuading people to become followers – and this is not just about charisma. It is about persuading them that the leader shares their values and represents the qualities that make them distinctive as a group. As we shall see later in this chapter, there are a number of styles that can be adopted to persuade people to do this, however, they all require an underpinning of empathy and emotional intelligence. Goleman (2004, 2005) defined this as requiring four skills:

- Self-awareness – This is the ability of leaders to understand themselves, their strengths, weaknesses and emotions – recognising emotions as they happen.
- Self-management – This is the ability to adapt their behaviour to meet different circumstances, and requires control, integrity, initiative and conscientiousness. Emotional self-control enables the leader to listen and pay attention to others in difficult circumstances. It may involve delayed gratification and patience in achieving a goal.
- Social awareness – This is the appreciation of different circumstances, both of people and the environment or context in which they find themselves, and requires empathy – sensing and recognising emotions in other people.
- Social skills – This is the ability to relate to and collaborate with people, managing their emotions and, above all, build relationships with them.

Goleman talks about the pliability of emotional intelligence. He observed that it increases with age, experience and maturity. Like the entrepreneurial mindset, we are born with elements of it in our character but we can also develop it by breaking negative habits and establishing new ones (left- and right-brain activity). Developing emotional intelligence involves making a commitment to change and develop the skills outlined above. However, it requires the ability and time to undertake honest reflection so as to identify areas of social interaction that need to be improved. This involves the leader cross-checking that their perception of themselves and of the situations they face corresponds with the perception of others. Perceptions can differ because people have different perspectives based upon their own values and interests. This may involve making a value judgement about which perception is most 'real'. And this requires a degree of mature judgement that is not easily taught, but develops over time. It can be much enhanced by the leader having a supportive network of people around them willing to give constructive feedback, such as family or a close management team that they trust and are able to talk with.

> *I now believe the best leaders are frequently the most likeable – because they are the ones who can motivate staff.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 4 August 2019

> *You have to be self-critical and constantly aware of how you translate yourself to your staff.*
>
> Alex Head, founder of Social Pantry, *The Times*, 25 February 2014

Trustworthy

A leader needs to create a community with a sense of belonging and common purpose based upon an almost familial bond. They need to build a close relationship with staff – something entrepreneurs

> *The final piece in the [leadership] jigsaw is trust ... Everyone should be trusted to do what they think is right, the people best placed to improve the business are those working on the front line ... Management should stick to strategy and leave processes to the people who do that job.*
>
> James Timpson, founder and Chief Executive of Timpson Group, *The Sunday Times*, 25 August 2019

ought to be good at. All relationships are based upon mutual trust, underpinned by mutual self-interest and demonstrated by reciprocity (Dubini and Aldrich, 1991; Larson, 1992). Followers need to aspire to the leader's vision and buy into the strategies that will make it happen. But they will only do this if they believe that, in exchange for their effort, there is something in it for them and they will share in the success of the organisation. It is easier to trust someone who has high moral characteristics and ethical values that guide their decision-making and influence their behaviours; values such as honesty, altruism, kindness, fairness, accountability and optimism (Luthans and Avolio, 2003; May et al., 2003). And these values need to be demonstrated in action. Effective leaders 'walk-the-talk'. They act as role models, aligning their goals and expectations with those of their followers (Shamir et al., 1993). These are the leaders who generate more commitment from staff and really command respect and loyalty. The 'relational contracts' they develop with staff underpin an organisation's culture and are important strategic assets that create real competitive advantage (see Chapter 22).

Authentic

Ethics are not just an 'add-on'. It is never easy to adopt personal attributes that do not represent the real person. Eventually their guard will slip and others will see through the image they portray. And that will lead to distrust and resentment. To sustain leadership, a leader needs to be 'authentic' – to believe in and act out these ethical underpinnings. Reflecting on interviews with 125 top leaders, George and Sims (2007) talked about 'authentic leadership' coming from those individuals who follow their real values and beliefs – their internal compass. Authentic leaders:

- Had strong values and beliefs that they practise at work and at home – they 'pursued purpose with passion'. They had ethical foundations and boundaries and led with their hearts as well as their heads.
- Built a support team of people with whom they had a close relationship (spouses, family members, mentors etc.) and had a network of professional contacts to provide counsel and guidance. These were people with whom they could reflect honestly on the issues they faced.
- Established enduring relations with staff because they listened to them and demonstrated that they cared.

George and Sims argued that, in this way, authentic leaders not only inspired those around them but also empowered people to lead. But they only do this by always being true to their own principles, values and beliefs. They were authentic. And that cannot be faked. Authentic leadership and transparent organisational communication have been found to generate a favourable reputation in the eyes of staff (Men, 2014). When the organisation's senior leadership is viewed as trustworthy and credible, employees tend to like the organisation more.

Explore further 16.1

Emotional intelligence

Access the *Digital Links* booklet to watch the following videos:

- A Harvard Business Review animation explaining the concept of emotional intelligence.
- A Harvard Business Review interview with author Daniel Goleman exploring the concept of emotional intelligence in leaders.
- A talk by author Simon Sinek on the importance of empathy and perspective for leaders.
- A Harvard Business Review talk by Gill Rider, President of the Chartered Institute of Personnel and Development, on the importance of building trusting relationships.

BUILDING SHARED ORGANISATIONAL VALUES

We looked at the founder's values and beliefs and how they influence the mission, vision and strategy of a start-up in Chapter 8. We will look at them again in Chapter 18 when we look at how they influence the development of a growth strategy. These values and beliefs form part of the cognitive processes that help shape and develop not only the vision but also the culture of an organisation. Organisational culture is about the unspoken, prevalent norms, basic beliefs, values and assumptions about the 'right' way to behave in an organisation. Hofstede (2001) defined it as the 'collective programming of the mind which distinguishes one group of people from another'. Along with other factors like personality, rules and laws, it influences behaviour. It can help cement relationships, binding the organisation together – aligning people to a common cause and motivating them. The culture within a start-up is usually grounded in the founder's own basic beliefs and values, so the entrepreneur's influence can be profound. For good or bad, consciously or unconsciously, the leader of an organisation is responsible for its culture.

> *Our values are things that help us get in a state of mind and motivate us to get the results we want. You want something that attaches emotionally to each person in the team.*
>
> Barbara McNaughton, founder of Elements, *The Times*, 25 February 2014

Values may be communicated by words but they also need to be reinforced by actions – so being an 'authentic leader' should mean sharing them is easier. The same principle applies to an organisation. Like its leader, the organisation will be caught out if it fails to practise what it says are its values and beliefs. Values are not negotiable and need to be reinforced through recognition and reward of staff. They need to be embedded in the systems, structures and norms of behaviour expected in the organisation so as to ensure conformity. Organisational values should endure long term. They should be reflected in the vision the organisation has, the strategies it adopts and the decisions it makes. Every organisation develops a distinctive culture that reflects certain underlying values, even if they are never made explicit. If these values are not made explicit – written down – there is always the risk that the culture that develops might be undesirable.

Organisations with strong values and culture have a clear identity – a sense of being an 'in-group'. Entrepreneurs often convey a sense of 'us against the world' – an 'in-group' fighting competition from 'out-groups'. These organisations tend to recruit like-minded staff, reinforcing those values and the culture over time. As we observed in Chapter 8, identity linked to purpose (a vision) can be a strong motivation. Strong values can also help create a bond with customers and suppliers and can be used to create brand identity. They are likely to be strongest in firms with a long history (like family firms) and where staff join young and stay for most of their careers. Many of the most successful UK Victorian businesses, such as Cadbury, Barclays Bank and John Lewis, were built around strong religious ethics whereby the success of the firm was shared with the workforce and many Victorian entrepreneurs went on to become great philanthropists (e.g. George Peabody in the USA or Titus Salt in the UK).

Shared values and beliefs create expectations regarding how the organisation should operate and treat people. They are strongest when they are underpinned by a sense of 'reciprocal obligation'. This is an important part of human well-being. It underpins family relationships. It creates identity, instils ideas of fairness and generates loyalty. The nature of this relationship discourages one party from acting in some way at the expense of the other because it is important that they continue to work together. It also encourages each party to do the 'right thing' by the other because it further cements the relationship and is likely to result in acts of reciprocity. Reciprocal obligations are focused around a common goal (or vision) and are based upon trust – trust in the leader and the organisation that they will act in certain ways. Shared values and beliefs create a sense of belonging with staff and engagement with the organisation. According to a survey in 2020, 'organisations with engaged workforces experience improved productivity, less [staff] churn and more profits' (*The Sunday Times Best Companies to Work For*, 23 February 2020).

THE CULTURAL WEB

Johnson and Scholes (1999) introduced the concept of a cultural web that describes but also shapes how a culture is formed within an organisation. They talked about the 'cultural paradigm' – how an organisation thinks and acts. They represented this as a number of interlinked and overlapping aspects of culture that help define it: organisational structures; control systems; routines; rituals; power; symbols; stories. As explained below, these elements are self-reinforcing. Together they make up the 'cultural web' of an organisation, as shown in Figure 16.4.

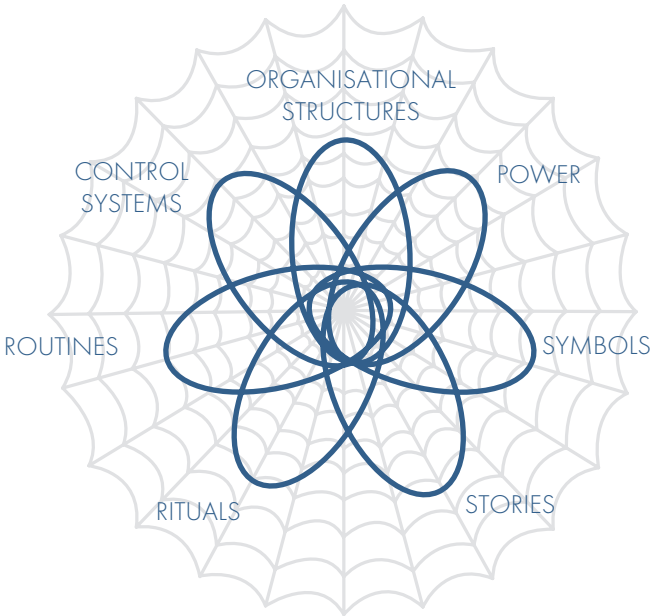


Figure 16.4 The cultural web

- Organisational structures – The structures of an organisation should be consistent with its culture, otherwise there is a disconnect between how people are inclined to behave and how they are supposed to behave. Structures might be quick and easy to change, but that does not mean that there will be a change in culture, at least in the short term.
- Control systems – These are the systems that monitor, measure and incentivise the behaviour of individuals, including the metrics against which their performance is judged. They overlap with organisational structures and reinforce routines.
- Routines – These are the ways in which people work and act towards each other. They enable the organisation to run smoothly and perform routine tasks. They may be partly rule-based. For example, many graduates have an induction programme when they join a firm which involves them undertaking routine 'shop-floor' tasks so as to get them to understand how different roles within it perform. However, not all rules may be written down and because of this they can be difficult to uncover or to change.
- Rituals – These are the regular events and traditions of the organisation, such as annual appraisals, sales conferences etc. They are the things that indicate what the organisation values. Employee innovation awards, 'seed-corn' funding and/or 'free time' for innovations indicate the importance an organisation places on that activity.
- Power – This is also closely linked to the organisational structure although people can also have power that is not shown in a hierarchical organisation chart, for example because individuals have experience, information, knowledge or just charisma. Finding out where the real power lies in an organisation can often lead to unexpected places. It can also lead to unintended consequences unless understood.
- Symbols – These are often used to reinforce power, for example the 'guarded' office or designated parking spaces. However, they can also be used to help shape the organisational culture in an intended direction, for example awards ceremonies, certificates, plaques etc. celebrating innovations. Many companies show case their most recent innovations in highly visible ways. Ericsson, the Swedish telecoms company, gives a loaded credit card and one week to experiment to any employees coming up with an innovative idea.
- Stories – Every organisation will have stories that are told to new employees or visitors that reflect things that happen within it. Some will be constructive, others less so. Some might almost go down

as part of the folklore of the organisation because they are repeated so often. Stories pass on and reinforce the values and beliefs of an organisation. For example, the 'invention' of the ubiquitous Post-it Note reinforces the reputation of 3M for encouraging intrapreneurship and innovation (see Case insight 22.1). Buckler and Zien (1996) talk about 'innovative leaders' reshaping old stories to inspire the future.

Case insight 16.2 James Dyson (2)

Corporate culture

James Dyson is the billionaire inventor of the bagless vacuum cleaner and other consumer products (see Case insight 2.3). Liam Kelly visited the Dyson factory in Malmesbury, UK, in 2019 and found that, despite stepping down as chairman of the of company that he owns in 2010, James Dyson (known as JD) was still very much involved with all products. He was told that the factory floor was 'live and connected to an App', so that JD could observe what is going on any time he wanted.

Kelly described the Dyson corporate culture as 'quirky' and 'inward-looking' with teams being discouraged from communicating. He described middle managers as always trying to second-guess what they think JD would like. He called it a 'cult of personality'. One employee commented: 'It's really cool, because you get to have meetings with him, but also kind of annoying, because it's really hard to make decisions unless James Dyson makes them.' Some employees describe JD as 'a nice old grandad, friendly and approachable' and one who 'didn't dominate the conversation at all'. But at least one engineer appeared somewhat sceptical about his engineering ability: 'He's a great ideas man [but] I don't think he's a great engineer. Engineering is about getting the final solution with the smallest number of steps.' Kelly dryly observed that it took 15 years and 5,127 attempts for JD to make that first bagless vacuum cleaner.

Question:

1. What insights into Dyson's corporate culture do you get from this article? What are the advantages and disadvantages of this sort of culture?

MEASURING ORGANISATIONAL CULTURE

While we may be able to describe and recognise cultures, measuring them in any scientific way can be more difficult. The Organisational Culture Assessment Instrument (OCAI) is a validated instrument that can be used by organisations of all sizes to measure their organisational culture. In it there are six statements each with four alternatives, and you are asked to distribute 100 points between the alternatives, depending on the extent to which each alternative is similar to the organisation now and how you might prefer it to be in five years' time. The six statements typify the dimensions of organisational culture:

- Dominant characteristics – The extent it is: a personal, sharing place; dynamic and entrepreneurial; aggressive and achievement-orientated; structured and controlling.
- Organisational leadership style – The extent it is: nurturing; entrepreneurial and innovative; aggressive and achievement-orientated; organised and efficient.
- Management of employees – The extent it is: characterised by participation and teamworking; innovation and individual risk-taking; competitiveness and achievement; conformity and predictability.
- Organisation glue – The extent it is built on: loyalty and mutual trust; innovation and development; achievement and goal accomplishment; formal rules and policies.
- Strategic emphases – The extent it emphasises: human development including trust and openness; acquiring new resources and creating new challenges; competitive actions and achievement; stability and efficiency.
- Criteria for success – The extent it defines success on the basis of the development of: human resources and concern for people; having the most unique products; winning in the marketplace; efficiency.

Answers to these questions measure the conflict between the internal and external focus of an organisation and its preference for stability and control compared to flexibility and discretion. These

conflicts define its position within the Competing Values Framework developed by Quinn and Rohrbaugh (1983). This framework has four competing cultural typologies:

» Adhocracy culture – This culture is mix of flexibility and discretion with an external focus – the one most associated with entrepreneurship. It is energetic and creative, innovative and risk-taking. It encourages freedom, individual ingenuity and experimentation. It has a long-term emphasis on growth. Leaders tend to be visionary entrepreneurs and innovators.

» Hierarchy culture – This culture is the more traditional one – an internal focus that emphasises stability and control. It usually signifies a traditional organisational structure with hierarchical controls and structures that respect position and power, and emphasises efficiency and low cost. It is characterised by formal procedures and policies that try to maintain uniformity and stability. Leaders tend to be coordinators, monitors and organisers.

» Market culture – This culture mixes stability and control with an external focus. It is results-orientated and emphasises achievement. Consequently this is a tough, highly competitive environment, one often associated with a sales- or marketing-orientated organisation. Leaders tend to be hard drivers.

» Clan culture – This mix of internal focus and flexibility usually signifies a sociable organisation held together by commitment, tradition and ethics with a sense of family (Hofstede's 'in-group') creating loyalty. Leaders tend to be facilitators, mentors and team builders.

The OCAI analysis includes a map like the one in Figure 16.5. This shows where the organisation is now (solid purple line) and where you might want the organisation to be on these typologies (dotted line). The analysis also provides a brief explanation.

Cameron and Quinn (2011) observed that most organisations employ multiple cultures – which compete with each other – but most have a leading or dominant one. In some sectors one culture dominates, for example in the health-care sector the dominant culture is said to be 'clan'. They also say that flexible organisations are the most successful, depending on the environmental context. However, this sometimes leads to conflicts that need to be reconciled.

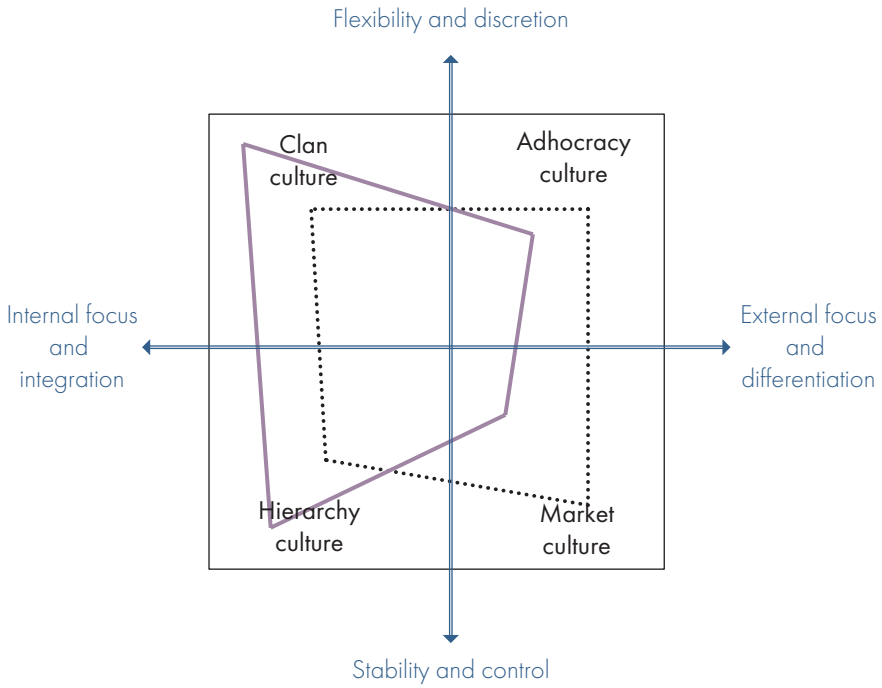


Figure 16.5 An Organisational Culture Assessment Instrument (OCAI) map

Source: Cameron and Quinn (2011). Reproduced with permission of Kim Cameron and Robert Quinn.

Explore further 16.2

Measuring organisational culture

Access the *Digital Links* booklet to use the free Organisational Culture Assessment Instrument (OCAI).

BUILDING A SHARED VISION

Building a shared vision of the future for any organisation is the prime job of its leader. A shared vision gives existence within an organisation to that most fundamental of human cravings – a sense of meaning and purpose. Building that emotional attachment is a right- rather than left-brain activity. As Bartlett and Ghoshal (1994) explained:

> Traditionally top-level managers have tried to engage employees intellectually through the persuasive logic of strategic analysis. But clinically framed and contractually based relationships do not inspire the extraordinary effort and sustained commitment required to deliver consistently superior performance … Senior managers must convert the contractual employees of an economic entity into committed members of a purposeful organisation.

> *I am often asked what it is to be an entrepreneur ... If you look around you, most of the largest companies have their foundations in one or two individuals who have the determination to turn a vision into reality.*
>
> Richard Branson, founder of Virgin Group, from Anderson (1995)

Where there is shared ownership in a business it is important that the partners share and commit to the vision for the organisation. As we observed in Chapter 14, the considerable research into what makes a successful partnership group has repeatedly shown the importance of cohesion and 'shared cognitions' – a shared vision but also effective communication and transfer of knowledge between partners. Shared cognition improves the quality of decision-making and the general performance of the business (Burgers et al., 2009; Smith et al., 2005; West, 2007). However, conflict can arise because each member of the partnership team may have a tendency to select goals that optimise performance indicators defined by their respective professions, while imposing unfavourable effects on other partners' areas of responsibility (Jehn and Bendersky, 2003). This underlines the importance of partner selection, since building shared cognition after launching the business can be difficult and is likely to take time. Indeed, resolving the almost inevitable conflict that is likely to arise between partners over major decisions can be challenging.

Entrepreneurs often have a strong vision for their start-up. Building that shared vision with staff as the organisation grows is altogether more difficult. It is not simply about going off and writing a vision statement that is circulated to staff. As Senge (1992) explained:

> Building a shared vision is important early on because it fosters a long-term orientation and an imperative for learning … Leaders may start by pursuing their own vision, but as they learn to listen carefully to others' visions they begin to see that their own personal vision is part of something larger. This does not diminish any leader's sense of responsibility for the vision – if anything it deepens it.

Visions should motivate people. Two strong motivations for people are fear and aspiration. Fear is probably the strongest motivation, galvanising action and forcing people to change, but it tends to have a limited life. It worked well for Winston Churchill in the Second World War, but not thereafter. However, *aspiration* – what we might become – has greater longevity and is altogether a more positive motivator. It is the one that underpins most entrepreneurial organisations. It emphasises striving – a continuous journey of improvement. Visions are living things that evolve over time. This involves continually checking with staff to ensure that the vision has a resonance with them – modifying it little by little, if appropriate. Some entrepreneurial leaders can find this difficult and frustrating as they are more used to setting goals and seeking compliance. But to succeed in larger organisations they need to develop their listening and influencing skills – their emotional intelligence.

THE ROLE OF STORYTELLING

Effective leadership involves mobilising people around this shared vision, appealing to their hearts and their heads through a variety of images, signals and forecasts. The vision needs to be simple, easily understood, clearly desirable and motivating. One important way a leader can build a shared, empowering vision is by becoming a storyteller. Storytelling is a unique characteristic of mankind and, as Senge (1992), said: 'Crafting a larger story is one of the oldest domains of leadership.' Gardner (1995) maintained this is *the* key leadership skill. Goffin and Mitchell (2017) said that managers 'can become "transformational leaders" if they develop and constantly tell enlightening stories about innovation at staff meetings, interviews and outside speeches'. This storytelling skill can be either verbal or written; however, to be credible, leaders must also 'walk-the-talk' – model the behaviour they expect from others (Kouzes and Posner, 2007). Gardner (1995) said that the most successful stories are simple ones that hit an emotional resonance with the audience, addressing questions of identity and providing answers to questions concerning personal, social and moral choices.

Storytelling can also help build identity and convey an organisation's values and beliefs. Haslam et al. (2020) called them 'skilled entrepreneurs of identity'. They craft the group narrative and their own personal narrative to make the two mesh so that they are seen as part of the group, representing its values and beliefs. When the leader's stories are retold by members of the organisation it further reinforces the sense of 'in-group'. Collier (2018) observed that there were three types of stories that can fit together to forge a web of reciprocal obligations: belonging, obligation and causality:

> Our narratives of obligation instil fairness and loyalty to tell us why we ought to meet those that are reciprocal. Our narratives of shared belonging tell us who is taking part: reciprocal obligations apply only over a defined group of people who accept them. Our narratives of causality tell us why the action we are obliged to take is purposive. In combination, they are a belief system, changing our behaviour … The web of reciprocal obligations enabled by shared belonging delivers states that are more trusted, and so more effective. With the myriad tasks of meeting obligations distributed widely [across an organisation], not only are the tasks better met, but people are more engaged and fulfilled.

Collier cited the terrorist group ISIS as an exemplar of leadership using narratives of belonging, reciprocal obligation and causality within a network, and in particular its use of different forms of social media to pass on these stories. Used strategically in this way, stories linked with consistent actions (walk-the-talk) can build a complete belief system that empowers and motivates people.

> *Great bosses can tell stories and do small talk, which is how you attract the attention of an audience.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 4 August 2019

In order to motivate, storytelling should create tension within the organisation by contrasting the shared vision with a constantly updated view of current reality. Too little tension produces inertia, no movement, but too much can create chaos. Senge (1992) called it a creative tension that energises the organisation:

> The leader's story, sense of purpose, values and vision, establish the direction and target. His relentless commitment to the truth, and to inquiry into the forces underlying current reality continually highlight the gaps between reality and the vision. Leaders generate and manage this creative tension – not just themselves but in an entire organisation. This is how they energise an organisation. That is their basic job. That is why they exist.

Creative tension should act like the elastic band linking the two fingers in Figure 16.6. If you raise the upper finger it pulls on the low finger and raises the hand gently, without forcing it. However, if the force exerted is too strong (control vs autonomy) or the distance between the two hands becomes too great (reality vs vision) the elastic will snap. Senge explained how this tension can create within the organisation a strong collective internal locus of control, one of the entrepreneurial character traits we looked at in Chapter 3. This creates the belief in control over destiny:

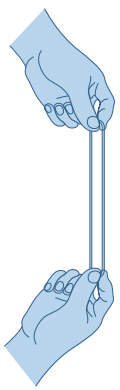


Figure 16.6
Creative tension

> Mastering creative tension throughout an organisation leads to a profoundly different view of reality. People literally start to see more and more aspects of reality as something that they, collectively, can influence.

This is an important way that individuals within the entrepreneurial organisation deal psychologically with the uncertainty they face. You might also recognise it as one aspect of 'empowerment' – a motivation for people to do 'the right thing' (whatever that might be) to resolve a problem or secure an opportunity for the good of the organisation, even if it is not in their job description. Leaders can also inspire their followers to high levels of achievement by showing them how their work contributes to worthwhile ends. It is an emotional appeal to some of the most fundamental of human needs – the need to be important, to make a difference, to feel useful, to be part of a successful and worthwhile enterprise.

LEADERSHIP STYLE AND CONTINGENCY THEORY

The style of leadership sends signals about appropriate behaviour. How leaders behave, make decisions, treat people, react to situations, even allocate their time, sends powerful signals about priorities that employees react to. Little things like 'guarded' or 'open' management offices, reserved or unreserved parking spaces, dress codes, normal methods of communication all influence the culture of the organisation. Figure 16.7 depicts three styles of leadership which have been popularised, although there are many permutations of these extremes. Each style involves different degrees of freedom or control for the employees:

- Authoritarian – This style focuses decision-making powers in the leader. It is most appropriate in times of crisis but usually fails to win 'hearts and minds'.
- Democratic – This style favours group decision-making and consensus building. It is more appropriate in circumstances other than crisis.
- Laissez-faire – This style allows a high degree of freedom for followers. However, a leader adopting this style is often perceived as weak.



Figure 16.7 Leadership styles and control

> *Don't underestimate the effect your management style has. It is not easy to motivate people because you can't do it with a large pay-packet in a small business, so you need to motivate with your vision and take people with you. Your labour turnover or attrition rate is the barometer of the culture of your business.*
>
> James Cain, MD Water Brands Group, *The Times*, 25 February 2014

Contingency theory emphasises that there is no one 'best' style of leading. This depends on the interaction and interconnections between the leader (or manager), the group they are leading, the task they face, the situation or context they are in and how these factors interact. This is called contingency or situational theory and is shown in Figure 16.8. This 'appropriate style' may vary from

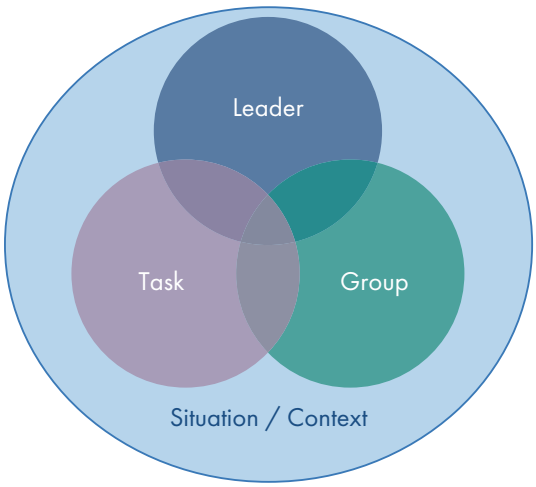


Figure 16.8 Leadership style

one company to another, even one department to another. It can vary with the situation a leader faces within that company. They may personally prefer an informal, non-directional style, but faced with an inexperienced apprentice working a dangerous lathe they might be forgiven for reverting to a fairly formal, directive style with heavy supervision. In that situation the change in style is appropriate. Try the same style with a group of experienced creative marketing consultants and there would be problems. Different styles may be effective for different tasks, with different groups and in different contexts. Remember there is no evidence of any single leadership style characterising successful businesses. By looking at the individual elements of these four factors we can understand what style is best suited to different circumstances.

Leader and task

Leaders have to work through others to complete tasks. The degree of concern for the people they are leading compared to the task in hand will, in part, determine the style they adopt. The leadership grid shown in Figure 16.9 shows style as dependent upon the leader's concern for task compared to the concern for people. Start-up entrepreneurs are usually more concerned with completing the task (Timmons, 1999), but as the firm grows they must become more concerned with people if the tasks are to be accomplished. Task leadership may be appropriate in certain situations, for example emergencies. However, concern for people must surface at some point if effective, trusting relationships are to develop. Low concern for both people and task is hardly leadership at all. Higher concern for people over task – the country club style – is rare in business but can be appropriate in community groups, charities or social clubs where good relationships and high morale might be the dominant objectives.

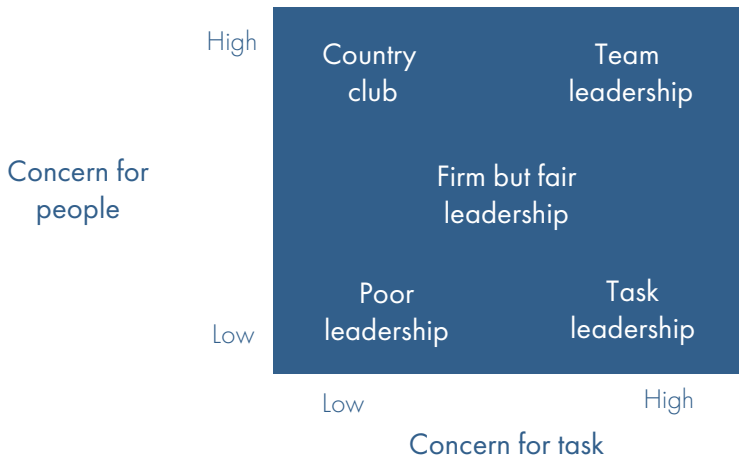


Figure 16.9 Leadership style: Task vs people

Source: Adapted from BlakeMouton (1978).

Explore further 16.3

Leadership style – task vs people

Access the *Digital Links* booklet to take a free leadership style questionnaire, measuring your trade-off between task and people.

Leader and group



Source: Jehyun Sung on Unsplash

Successful leaders are likely to adopt different styles with different groups approaching the same task, depending on the relationship they have with the group. Figure 16.10 shows this in relation to the leader's degree of authority and the group's autonomy in decision-making. An entrepreneur's authority is likely to derive from their abilities rather than their position in any hierarchy. If a leader has high authority but the group has low autonomy, the leader will tend to adopt an autocratic style, simply instructing people what to do. If they have low authority (e.g. because of past failure) they will tend to adopt a paternalistic style, cajoling the group into doing things, picking off individuals and offering grace and favour in exchange for performance. If the leader has low authority and the group has high autonomy, then they will tend to adopt a participative style, involving the whole group in decision-making and moving forward with consensus. If the leader has high authority then they will seek opinions but make the decision themselves using a consultative style.

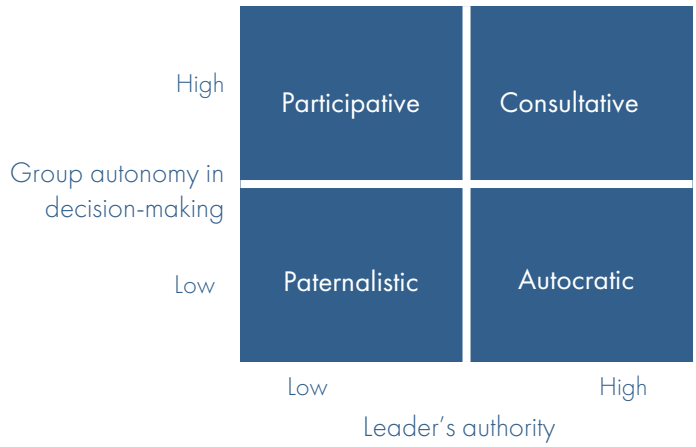


Figure 16.10 Leadership style: Leader's authority vs group autonomy

Leader and situation or context

The weight the leader should put on these different influences depends on the situation or context they face. However, taking an objective view of any context is always problematic because we view life through our own, biased lens and we might be tempted to 'construct' social contexts that legitimate our intended actions rather than viewing them objectively. Nevertheless, one situation that leaders are likely to face is that of conflict, and entrepreneurs seem to be good at dealing with it. As Timmons (1999) observed:

> There is among successful entrepreneurs a well-developed capacity to exert influence without formal power. These people are adept at conflict resolution. They know when to use logic and when to persuade, when to make a concession, and when to exact one. To run a successful venture, an entrepreneur learns to get along with different constituencies, often with conflicting aims – the customer, the supplier, the financial backer, the creditor, as well as the partners and others on the inside. Success comes when the entrepreneur is a mediator, a negotiator, rather than a dictator.

Entrepreneurial firms face an environment that is uncertain, ambiguous and constantly changing, which can often lead to conflict as they try to get people to do different things or things differently.

> *You can't avoid conflict. As well as rewarding people you need to be able to say 'that won't do'.*
>
> Alex Head, founder of Social Pantry, The Times, 25 February 2014

Conflict between the partners of a business is almost inevitable and can be constructive if it brings diverse views into open discussion. However, it can also be damaging and affect performance, even survival. As we observed in Chapter 14, conflict generally takes two forms – relationship conflict and task conflict (De Dreu and Weingart, 2003; Jehn and Bendersky, 2003). While conflicts over task can be productive and beneficial, relationship conflicts are rarely beneficial and may erode cohesion within the team, negatively affecting performance (Gelfand et al., 2008; Marks et al., 2001). Relationship conflict is mainly about personal taste, political preferences and interpersonal style (De Dreu and Weingart, 2003). Shared cognition has been shown to cut down on this conflict and positively affect performance (Burgers et al., 2009). Not only does it improve collective understanding within a group, it also helps individuals with different functional backgrounds to reach consensus. However, conflict situations between partners as well as other staff are almost certain to arise and will need to be resolved.

The Thomas–Kilmann Conflict Mode Instrument gives an insight into how conflict might be handled. It shows how a person's behaviour can be classified under two dimensions:

» Assertiveness – The extent to which individuals attempt to satisfy their own needs.

» Co operativeness – The extent to which they attempt to satisfy the needs of others.

These two dimensions led the authors to identify the five behavioural classifications:

1. Avoiding – This is both unassertive and uncooperative. It may involve side-stepping an issue or withdrawing from the conflict altogether. In this mode any conflict may not be even addressed. This is not the way to handle conflict.
2. Competing – This is assertive but uncooperative. Individuals are concerned for themselves and pursue their own agenda forcefully, using power, rank or ability to argue in order to win the conflict. This can be seen as bullying with less forceful individuals or, when others use the same mode, it can lead to heated, possibly unresolved, arguments.
3. Accommodating – This is cooperative but unassertive – the opposite of competing. Individuals want to see the concerns of others satisfied. They might do so as an act of 'selfless generosity' or just because they are 'obeying orders', either way they run the risk of not making their own views heard.
4. Compromising – This is the 'in between' route involving some assertiveness (perhaps over the things that are important) and some compromise (over the things that are less important). This is the diplomatic and expedient solution to conflict which partially satisfies everyone. However, the outcome depends upon the styles adopted by those a person is in conflict with and there is no guarantee that this solution is the 'optimum' one.
5. Collaborating – This is both assertive and cooperative, the complete opposite of avoiding. Issues get addressed but individuals are willing to work with others to resolve the conflict, perhaps finding alternatives that meet everybody's concerns. This is the most constructive approach to conflict for a group as a whole.

With the exception of 'avoiding', each style has its advantages and disadvantages and can be effective in certain situations. However, management teams or boards of directors, if they are to get the most from each member over a longer period of time, work best when all members adopt the collaborating and/or compromising modes. A team made up of just competing individuals would find it difficult to get on and, indeed, to survive. A team made up of just accommodators would lack assertiveness and drive.



Explore further 16.4

Leadership style – dealing with conflict



Access the *Digital Links* booklet for the web link to the Thomas–Kilmann Conflict Mode Instrument.

Case insight 16.3 Amazon and meeting protocols

Decision-making in meetings

Decision-making in meetings is notoriously problematic and this book has pointed out how biases in decision-making are easy to establish. Leaders with dominating personalities or physical charisma (often the entrepreneur) can rely on these characteristics to get their way – whatever the evidence underpinning the decision might indicate. They can stifle new ideas and creativity, imposing their own dominant logic on the group. Information relating to a decision may not be shared in advance, meaning that there is insufficient time to think through the implications thereby making these influences all the greater. Establishing some form of 'psychological safety' within an organisation – where people feel free to question, criticise and come up with new ideas – is seen by many as the key to effective teamworking (Syed, 2019).

Amazon has pioneered a different approach to meetings for over ten years in an attempt to counter these problems. All meetings start with a 'golden silence' of 30 minutes during which participants read a memo that summarises in narrative form the main agenda item – six pages and no bullet points. The narrative form is intended to solicit deeper thought about proposals. The silence is intended to allow time for participants to consider their reaction and bring to bear their diverse ways of thinking to the discussion before it starts. Even when the discussion begins, the most senior person at the meeting speaks last. The technique is intended to commit people to deciding what they think – reasoning through the strengths and weaknesses – before learning the opinion of others.

Questions:

1. What are the advantages and disadvantages of this approach?
2. Would it work with virtual meetings?

LEADERSHIP PARADIGMS

Notwithstanding contingency theory's assertion that the appropriate leadership style depends on group, task and context, a number of leadership paradigms have emerged in the literature.

Transactional leadership

This style of leadership is about setting goals, putting in place systems and controls to achieve them, and rewarding individuals when they meet the goals. It is about efficiency and incremental change, reinforcing rather than challenging organisational learning – which is not the entrepreneurial context. It is associated with closed cultures, rigid systems, formal procedures and bureaucratic organisation structures.

Transformational leadership

Bass (1985, 1998) contrasts transactional with transformational leadership. Transformational leadership is more emotional and is about inspiration, excitement and intellectual stimulation. It is a style best suited to highly turbulent and uncertain environments where crises, anxiety and high risk are prevalent (Vera and Crossan, 2004) – which better describes the entrepreneurial context. Not surprisingly, this style of leadership is associated with open cultures, organic structures, adaptable systems and flexible procedures. Transformational leaders are often seen as being charismatic, inspirational, intellectually stimulating and individually considerate (Avolio et al., 1999), and as having empathy and self-confidence (Egri and Herman, 2000). They inspire and motivate with a vision, create excitement with their enthusiasm and get people to question the tried-and-tested ways of doing things, 'reframing' the future (Bass and Avolio, 1990). However, it might be said that charismatic leaders deal in visions and crises, but little in between.

Visionary leadership

Sashkin (1996) characterised this style as providing a clear vision which focuses everyone on the key issues, goals and concerns that are part of that vision. They are good at getting everyone to work together towards common goals. The visionary leader has good interpersonal and communication skills. They

have inner self-confidence. They act consistently over time to develop trust and they care and respect others, making others more self-confident. Finally, they provide creative opportunities that others can buy into and 'own' – empowering opportunities that involve people in making the right things their own priorities. Visionary leadership is often associated with Mintzberg et al.'s (1998) entrepreneurial school of strategy development which 'promotes a view of strategy as *perspective*, associated with image and sense of direction, namely *vision*', based around a single leader with full knowledge of all operations.

Dispersed leadership

This style draws on models of dispersed or distributed leadership which focus on leadership across all levels and in different forms (Bradford and Cohen, 1998; Chaleff, 1995; Mintzberg, 2009). It emphasises the importance of 'emotional intelligence' in the leader and their ability to listen, empathise and communicate with those they lead (Goleman, 2005) – social skills essential for effective relationship. It emphasises 'authenticity' (George, 2003; George and Sims, 2007) – leaders being true to their own beliefs (having an ethical underpinning) so that trust and respect can be built. It also emphasises leaders as 'servants' of their workforce, acknowledging that self-interest is part of any relationship (Greenleaf, 1970), and leaders as 'educators' that develop organisational learning (Heifetz, 1994).

These paradigms are not, of course, mutually exclusive. They can overlap and need to be adapted to particular contexts. Nevertheless, Kouzes and Posner (2007) summarised five core practices of good leaders:

1. They establish core values, principles and organisational goals by 'modelling the way' ('walk-the-talk').
2. They motivate people and open minds to new possibilities by 'inspiring a shared vision' for the organisation.
3. They change the status quo in innovative ways by 'challenging the process'.
4. They empower people to take responsibility and 'enable others to act'.
5. They give people faith that outcomes will be achieved by 'encouraging heart' (right-brain).



Explore further 16.5

Leadership



Access the *Digital Links* booklet to watch the following videos:

- A short animation which explains ten leadership paradigms.
- A short Harvard Business Review video about what makes a great leader.
- A TED talk by author Simon Sinek on how great leaders inspire action.
- A TED talk by Professor Moss Kanter on six keys to lead positive change in any organisation.

There is also a web link to Sashkin's Leader Behaviour Questionnaire which is a 360-degree assessment instrument that measures visionary leadership behaviours, characteristics and contextual effects. It needs to be filled out by between three and six colleagues.

ENTREPRENEURIAL LEADERSHIP

Entrepreneurial leadership is about creating a sustainable entrepreneurial organisation – one that has organisational architecture appropriate to different contexts. Context is everything in leadership, dictating the approach that needs to be taken. The entrepreneurial context is characterised as an environment of uncertainty, constant change and super-competition with societal norms changing just

as quickly as markets. This creates complex problems for leaders as they try to lead and manage staff, develop strategy and make decisions. As Grant (2012) observed:

> Not only is it impossible to forecast the business environment but managers cannot predict with any certainty what the outcome of their actions will be. The concept of the CEO as the peak decision maker and strategy architect is not only unrealistic – it is undesirable.

In this environment an entrepreneurial leader needs to be both visionary and transformational but, importantly, they also need to set out to build and embed leadership into the organisation to make it sustainable. This is more than just dispersed leadership. Instead of concentrating just on acquiring the individual attributes of leadership they need to take an architectural approach and build them into the organisation itself, empowering staff to make 'the right decisions' in the unpredictable circumstances they face. We shall explore how this is achieved in Chapter 22. An analogy by Collins and Porras (1994) illustrates the difference:

> Imagine you met a remarkable person who could look at the sun or stars at any time of day or night and state the exact time and date … This person would be an amazing time teller, and we'd probably revere that person for the ability to tell the time. But wouldn't that person be even more amazing if, instead of telling the time, he or she built a clock that could tell time forever, even after he or she was dead and gone.

Being just a transformational, charismatic or visionary leader is 'time telling'. Being an entrepreneurial leader is about building an organisation that can prosper far beyond the individual, through multiple product life cycles – it is 'clock building'. Authors have acknowledged that the role of leader is changing:

> The notion of the leader as a heroic decision maker is untenable. Leaders must be recast as social-systems architects who enable innovation … Leaders will no longer be seen as grand visionaries, all-wise decision makers, and ironfisted disciplinarians. Instead they will need to become social architects, constitution writers, and entrepreneurs of meaning. In this new world, the leader's job is to create an environment where every employee has the chance to collaborate, innovate, and excel. (Hamel, 2009)

A good entrepreneurial leader realises that organisations are networks of individuals, all exercising some form of leadership and with no one person in total control, but with everyone open to influence through patterns of relationship (Raelin, 2003; Rost, 1991). The concept of entrepreneurial leader therefore draws on the models of dispersed leadership which emphasise the importance of 'emotional intelligence' and 'authenticity' in the leader as well as being 'servants' and 'educators' of their workforce. They create a strong organisational identity, a sense of 'in-group'. However, they also create a web of reciprocal obligations – belonging, obligation and causality – that reinforces the identity, gives it meaning and purpose, empowering its staff. Entrepreneurial leaders learn to soften hierarchies, giving people more independence and autonomy but a clear sense of responsibility. They learn that they have just as much, if not more, responsibility as they have power, and the real power they have is the ability to persuade, not command. Rather than being 'commanders-in-chief', entrepreneurial leaders must be 'storytellers-in-chief'.

> *Making an enduring company is far harder and far more important than making a great product.*
>
> Steve Jobs, founder of Apple, Walter Isaacson, 'The Real Leadership Lessons of Steve Jobs', *Harvard Business Review*, April 2012

CHAPTER 16

However, there is always the caveat that leadership style needs to be modified to fit specific groups, tasks and situations. It is not a case of 'one-size-fits-all'. Entrepreneurial leaders might also need to be able to adapt their style as the organisation goes through different business cycles – from more visionary or transformational in periods of rapid change, to more transactional in periods of consolidation. And if the leader cannot change their style, then the leader may need to be changed. Nobody said leadership is easy. These combinations of influences are shown in Figure 16.11.

The concept of the entrepreneurial leader is therefore subtly different to other leadership typologies. Kirby (2003) likened the entrepreneurial leader to the leader of a jazz band. They decide on the musicians to play in the band and the music to be played but then allow the band to improvise and use their creativity to create the required sounds. In the process they have fun as the leader brings out the best in them. The leader's authority comes from their expertise and values rather than position. Leaders of jazz bands lead by example – playing an instrument themselves. They empower their teams

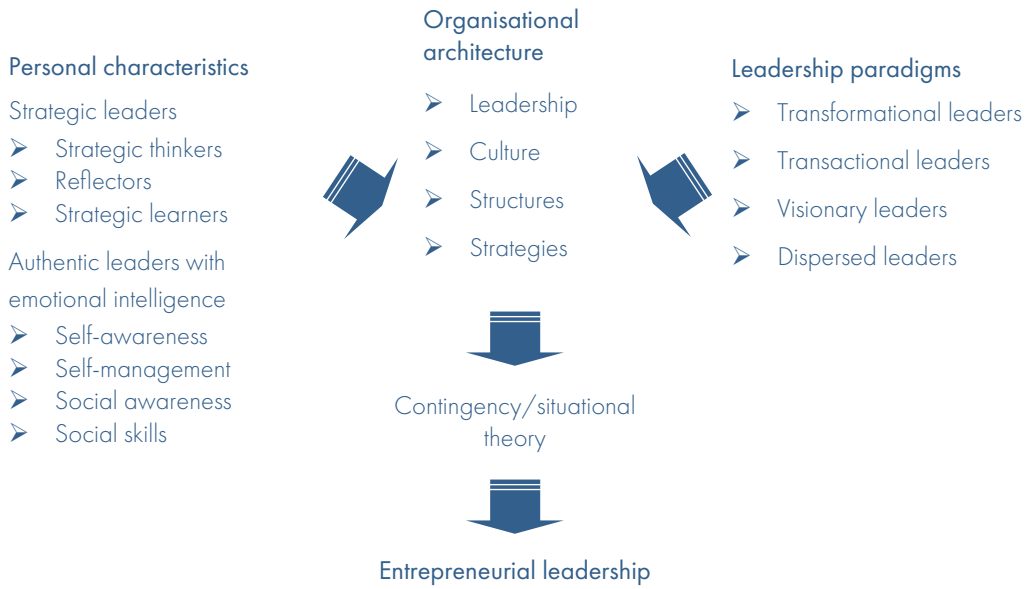


Figure 16.11 Entrepreneurial leadership

and nurture leaders at all levels – encouraging solo performances. There is an ancient Chinese proverb that still rings true:

> The wicked leader is he who the people despise. The good leader is the one who the people revere. But the great leader is he who the people say 'we did it ourselves'.

Case insight 16.4 Steve Jobs and Apple

Entrepreneurial leadership

Steve Jobs was the epitome of an entrepreneurial leader who became a Silicon Valley hero. By the time he died in 2011, Apple had become the second most valuable company in the world measured by market capitalisation, with a cash mountain of some $80 billion. But many of Jobs' personal character traits did not endear him to others in business. He was a perfectionist who was highly secretive and had, at the very least, what might be described as a hard-driving management style. In 1993 *Fortune* magazine placed him on the list of America's toughest bosses for his time at NeXT, quoting co-founder Daniel Lewin as saying: 'The highs were unbelievable ... but the lows were unimaginable' (18 October 1993). Fourteen years later it called him 'one of Silicon Valley's leading egomaniacs' (19 March 2007).

The Sunday Times (30 October 2011) was just as scathing about his personality, giving examples of his bad-tempered, often rude, tantrums with staff and suppliers. He had a propensity for tears and the article cited the example of him throwing a tantrum and crying when he was assigned No. 2 on the Apple payroll and Wozniak was assigned No. 1. Jobs insisted on being 'number zero'. It cited examples of him



Source: Konsepta Studio on Unsplash

often claiming the ideas of other Apple employees as his own and described him as 'selfish, rude, aggressive, lachrymose, unpredictable ... a good candidate for the boss from hell'. It described Apple as 'a cultish, paranoid, joyless organisation where public humiliations were a regular occurrence and cutthroat competition among the ranks was encouraged' (*The Sunday Times,* 29 January 2012). And yet it also observed that Jobs could inspire incredible loyalty, albeit in the people he had helped to make rich. Writing about the culture at Apple, Adam Lashinsky (2012) said: 'you're expected to check your ego at the door' because there really is only room for one – that of Jobs, who exhibits 'narcissism, whimsy and disregard for the feelings of others'. Jobs emerged as

a short-tempered, authoritarian dictator ruthlessly pushing, even bullying, staff to complete assigned tasks. On a (slightly) more positive note he also described Jobs as 'a visionary risk taker with a burning desire to change the world ... charismatic leader willing to do whatever it takes to win and who couldn't give a fig about being liked'.

Central to Apple's culture was a cult of product excellence – where employees did not want to let the company down by being the weakest link. If they did, they could become collateral damage because of the aggressive, competitive environment. Jobs was notorious for micromanaging things from the design of new products to the chips they used. *The Daily Telegraph* (6 October 2011) claimed in his obituary that he was 'almost pathologically controlling' when it came to dealing with news reporters and the press, actively trying to stifle any reports that might seem critical of him or Apple. Lashinsky saw the culture at Apple as work-orientated – long hours, missed holidays and tight deadlines were expected and encouraged. However, he admitted that 'by and large, Apple is a collaborative and cooperative environment, devoid of overt politicking ... but it isn't usually nice, and it's almost never relaxed'. In his view unquestioning collaboration and cooperation were necessary to ensure instructions were communicated and followed in this command-and-control structure. He believed that employee happiness was never a top priority for Jobs. But on the other hand, employees derived pride from Apple's products and in working for Jobs' vision. Jobs appeared omni present, or at least visible, around the campus, despite the fact that very few people had access to his office suite. Secrecy, mistrust and paranoia seem to underpin the Apple culture. Apple under Jobs emerged as a cultish, joyless organisation, built on fear and mistrust, where competition and aggressive in-fighting between staff was encouraged and public humiliation was regular. A cultural web, based on the words used in Lashinsky's book to describe Apple's culture, is shown in Figure 16.12.

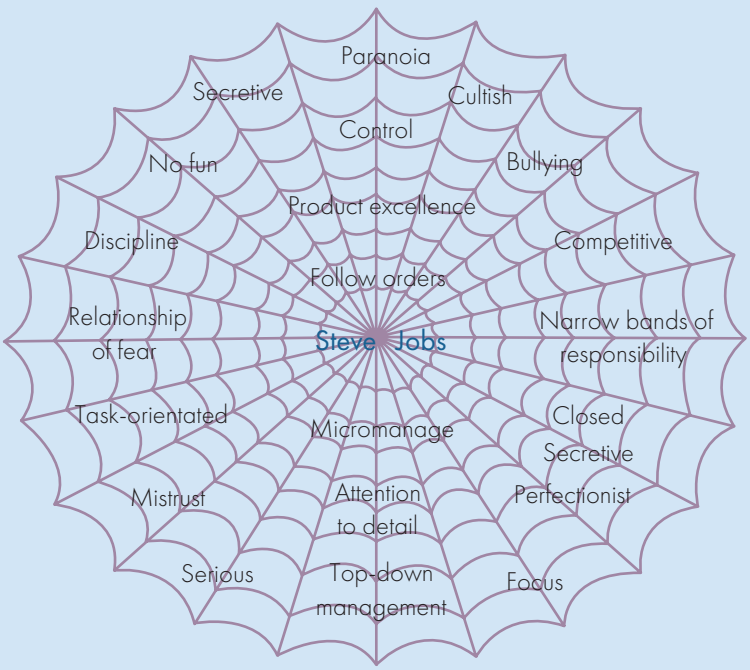


Figure 16.12 Apple's cultural web under Steve Jobs

Apple's organisational structure encouraged secrecy. It did not have organisation charts, although Lashinsky's attempt to draw one showed Jobs in the middle of a spider's web. He described Apple's organisation as 'unconventional', with 15 senior vice presidents and vice presidents reporting directly to Jobs 'at the centre'. Staff were frequently organised around small project teams with teams isolated from each other and operating under strict secrecy rules. He described them as 'siloes within siloes'. Staff only knew about the elements of new product development that they needed to know about. The fact there were no conventional organisation charts limited the number of people employees knew outside their immediate environment – a cell-like structure.

Jobs' personality was integral to his leadership style and he built an organisation structure and culture to match this. However, it was almost the direct opposite of most successful high-tech businesses in Silicon Valley. Lashinsky frequently contrasted Apple with Google. And, at the time of his death, many commentators observed that this organisation was so based upon one man, that they questioned how long it would prosper without him.

Nevertheless, Jobs had many admirers and he certainly achieved enormous things in his life. Walter Isaacson (2012) believed that you should not 'fixate too much on the rough edges of his personality ... His petulance and impatience were part and parcel of his perfectionism'.

Isaacson listed 14 keys to Jobs' success with Apple:

1. *Focus* – Jobs was always able to focus and spend time on what he considered important, often to the frustration of others trying to get him to consider other things. As he explained to the 1997 meeting of the Apple Worldwide Developers Association: 'Focusing is about saying no ... and the result of that focus is going to be some really great products where the total is much greater than the sum of the parts.'
2. *Simplify* – Jobs admired simplicity. Simplicity of use was a key design feature of all Apple's products: 'It takes a lot of hard work to make something simple, to truly understand the underlying challenges and come up with elegant solutions.'

3. *Take responsibility end to end* – In his quest for simplicity, Jobs took end-to-end responsibility for the user experience, integrating hardware, software and peripherals – part of his controlling nature and drive for perfection.
4. *When behind leapfrog* – Rather than copying competitors, Jobs would always try to create something better and different.
5. *Push for perfection* – Jobs was a perfectionist and would delay production until he thought the product was 100% right.
6. *Put products before profits* – Because he was a perfectionist Jobs also wanted his products to be the best, whatever the price, believing that if the product was great, profits would follow.
7. *Don't be a slave to focus groups* – Because Apple's products were so innovative, Jobs never trusted focus groups and market research, preferring his own instincts: 'Customers don't know what they want until we show them.'
8. *Bend reality* – Jobs' famous 'reality distortion field' persuaded people that his vision of the future would prevail. Some called it bullying and lying, others called it effective communication of strategic intent.
9. *Impute* – Jobs used the design of products and even its packaging to 'impute' signals to customers, signals that underpinned the brand identity.
10. *Tolerate only 'A' players* – Jobs' passion for perfection extended to employees and, perhaps, explains his rudeness to people who did not perform as he expected.
11. *Engage face to face* – Jobs was a believer in face-to-face meetings. His executive team met once a week, without an agenda, to 'kick around ideas'.
12. *Know both the big picture and the detail* – Jobs had both vision and a grasp of detail, or at least the detail he thought important.
13. *Combine humanities and sciences* – Jobs was able to connect ideas from different disciplines to create features in his products that customers valued (a key 'discovery skill').
14. *Stay hungry, stay foolish* – Jobs never wanted to lose the drive he had in his youth and always wanted Apple to keep the culture of a start-up.

Steve Jobs was a great entrepreneur. And under his leadership Apple certainly was extremely successful. But was he a great entrepreneurial leader? Has he created an organisation that will endure entrepreneurially, one that can succeed and prosper without him? Only time will tell.

Access the *Digital Links* booklet to watch a short video obituary for Steve Jobs, a two-part interview with Walter Isaacson about Jobs and his leadership characteristics, and a 40-minute video which sets out '10 rules for success' based on advice Jobs gave during his life.

Questions:

1. What elements of the entrepreneurial character did you spot in Jobs and how are these reflected in his leadership?
2. How did this reflect itself in the culture and structure of Apple under his leadership? Are these organisational strengths or weaknesses?
3. Was Jobs a great entrepreneurial leader? Explain and justify.
4. Do you have to be a likeable character to be a great entrepreneurial leader? Explain and justify.

Disclaimer: All information in this case study is collected and interpreted by its author and does not represent the opinion of Apple or its current management.

SUMMARY

- Management and leadership are different and distinct terms, although the skills and competencies associated with each are complementary. Management is concerned with handling complexity in organisational processes and the execution of work. It is about detail and logic, efficiency and effectiveness (left-brain). Leadership on the other hand is concerned with setting direction, communicating and motivating. It is about broad principles and emotion (right-brain).
- Values and beliefs underpin organisational culture. They are strongest when based on the principle of reciprocal obligation. A leader's own values and beliefs have a strong influence on those of the organisation.
- Strong values and beliefs create a sense of identity. They influence how staff interact with each other. They are based on trust, which must be demonstrated by actions, not just words.
- A vision is a desired future state. It must be attractive but credible – acknowledging the tension created by a realistic appraisal of the current situation. Developing vision is a continuous process, checking with staff that it resonates with them, modifying it to suit changing circumstances.
- Visions and culture can be communicated as a 'story' that, in some way, appeals to emotions and motivates staff to achieve. There are three types of stories that can fit together to forge the web of reciprocal obligations: belonging, obligation and causality.
- Leaders also need to be able to be strategic thinkers and learners and be able to reflect. They need to be authentic with emotional intelligence (self-awareness; self-management; social awareness; social skills).
- Contingency theory tells us that the most appropriate leadership style to adopt depends on four factors: the leader, the group, the task, and the situation or context they face.
- The entrepreneurial context is characterised as one of uncertainty, constant change and super-competition. There are leadership paradigms that inform us about leadership in this context – transactional leadership, transformational leadership, visionary leadership and dispersed leadership.
- To create an entrepreneurial organisation a leader needs to take an architectural approach, building entrepreneurial attributes into the organisation itself, spreading them throughout it and empowering staff to make 'the right decisions' in the unpredictable circumstances they face.

GROUP DISCUSSION TOPICS

1. Is Greiner's model an accurate predictor of the growth process?
2. Is operational capability more important than strategy at start-up? Explain.
3. What are the effects of a social enterprise being over-reliant on an external stakeholder such as government?
4. What are the differences between the accumulation of social capital and financial capital?
5. Can you undertake a financial ratio analysis on a social enterprise? What would it tell you?
6. How does the role of leader differ from that of entrepreneur?
7. How does the role of leader differ from that of manager?
8. Leaders are born not made. Discuss.
9. Explain what the job of leader involves.
10. What personal qualities do leaders need? Explain.
11. Why is trust in the leadership of an organisation important?
12. How can a leader develop trust?
13. How do you build a relationship? Give examples.
14. How do you develop a sense of 'reciprocal obligation'?
15. Why is 'walking-the-talk' important for a leader?
16. How can storytelling reinforce vision and culture?
17. What is the contingency theory and how does it affect leadership style?
18. Why is an ability to handle conflict important in the entrepreneurial firm?
19. How do the leadership paradigms discussed in this chapter reconcile with contingency theory?
20. How is entrepreneurial leadership different from visionary, transformational and distributed leadership?

STUDENT ACTIVITIES

1. Answer the leadership styles questionnaire (Explore further 16.3) on the companion website bloombury.pub/burns-esb-5e. Do you agree that this is your preferred leadership style? Explain and justify with examples of your behaviour.

2. Based upon an organisation you are familiar with, use the Organisational Culture Assessment Instrument (Explore further 16.2) to evaluate their organisational culture. Explain the results giving example to justify (or otherwise) the analysis.
3. Obtain the Thomas–Kilmann Conflict Mode questionnaire (Explore further 16.4) and evaluate how you handle conflict. Do you agree that this is your preferred approach? Explain and justify with examples of your behaviour.
4. Using detailed examples, show how the appropriate leadership style might differ for:
   a) three different tasks, given the same group and situation;
   b) three different groups, undertaking the same task in the same situation;
   c) three different situations, where the same group is undertaking the same task.
5. Research and write a profile of a successful entrepreneurial leader, emphasising their leadership style.

START-UP ACTIVITIES

1. If there is more than one founder or a leadership team, ensure they all undertake activities 1, 2 and 3 above.
2. Review the results from activities 1, 2 and 3 above and, with the preferred Belbin team roles of the founders and other psychometric tests by the management team in mind (Start-up activity 4 in Chapter 14), list the implications for the business and how leadership skills might be developed in the future (e.g. training and recruitment).

17 DEVELOPING STRATEGY AND THE BUSINESS PLAN

Contents

- Penetrating the market
- Undertaking a strategic review and pivoting
- Strategy development
- Coping with crises
- Reasons for writing a business plan
- Different plans for different audiences
- Structure and content of a business plan
- Tips on how to write a business plan
- Business plans for social enterprises
- Summary
- Group discussion topics
- Student activities
- Start-up activities



Source: Getty Images/jun xu

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand the difference between emerging and deliberate strategy development and how strategy is typically developed in SMEs;
- Undertake a SWOT analysis as part of a strategic review;
- Explain the issues facing an entrepreneur and their staff as they face recurrent crises;
- Explain the purpose, structure and content of a business plan for both a commercial and a social enterprise.

Case insights

17.1 AudioBoom
17.2 Google Glass
17.3 Uber
17.4 The London School
17.5 Net-Works™

Explore further links

17.1 Change management
17.2 How to write a business plan

PENETRATING THE MARKET

The growth phase of the customer journey (Figure 10.1) centres around penetrating the target market(s) highlighted in the original business model. This involves encouraging customers to repeat-buy (if it is a small ticket item) and/or become loyal supporters of the product/service. Most businesses grow through a combination of repeat sales and new customers. Repeat sales are built on the relationship developed with customers. As competitors emerge the brand image and reputation become increasingly important. New customers come from a combination of promotional activity using all the media outlined in Chapter 10 (including face-to-face selling) and finding new distribution channels. Using existing customers willing to act as advocates in some way is particularly effective. Reputation spreads, but it can take time. And as a product/service attracts more customers, it will attract more attention from competitors. They may adapt their marketing strategy and even change their product/service characteristics so as to compete more directly. So, the marketing strategy (including pricing) appropriate at start-up may need to adapt and change to suit this.

The strategy to adopt in this growth stage depends, in part, on the competitive position the start-up finds itself in and whether the metrics it has set itself as measures of 'success' have been achieved (Chapter 15). Referring back to the new venture typologies in Figure 4.1, the more radical a product/service innovation, the more likely a firm is to have a strong competitive position, reflecting itself in a low level of competition. A firm in a strong competitive position should expand as rapidly as possible, aiming to dominate its market. This will involve investing in whatever is the basis for its value offering and developing its brand identity. There is a window of opportunity for the firm to capitalise on its first-mover advantage before competitors copy it. In terms of the generic business models outlined in Chapter 7:

- If the business model centres on high differentiation then the firm should continue to differentiate itself from the competition and build its brand. It will probably have been able to charge a premium price for the product/service at launch and it should have been investing these profits in this strategy from the start. However, as competitors emerge price reductions may be needed, either directly or, more likely, by improving the product/service's value to the customer in some way. For example, second-generation electronic products are typically better in some way (e.g. memory capacity for computers) but at the same price.
- If the business model at launch involves low price and therefore cost leadership then the firm must obtain the necessary economies of scale as quickly as possible to gain that dominant position. This involves investing in ways of keeping costs low and, at the same time, expanding sales through aggressive marketing, including price promotions.

The key to success for a firm in a strong competitive position is to gain market dominance as rapidly as possible – winning over the early and late adopters – at the same time as building close customer relationships that encourage their loyalty and advocacy. This might involve making an intensive push on distribution – organising frequent sales promotions, continually finding new channels of distribution, expanding into new geographic areas etc. – a topic we shall return to in the next chapter. Distributors love to sell products/services that have proved successful elsewhere. It reduces their risk.

A company in a weak competitive position has more of a problem. This may be the result of a poor business model and underlying strategies or unexpected customer or competitor reaction. It will show itself in lower-than-planned sales or strong price competition, leaving the firm with lower-than-expected profits and possibly facing a cash flow crisis. Whatever the outcome, if the metrics the firm has set itself as measures of 'success' have not been met, the business model will have to be reviewed. One attractive option may be to seek out a smaller niche for itself within that competitive industry, ignoring the mass market. In this way it might be better able to charge a higher price for a more distinctive and more valued product/service (Chapter 7). Undertaking a strategic review of the strategies that underpin the business model should highlight the options available.

UNDERTAKING A STRATEGIC REVIEW AND PIVOTING

The real test of any start-up is how customers react. Does the business model deliver what customers want, at a price they are willing to pay – the value proposition? The reality is that, while planning may have been meticulous and market testing rigorous, the only certain way of finding out whether a new product/service is viable is to launch it and then monitor its progress. The success of the product/service will determine the success of the business and the sad fact is that most businesses will not grow to any size and many will fail. The first step in growing the business is to understand how it has survived so far – what has worked and what has not, how the original launch strategies have been adapted to suit unanticipated changes to the competitive environment. So, the thing to do is to review the start-up strategy in the light of reality, learning from both the elements of success and the failure. The first year of a start-up has been called the real validation phase – when it is proved that the business model works. This is why setting appropriate metrics to evaluate the business is so important (Chapter 15).

It is good practice to have a strategic review at the latest one year after launch whether the firm is in a strong competitive position or not, simply because the competitive environment is likely to have changed. The process of strategic review is shown in Figure 17.1. The review tries to identify any deficiencies in the product/service and/or its business model (compared to competitors). It starts by comparing performance against the 'success' metrics the start-up has set for itself and the assumptions on which they were based. Have any of these proved to be wrong? Has the commercial environment changed? The assumption that is most likely to be wrong concerns competition since this is hard to anticipate in a changing market. Even if a product/service has proved successful with consumers, new competitors may have already emerged and their performance needs to be assessed, perhaps using market research.

Central to the review is a process called 'strategic analysis' – the process of developing strategy by reviewing the business and the commercial environment it operates in to determine the optimum 'fit'. Having looked at the commercial environment, the next step involves revisiting the vision and mission of the business (Chapter 7). These were based on aspirations (strategic intent) but also on the core competencies and strategic assets that the business enjoyed. The question is whether they are still realistic and appropriate. Visions can change and evolve as an entrepreneur gains more knowledge about their commercial environment. Indeed, Read et al. (2011) point out that many entrepreneurs do not have a vision when they launch their business. Have new, more attractive, opportunities emerged since the business was launched? And have the core competencies and strategic assets available changed, perhaps because of staff recruitment or partnership opportunities? Have the values and beliefs on which the business is based changed, perhaps because of changes in personal circumstances for the entrepreneur? Has the mission changed, perhaps because of new opportunities or, in the case of a social enterprise, because of changing social needs? The strategic analysis might therefore modify both the entrepreneur's vision and mission (shown as feedback loops). However, its main function is to generate strategic options and to inform strategy formulation. This then feeds into a tactical plan.

One technique often used in a strategic review is the classic SWOT analysis (strengths, weaknesses, opportunities and threats) of the current market position. A SWOT analysis can be carried out for a

> *Any plan will collide with reality and something else will emerge. People have to adjust their models to the market, the competition and events.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 20 April 2014

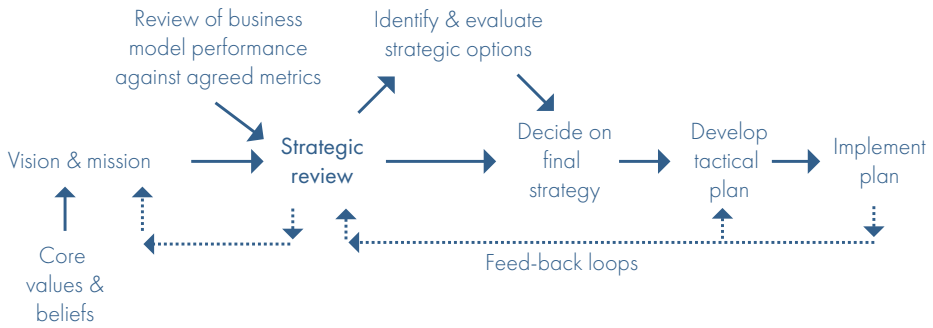


Figure 17.1 A framework for a strategic review

product/service or for an organisation as a whole. For an SME with one product/service they are likely to be the same. Some of the tools that can be used in a SWOT analysis are listed in Table 17.1. Strengths and weaknesses of the product/service (or firm) can be ascertained using tools like both desk- and field-based market research into customers and competitors, benchmarking against performance metrics, industry norms (including financial criteria) and CSFs, value chain analysis and two topics covered in the next chapter – product/service life cycle and product/market portfolio analysis. The threats and opportunities facing the product/service (or firm) can also be ascertained through market research (typically shorter term) but longer term through the PESTEL analysis and the other futures thinking techniques. Porter's Five Forces analysis is a tool used for market analysis and judging competition within an industry. It can be used to ascertain the strength or weakness of a product/service (or firm) within an industry, although it is predominantly used to understand the shorter term threats it faces. If competing product/services have emerged since the launch, assessing performance against them on the dimensions of the generic business model in Figure 7.2 (price/cost; quality/differentiation; customer focus/intimacy) will be particularly significant.

Table 17.1 Tools for a SWOT analysis

* Market research (Chapter 5)
* Benchmarking against performance metrics, industry norms and CSFs (Chapters 6 and 15)
* PESTEL analysis and other futures thinking techniques (Chapter 4)
* Value chain analysis (Chapter 4)
* Porter's Five Forces analysis (Chapter 5)
* Financial ratio analysis (Chapter 15)
* Product/service life cycle analysis (Chapter 18)
* Product/market portfolio analysis (Chapter 18)
* Business model frameworks (Chapter 6)



Bonus Case Xtreme SnoBoards (3)

Visit the companion website at www.bloomsbury.pub/burns-esb-5e to access this four-part bonus case that covers pricing, the preparation and evaluation of financial forecasts, and an estimated company valuation.

The business model frameworks outlined in Chapter 6 can be used to construct alternative business models that can then be evaluated. They also provide a framework for the tactical planning and implementation that subsequently takes place. There could be dozens of ways of changing a business model, so this process may involve multiple iterations before the financial outcome is satisfactory. When there are significant changes to a business model it is called 'pivoting', defined by Ries (2011) as a 'structured course correction designed to test a new fundamental hypothesis about the product, strategy, and engine of growth'. Twitter, Instagram and WhatsApp all 'pivoted' and radically changed their start-up business models when they found they were not working in practice.



Review your strategy constantly to ensure you are meeting market demands.

Elizabeth Gooch, founder of eg Solutions, LaunchLab, 13 January 2009: www.launchlab.co.uk



However, strategic pivoting can also be a sensible reaction to a fundamental change in the business environment that brings into question the current business model (e.g. the coronavirus pandemic of 2020/21). Sometimes risks materialise unexpectedly – whether they are 'known' or 'unknown' – and that might require a firm to pivot. Sometimes a pivot is preceded by a crisis, but a crisis for one firm might be an opportunity for another. While a particular strength of SMEs is their flexibility, a strategic pivot is aided by any previous analysis of risks and the development of strategic options (Chapter 13).

The whole process of strategic analysis is an art rather than a science and there is no prescriptive approach. It should give strategic direction to the firm and help provide a clear understanding of which elements of strategy have worked, which have not and how they might be improved. It may

even identify new, emerging opportunities. However, in developing the initial business model for the product/service, critical success factors should have been highlighted and, out of this, strategic options developed. These may cover the reasons for needing to review the business model and provide 'ready-made' contingency plans. As we have seen, strategic options are important and valuable in an unpredictable commercial environment.

Case insight 17.1 AudioBoom

Pivoting

The podcast market is booming. There are 73 million monthly listeners in the USA and 5.9 million in the UK. About 28% of the population in Canada and 18% in Australia are podcast listeners. AudioBoom is an on-demand audio and podcasting platform. The business was originally launched in 2009 as AudioBoom and is now quoted on the London Stock Exchange after a reverse takeover of One Delta, an AIM (Alternative Investment Market) listed shell-company in 2014. Later the same year the company raised £8 million in a share placing with a number of blue-chip institutional investors, valuing it at over £73 million. The reason AudioBoom has attracted so much attention is because analysts believe it has tremendous potential for future growth, particularly outside the UK in markets like the USA, Australia and India. AudioBoom's strategy and business model have changed a number of times since its launch.

Original strategy: Amateur users were allowed to record, post and share audio clips – spoken word, not music – for free. Because there was no music, AudioBoom did not have to pay performance royalties. This phase attracted many celebrity users and generated a loyal listening. The problem was that AudioBoom had not yet worked out how to generate income.

Pivot 1: This first strategy pivot was to target professional organisations and persuade them to make audio content such as news, reviews and interviews available on the site. By 2014 it had developed some 2,000 commercial partners such as the BBC, Sky Sports, talkSport, Premier League and many newspapers and magazines.

At the same time it started developing a new business model that would allow it to generate income, but to enable this to happen it also had to develop a new software platform. This was what most of the £8 million funding raised in 2014 was used for.

Pivot 2: Later in 2014, the service was relaunched. Podcasters were offered an embeddable audio player that allowed them to share content on their own website and social media feed. Listeners could create their own personalised feed by downloading content that they wished to receive and this could be downloaded automatically at times they selected – a system called 'content curation'. Content could range across sport, news, financial markets and entertainment. Using AudioBoom a sports fan could download up-to-date selected content and listen to it as the news breaks or store it to listen to on the way to work.



Source: Siddharth Bhogra on Unsplash

AudioBoom is now the leading podcasting and on-demand audio platform for hosting, distributing and monetising content. It now hosts thousands of podcasts from around the world from organisations such as Associated Press, BBC, NBC Sports and Red FM. It has automated distribution through partnerships with platforms such as iTunes, iHeartRadio, Google Play, Spotify, Stitcher, Facebook and Twitter as well as users' own websites and mobile apps. Just as YouTube does not pay for content, AudioBoom does not pay for most audio clips and generates income by selling advertising which is inserted before, during and after an audio clip. It also generates income from the host-read endorsements, sponsorship and branded content.

The company is still based in London, where most of its users remain, but it also has studios in Los Angeles and New York that produce original content for the AudioBoom podcast network and as part of bespoke production deals with well-known personalities and brands.

Access the *Digital Links* booklet to visit the company website and to watch a video interview with CEO, Robert Preeter, about how he planned to make the business generate cash.

Question:

1. What lessons do you learn from AudioBoom about changing your business model?

STRATEGY DEVELOPMENT

This book has set out a framework for developing a launch strategy in a systematic way using the business model frameworks outlined in Chapter 6. But Chapter 3 observed that entrepreneurs do not like formal research and planning (Sarasvathy, 2001) – an analytical left-brain activity. They have broad goals that evolve over time depending on their resources. They prefer to approach strategy and decision-making differently, often being seen as intuitive using what they might call a 'gut feeling'. For them strategies, a series of linked coordinated actions, evolve on an informal, step-by-step basis – they 'emerge'. In fact, the 'science of muddling through' (Lindblom, 1959) is as old as strategy itself. If one step works then the next is taken. Each step provides more information about a risky outcome – a process of learning-by-doing. At the same time, they create and keep open as many options as possible at each stage.

A number of tech start-ups have business models based up the premise that they will disrupt a market. Often these can attract large amounts of funding, based upon the hope that at some point in the future the company will come to dominate the market it disrupts and make high profits (see Chapter 7). However, investment in these disruptor companies is risky and changes in strategy are common. Founded in 2008, Airbnb is a loss-making disruptor with a low-cost business model. The original concept was that travellers could rent direct from homeowners through Airbnb, avoiding the additional costs and regulations associated with professional renters. This concept is still reflected in the advertising on its website. However, the number of professional renters is growing at three times the rate of amateur hosts – up from only 10 per cent in 2016 to 22 per cent in 2019, and growing (*The Sunday Times*, 23 February, 2020). Airbnb has not explained how this major shift in its customer base might affect its business model. Nevertheless, despite this and the downturn in its revenue because of the coronavirus pandemic, Airbnb was successfully floated on the stock market in 2021 with its share price valuing the company at some $100 billion.

It was Mintzberg (1978) who first coined the phrase 'emergent strategy' development, which he contrasted with the more systematic approach he called 'deliberate', where strategy is decided on well ahead and firmly adhered to (often associated with a machine bureaucracy). As he put it, with emergent strategy 'the strategy-making process is characterized by reactive solutions to existing problems … The adaptive organization makes its decisions in incremental, serial steps.' Emergent strategy can only be developed through a process of continual *strategising* – a process that involves evaluating strategic options on a continuous basis. Because outcomes are uncertain, the more options available the better. Burns (2005) observed that it is an approach that resonates with complexity theory, which attempts to describe how to navigate complex, unpredictable systems that are affected by multiple independent actions – a good description for today's turbulent, interconnected global marketplace.

However, in a study of growing firms, McCarthy and Leavy (2000) showed that strategy development was *both* deliberate and emergent; changing from one to the other as the firm went through recurrent crises followed by periods of consolidation, perhaps related to the crises in Greiner's growth stage model (Figure 16.1). These crises force the entrepreneur to change their preconceptions and 'unlearn' bad habits or routines ahead of learning new ones (Cope, 2005). Therefore, rather than having only one style of strategy development, entrepreneurs would seem to adopt both, depending on circumstances. In this way the well-documented process of *growth → crisis → consolidation* facing most SMEs parallels a process of *emergent → deliberate → emergent* strategy formulation, with strategic intent giving direction – a process shown in Figure 17.2. It is easy to envisage a crisis that involves not only a pivot in strategic direction but also a related cash flow crisis resulting in the need to seek external finance. In these circumstances deliberate, formal planning may be required by the provider of finance in the form of a written business plan – a topic we shall return to later in this chapter.

While *models* themselves are not good at predicting any system that changes, the business model frameworks outlined in Chapter 6 should provide a useful *framework* for strategising and help with emergent strategy development. Linked with the tools of strategic analysis, they provide a structure and focus for a strategic review. They generate a common language and mechanism for communication. They should replicate good practice, providing a link from judgement through experience to learning. They ought to be logical and common sense. They are not in the nature of a scientific discovery. They are, to quote a colleague, 'a glimpse of the blindingly obvious' – something you knew all along but were never quite able to express in that simple way. In that sense they help organise and develop what might

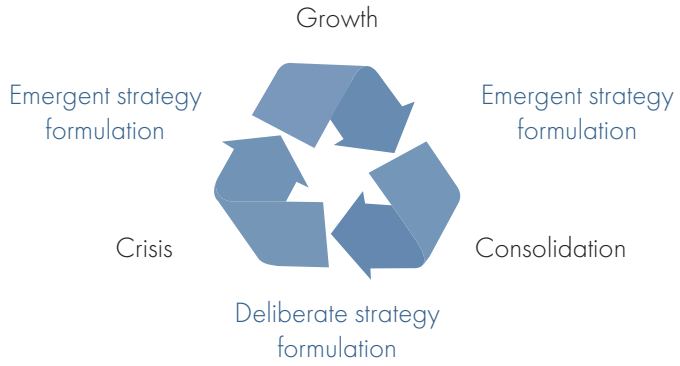


Figure 17.2 Strategy formulation cycle

Case insight 17.2 Google Glass

Learning from failure and pivoting

Google has a low-cost, try-it-out, experimental approach to new product development. It believes in launching early and then developing and perfecting the product as it learns from the market. One of its 'Principles of Innovation' is: 'Innovation, not instant perfection'. However, following this principle has its risks and means that not all products have been commercially successful. Nevertheless, Google believes that all its projects have some value and aims to learn from these projects and build upon the knowledge gained. Another of these principles is: 'Morph projects, don't kill them.'

In 2013 Google launched the smart glasses called 'Glass' amid much fanfare and PR. 'Glass' incorporated an information display system and camera linked to the internet via a smartphone that wearers could communicate with through voice commands. However, the product has never really taken off because of a combination of privacy concerns (it might be used in ways that break existing privacy laws), high price and fashion (early adopters were labelled 'glassholes'). Google's response was to continue to develop the product (there are now a range of apps that can be used alongside the product) but also to seek out non-consumer uses.

Glass morphed into a number of different applications. An MIT start-up called Brain Power developed software for it to help children with autism and ADHD to build socio-emotional skills. Glass has found many uses in hospitals; for example to demonstrate surgical procedures. However, its most important commercial application has been in the workplace. Rather than close down the project, Google expanded its 'Glass at Work' programme, which sought business applications for the device, usually in partnership with other organisations. The product morphed into Glass Enterprise Edition, a small, lightweight wearable computer with a transparent display for hands-free work – a device capable of providing access to immediate, on-site, customised technical data and information. It is now used by companies such as AGCO, Boing, DHL, Dignity Health, NSF International, Sutter Health and Volkswagen. For example, the device is used by workers on the assembly line at AGCO, a US company that manufactures custom-designed agricultural equipment. By reducing the time involved in viewing checklists and instruction manuals or sending photos from tablets or laptops, it reported a 25% reduction in production time and 30% reduction in inspection times for workers using the device on its low volume, complex assembly lines.

Access the *Digital Links* booklet to visit the website and to see how AGCO use Glass Enterprise Edition.

Questions:

1. What are the pros and cons of trying out new products in the marketplace?
2. Could Google have known about consumers' reactions to Glass without launching the product?
3. How different would the business model for Glass be, compared to Glass Enterprise Edition? How easy would it be, even for Google, to change the business model?

otherwise be a disjointed and unsystematic process. Using these business model frameworks as part of the strategic review should help to come to the right decisions about strategy, consistently.

However, strategising in the uncertain environment of today presents challenges. Kay and King (2020) certainly do not believe in prescriptive planning using data-driven models. They make a number of suggestions for strategic decision-making in uncertain environments:

- Never aim for an optimum outcome, it is impossible to identify. Instead aim for 'good-enough' while minimising down side risks;
- Ditch any strong prior beliefs and/or dominant logic. Treat every decision as a one-off using frameworks and data only as guidance but also giving credence to anecdotes and stories;
- Solicit constructive criticism from a wide range of people and do not succumb to groupthink.

Case insight 17.3 Uber

Business model success and failure

It can be difficult to change your business model if the reason investors funded the business was because the model was seen as innovative and disruptive of an industry. However, Uber has been doing just that recently. Founded in 2009, Uber disrupted the taxi industry with its low-cost business model and, having raised some $25 billion in funding from the stock market, has expanded rapidly worldwide. The problem for Uber is that it continues to be loss-making.

Uber has a low-cost business model. Passengers use the Uber app to order a taxi at which point they are quoted a fare based on a dynamic pricing model depending on demand at the time. The taxi can be tracked and the passenger pays at the beginning of their journey. The original business model had drivers as self-employed (avoiding employment law and taxes), using their own vehicles (avoiding capital or lease costs), meeting local laws and regulations themselves (avoiding regulation costs) and using the Uber app to receive and accept fares. This model was designed to keep costs and therefore prices low. However, this model is increasingly under threat as governments legislate to ensure Uber drivers are covered by employment law and that Uber must meet local laws and pay employment and other taxes. For example in 2021, after a protracted legal battle, the Supreme Court in the UK ruled that Uber drivers must be treated as workers rather than self-employed (a decision that affects other gig-workers). Uber has gradually been raising its fares recently (an estimated 7% rise in 2019). And in 2020 it started trials of a 'new' system in Arizona whereby passengers can call a real dispatcher, who then sends a taxi to their location – very like conventional taxis. What is more, in California Uber drivers can now charge what they want, although Uber posts a suggested charge. By doing this the company hopes to give drivers more 'control' – a legal test for being self-employed in many US states and other countries – and thereby avoid having to make them employees with more rights and higher costs.

The problem for Uber is that it continues to be loss-making. Expansion into each new country poses different problems, such as laws and regulations. And generating the required network effects needed for Uber to be successful is expensive – passengers need Uber vehicles to be available before they will use Uber, and Uber drivers need passengers before they will sign up to Uber. Keeping prices low discourages new drivers signing up. Many believe the only way Uber's business model will work is with the advent of self-driving cars – but that could still be some years away. To make matters worse, many of Uber's diversification plans have not worked and have proved expensive (see Case insight 7.6 on Uber Eats). Stock market investors are beginning to expect to see a return on their investment, after all, Facebook became profitable only a couple of years after floating.



Source: Victor Xok on Unsplash

Access the *Digital Links* booklet to visit the company website and watch a video exploring the economics of the Uber business model.

Questions:

1. Is this the beginning of a major strategy pivot or just a minor strategy adjustment?
2. Is having stock market funding for a disruptive innovation an advantage or a disadvantage?
3. Do you agree that the only way the Uber business model will work is with the advent of self-driving cars? Explain.

COPING WITH CRISES

The recurring crises faced by many SMEs are often attributed to short-term, reactive decision-making – tactics being deployed without an underlying strategy. But this can lead not only to bad decision-making, it can also lead to management chaos. There is a wonderful Chinese proverb that underlines the need for a consistent, coherent strategy: Tactics without strategy is the noise before defeat.

The point being made is that, without an underlying strategy, deploying tactics as reactions to situations will not only fail but also cause 'noise' – arguments among stakeholders about what is being done, why it is being done and how it should be done. Navigating a way through a crisis is the responsibility of the leader of the organisation, but they need to understand how staff are likely to react and that people often do not like the changes that are likely to be necessary as a result of an organisational crisis.

By definition, a crisis involves risk and danger not only for the organisation but also the individuals within it (including the owner-manager). Most people find this, at the very least, unsettling, even threatening and some can become emotional over it. This reaction is instinctive and deep-seated within us. And this reaction to the threat posed by a crisis can carry through to the changes required to get through it – the pivot in strategy resulting in day-to-day changes in how things are done. Our reaction depends to some extent on our personality. Individuals who are seen as reliable, steady or dependable often find change difficult, as do process-orientated people. And certain industries and disciplines can attract individuals with these characteristics. What is more, an individual's priorities and motivations are also different at different stages in their lives, for example with increasing family and financial commitments, and this can be reflected in their apprehension about change. Resistance to change can also be deeply rooted in historical experiences, for example if people are rewarded for 'not rocking the boat' – penalised for making bad decisions or rewarded for not making any decision at all. People may have good reason to fear change if they have always suffered as a result of it in the past. And fear of change can lead to stress – the single most frequent cause of absenteeism in most Western organisations. However, it was Milton Friedman who said: 'Only a crisis – perceived or real – produces real change' (Friedman, 1962).

An entrepreneurial organisation will face change aplenty, often seeming generated by a succession of crises. Some crises might be generated deliberately by the entrepreneur, others the result of inadequate risk management (Chapter 13). Each crisis precipitates a reaction from individuals as they are required to change. The psychologist Kurt Lewin (1947) originally proposed a three-phase change model: *unfreeze* → *change* → *refreeze*. Subsequently Kübler-Ross (1969) proposed a change model for patients approaching and/or surviving death. This is the basis for the three-phase managerial change curve shown in Figure 17.3 developed by Kakabadse (1983). As the organisation passes through each phase, individuals can encounter a roller coaster of human emotion as they find themselves facing a different role with new demands and responsibility rests with the managers of the organisation. The skill of managing change is crucial and understanding the emotions an employee is likely to face can help both leaders and managers:

1. Getting used to the new situation (unfreezing) – After the shock of a change event or crisis, individuals might question or deny the need for change. The unfamiliarity with their new roles makes them feel anxious about their contribution and so their organisational effectiveness drops slightly. However, as they get used to the new circumstances and find support to help them, their effectiveness may improve and they may therefore start to believe that they do not have to change.
2. Relearning (changing) – Hard demands are now being made and individuals experience real stress as they realise that they do have to develop new skills to keep up with the job. They need to relearn their role. Although they may eventually learn how to do their new job, a period of anxiety and depression is likely to make them less effective because they can no longer rely on their old skills and they may believe that they can no longer cope. In fact this 'low' indicates that the person is realising that they have to let go of the past and change. This is the most dangerous point in the change cycle as the individual feels highly stressed and may be tempted to give up. It is the point where they need the greatest support and encouragement if they are to progress through the cycle. It is also the point where they may be persuaded to leave the organisation, if it is clear that they cannot change.

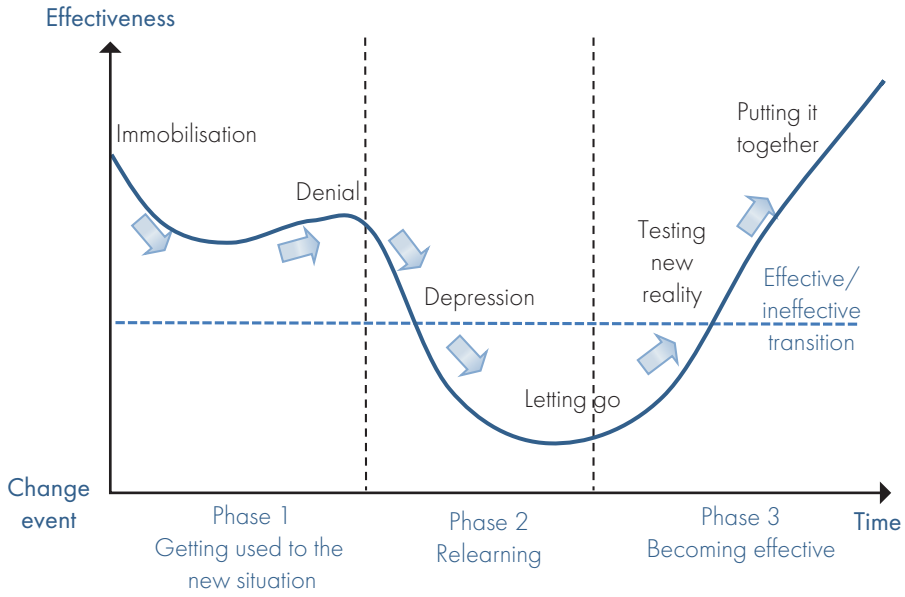


Figure 17.3 Change curve

3. Becoming effective (refreezing) – This is the stage when, having accepted the changes, individuals start learning and testing out new skills. They start finding out how effective they are in dealing with this new, changed reality. This can be as frustrating as it can be rewarding. In making the transition, individuals will inevitably make mistakes, causing them further stress. But, as newly learnt skills are brought into play effectively, their performance should improve and they should become happier. They should now have a new set of skills alongside their old ones.

There may be lessons here for managing others, but thought should also be given to the entrepreneur themselves as they go through this roller coaster of emotions. The crisis threatens their business, their livelihood and even their family well-being. Of course elements of their character might make them better able to cope but the stress involved can lead to them giving up. The transition through to phase 3 is not guaranteed.

Kotter (2012) suggested an eight-step process for leading change (whatever its cause) in an organisation:

1. Create a sense of urgency – If the necessary changes are the result of a crisis, then the urgency may already be apparent, if not welcome.
2. Form coalitions with influencers – Finding others who might welcome, influence or lead change can help with the 'internal politics' and spread the work load.
3. Create a vision for change – This is something the entrepreneur should already have. We discussed it in Chapter 16.
4. Communicate the vision – Again, this is something we already discussed in Chapter 16.
5. Remove obstacles – By this stage the structures for implementing change should be in place. Those making change happen should be recognised and rewarded. Any obstacles in the way may need to be removed (human or otherwise). This can empower others to make the necessary changes.
6. Create short-term wins – This lets people see that the changes are working and helps motivate them. Without this critics may quickly emerge.
7. Build on the change – If there are changes in strategy, analyse what works and what does not, taking corrective action as necessary. Today change is a continuous process, not a one-off event.
8. Anchor the changes – The changes need to be embedded in the organisation structure and culture.

Explore further 17.1

Change management

Access the *Digital Links* booklet to watch the following videos:

- A consultant explaining the principles of change management.
- Professor John Kotter talking about his eight-step process for leading change.

Case insight 17.4 The London School*

Managing a turnaround

The London School is a multicultural, inner-city, state secondary school in the centre of London. Built in the 1980s to take over a thousand pupils, a lack of maintenance and capital investment had led to many of the buildings showing signs of wear-and-tear. One of the challenges for the school was that its catchment area was largely affluent middle class and its main competitors were local private schools. At the same time, pupil numbers had been dropping over a number of years, leading to budget cuts. This had, in turn, led to staff also leaving and most remaining staff had been in post for many years. Teaching standards and pupil performance were declining and, as the result of an adverse report by teaching inspectors (called Ofsted), a new head-teacher was appointed just as the school was placed under 'special measures', requiring continuing monitoring of its teaching standards by the inspectors until they improved. If they did not there was the risk that the school would be closed.

The head-teacher immediately brought in a number of new senior managers. Together they imposed a rigid set of demands on the teaching staff in order to get through the follow-up inspection – lesson plans, teaching styles, discipline etc. Classrooms even had to be laid out in a certain way. Initiatives were quite simple but designed to have an effect quickly both on behaviour of students and levels of learning in the classroom. Despite restricting their professional autonomy, staff were compliant, realising the implications should there be no improvement. Within a couple of years the school began to improve and it was taken out of 'special measures'. That led to increased pupil recruitment and a change in the demographics of the school, in terms of the type of pupil.

With this turnaround, the school needed to recruit new teachers and it chose to do so through a UK initiative called 'Teach First' which recruited high-achieving graduates and placed them in schools under the supervision of local universities. The school took in some ten new teachers. This is when a new set of problems started to emerge. As they settled into their careers and qualified as teachers, these recruits became increasingly



Source: Getty Images/Cultura RF/Tim Hall

frustrated by the lack of autonomy teachers had within the school. Despite their enthusiasm to be creative and innovative in their teaching, the head-teacher continued to demand that they stick rigidly to the school teaching policies and practices. He was now used to operating as a leader in a school in crisis and found it hard to change his style in order to develop a different culture, one that would have allowed ideas to come from across the school rather than just from the senior staff and, if harnessed properly, could have been instrumental in taking the school to the next level.

Questions:

1. Was the head-teacher right to be authoritarian and impose such rigid teaching policies and procedures to turn the school around?
2. How easy is it to now change these policies and procedures? Should they be changed?
3. What are the dangers the school faces if they were to change?
4. What are the dangers if they were not to change?
5. What does this tell you about the context of leadership and management?

*The facts of the case are accurate but the name of the school has been changed. Case contributed by Dr Jean Burns.

REASONS FOR WRITING A BUSINESS PLAN

While business model frameworks facilitate informal strategising, a written business plan may be required when a business faces one of these recurring crises. A business plan is a lengthy formal document that provides details of the business model, the strategies that underpin it and the rational for adopting them. Because it is a lengthy document it can take time to produce. There is no point in formalising frameworks and documenting plans unless they help in the planning process or are needed to help communicate those plans to a wider group of stakeholders in the venture – shareholders, lenders, employees, partners etc. As we have observed, it will probably be required if external funding is being sought – whether to finance the start-up, its growth, a strategy pivot or any form of crisis. Small-scale ventures may not need lengthy, formal plans to help run the business, but many providers of finance still expect them. Larger scale ventures may provide business plans as a matter of course because it is the best way of communicating with a large number of stakeholders or because they are seeking a large amount of external funding. As Bygrave et al. (2007) argued: 'unless a would-be entrepreneur needs to raise substantial start-up capital from institutional investors or business angels, there is no compelling reason to write a detailed business plan before opening a new business'.

Evidence about the positive effect of business plans can be mixed, particularly for early-stage businesses where the product/service may still not be well defined and the market uncertain. Based on her study of 27 successful US entrepreneurs, Sarasvathy (2001) observed that entrepreneurs do not like extensive, formal research and planning. On the other hand, Timmons (1999) claimed that the 'vast majority' of *INC.* magazine's annually produced 500 fastest-growing US companies had business plans at the outset – although another study claimed that this figure was only 28 per cent based on a 'sample' of these companies (Bhidé, 2000). A separate survey of 600 US SMEs claimed only some 31 per cent had business plans at the outset (Wells Fargo, 2006). Burke et al. (2010) asserted that the impact of business plans depends on their purpose. However, he also observed that in the UK firms with formal, written plans reported superior employment growth.

Developing a business model and then writing it down as a formal business plan does have some benefits. It forces the entrepreneur to crystallise their business idea and to think systematically through the challenges they will face before they have to deal with them. The process allows them to develop strategies and strategic options that should improve their chances of success. It allows them to set key milestones against which to monitor their performance that should be measured by the performance metrics they have established. And the greater rigour involved in writing a formal business plan often ensures that the document faces greater scrutiny ensuring that details are not overlooked. But perhaps of more immediate importance, it can also act as a vehicle to attract important external funding in the form of loan and/or equity finance. The more finance required, the more detailed the business plan is likely to be, particularly if equity investors are being sought. Even social entrepreneurs may have to write business plans to obtain finance and government grants. Entrepreneurs may not like formal plans, but they do seem to produce them – or at least hire accountants to produce them – when they need to obtain external funding.

> *Write a business plan – and get advice on doing it properly … I needed a business plan when applying for funding and it's the most useful thing I've done.*
>
> Julie Spurgeo, founder of Material Pleasures, *Sunday Telegraph*, 12 July 2009

> Entrepreneurs treat a business plan, once written, as a final collection of facts. Once completed you don't often hear about people rewriting their plan. Instead it is treated as the culmination of everything they know and believe. It's static. *In contrast, a business model is designed to be rapidly changed to reflect what you find outside the building in talking to customers. It's dynamic.*
>
> Steve Blank, serial entrepreneur, 8 April 2010: https://steveblank.com/category/customer-development-manifesto/page/3/

DIFFERENT PLANS FOR DIFFERENT AUDIENCES

There are no set rules for the format of a business plan, although the next section will set out a general pro-forma. Because each business is unique, every business plan will be different, at least in the detail it contains. But every plan should also be appropriate for its purpose and tailored to the audience it is aimed at. It may be appropriate to omit or add, expand or contract complete sections to suit different circumstances. Large-scale enterprises will require longer plans than small-scale enterprises. A plan simply for the entrepreneur might be brief and functional, almost an 'aide-mémoire' or summary plan, running to a few pages. A plan for business angels or venture capitalists will be longer and more detailed, perhaps resembling more a sales brochure than a technical plan. A full business plan of this sort may run to some 20–30 pages, depending on the amount and nature (debt vs equity) of funding being sought, with financial projections and other details going into the appendices (which may be large enough to warrant being in a separate document). Chapter 19 will explain what different providers of funding might be looking for in a plan. It will also show how a business plan can be used to obtain finance.

If a firm is developing a completely new and innovative product/service, the business plan will need to explain what stage the development is at, and what further development is needed to take it to market. Basic ideas are unlikely to find funding. Even when there is a working prototype, finding finance might prove difficult. The earlier the stage in its development, the more difficult this will prove. There is no guarantee the product will work and there is no guarantee that there will be customers for it. Even if it works will the firm be able to stop competitors copying it?

Every business plan for use outside the firm should be succinct and well written. The benefits (or solutions to problems) that the product/service offers to customers must be clearly articulated at the very beginning of the plan. Simplicity and clarity are vital, although the details to support claims must also be present. There is always a fine balance between including sufficient detail in the plan to convince the reader that the author knows what they are talking about, but not so much that the reader loses interest. Indeed, too much focus on the operations may convince equity investors that the entrepreneur is product- rather than market-focused – and that will definitely turn them off.

> *I see business plans so complicated that you need to set aside a week to read them but it's the ability to identify a simple solution that continues to set apart the best entrepreneurs.*
>
> Duncan Bannatyne, serial entrepreneur, *Sunday Telegraph*, 30 July 2009

One set of details that providers of finance always pay particular attention to are the assumptions on which the financial projections are based. They will form their own judgement as to whether these are appropriate and accurate. Lenders and investors are trying to assess the riskiness of the venture. The section on risks identified by the entrepreneur and how they might be mitigated will therefore also be of particular interest to them. The higher the risk, the higher the return they will expect. But different providers of finance will have their own criteria for the level of risk they will or will not be willing to accept.



Source: Hannah Olinger on Unsplash

A written business plan can provide an invaluable set of milestones against which progress can be checked. And if assumptions and circumstances change, then the firm may have to start altering their plans. A business plan should be sufficiently detailed to give direction but should never be so rigid as to blind a firm to new opportunities or threats.

The audience for the business plan for a social enterprise can also vary – from funding agencies to volunteers, banks to the general public. Great attention therefore needs to be paid to how it will achieve both its social and its commercial objectives, and how it will be held accountable. This can make it more complicated than the plan for a commercial enterprise. We return to this topic later in the chapter.

Explore further 17.2

How to write a business plan

Access the *Digital Links* booklet to watch a Harvard Business Review animation explaining what should go into a written business plan.

STRUCTURE AND CONTENT OF A BUSINESS PLAN

Table 17.2 shows the typical structure and content of a full business plan intended for external use. This is a general pro-forma and it may be appropriate to emphasise, add or omit sections depending on the nature of the business and the audience the plan is intended for. For example, location is a vital part of a business plan for a retail start-up, web functionality for an internet start-up. A social enterprise must include a section on its social objectives and how they will be met. A business plan should read like a professional business report – succinct and to the point, and full of vital information. It must be accurate and convincing. It will be used to judge the entrepreneur as well as their product/service.

Table 17.2 Business plan structure

* Cover	* Management team and company structure
* Table of contents	* Resources
* Executive summary	* Financing
* Business details	* Financial projections
* Industry and market analysis	* Risks and strategic options
* Customers and value proposition	* Key milestones
* Marketing strategy	* Appendices
* Operations plan	

The following guide to the content shown in Table 17.2 also provides an indicative page extent (in brackets). This is based upon a typical 20-page plan – anything more should go into the appendices. Relevant chapters are shown boxed in the margin.

Cover

The cover should include the business name and contact details. Many plans are marked 'confidential'. This is particularly important if there is important IP involved in the venture.

Table of contents

This is a list of sections and sub-sections, with page numbers.

> *I receive business plans of 20 to 40 spreadsheets. It makes my head spin. If it's all too technical, then it will alienate investors.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 20 April 2014

Executive summary (1–2 pages)

If external finance is being sought, this is probably the most important section of the plan. Many equity investors will only read the full plan if they find the summary attractive. It should only be written after the full plan is complete, and then it should be written with the reader and purpose of the plan in mind. If the plan is to be used to attract funding, it should state what is requested from the lender or investor and how they will benefit by providing the funds. It must be a summary of the plan – not an introduction. It should highlight the nature of your product/service, target customers, value proposition (benefits or problem solutions) and uniqueness and/or competitive advantage. It should appeal to the reader by highlighting the distinctive capabilities and potential of the business, including the financial return. If the plan is written to attract an equity investor it should state what deal is being offered (e.g. 20 per cent of the business in exchange for £100,000). Above all, the executive summary must be focused and succinct – no more than one or two pages.

Business details (1–2 pages)

(See chapters 7 and 11)

This section covers basic information such as business name, address, legal form and ownership. It should include:

- A description of the product/service;
- The mission and vision statement for the business;
- The aims and objectives of the business.

If this is an existing business, a brief business history should also be included.

Industry and market analysis (2–3 pages)

(See chapter 5)

This section provides background information on the industry sector and the market segments within it. It should take the form of a narrative informed by academic models such as a PESTEL analysis and Porter's Five Forces. It should review competitors and their strengths and weaknesses. The more known about an industry and market, and the competitors, the more confidence readers will have in the entrepreneur's ability to compete within it. This section should include:

- Industry size, growth, structure (macro and micro/local level).
- Industry and market trends (macro and micro/local level).
- Market segments and reasons for target market(s) selection.
- Buyer behaviour across segments.
- Competitor analysis (strengths and weaknesses).
- For an existing business – market share.

In most industries there are some key success factors that industry players have to have mastered in order to compete. These need to be highlighted but judgement is required about what is important for this particular venture.

> *In a well-thought-out business plan, it should be made clear that a company is attacking a big enough market and that there is an experienced team.*
>
> Darren Westlake, founder of Crowdcube, *The Sunday Times*, 14 September 2014

Customers and value proposition (2–3 pages)

(See chapters 7 and 8)

This section outlines the target market segment(s) and the value proposition(s) for the product/service. It is essential that the 'unique selling proposition(s)' is clearly and simply articulated, highlighting the differential advantage(s) the firm has over competitors. The more points of difference and the stronger and more sustainable these differences, the better. This is where sales targets are also set out. If there are already firm orders for the product/service, this should be mentioned here.

Marketing strategy (3–4 pages)

(See chapters 8, 9, 10 and 18)

This section provides the details about how these sales targets will be achieved – not only the details of the marketing mix but also the marketing and marketing communications strategies for the launch and growth stages. It should include strategies for establishing the brand dealing with competitive reaction. It should also highlight the growth potential through market and product development and scale-up plans. It should include:

- Marketing mix: price, promotions, distribution etc.
- Launch strategy.
- Sales tactics.
- Brand development.
- Competitive reaction.
- Product and market development.
- Growth potential and scale-up plans.

Investors are always particularly interested in pricing strategy because this is a prime determinant of the profitability of the business.

Operations plan (2–3 pages)

(See chapter 12)

This section outlines how the business will be run and how the product/service will be produced/delivered. What goes into the operations plan varies depending on the nature of the venture. However,

what is important is that the plan demonstrates an understanding of the key operating activities for the venture and from these its critical success factors are highlighted. The operations plan must convince the reader that the management of the firm understand and can undertake its operations – able to do whatever needs to be done to deliver the product/service. So, issues of business control, if critical to the business, need to be covered. Also, the prospect of scalability – should the business prove to be even more successful than planned – can be addressed in this section. What are the strategic options? The content of this section is difficult to predict but might include:

- Key operating activities (e.g. manufacturing processes, business model etc.);
- Critical success factors;
- Partnerships;
- Business controls;
- IP issues;
- Scalability.

Management team and company structure (1–3 pages)

(See chapters 14 and 16)

This section outlines all the people involved in the venture – details of their background and experience – as well as the organisational structure. A new venture team with an established track record in the industry or with relevant experience will certainly add credibility to any start-up. Remember that investors ultimately invest in people, not products. An experienced board of directors can achieve the same result. Brief CVs can go in the appendices. For larger start-ups, an organisation chart can go in this section. This section should include:

> *Investors are backing the people behind the idea as well as the idea itself.*
>
> Peter Jones, serial entrepreneur, *The Guardian Media Planet*, May 2015

- Founders and other key people, their functions and background;
- Business organisation or structure;
- Directors, advisors and other key partners;
- Skills gaps and plans for filling them.

Resources (1–2 pages)

(See chapters 12 and 14)

This section describes the firm's facilities, equipment and staff requirements. It should include:

- Premises and facilities;
- Machinery and equipment;
- Staff.

Financing (1–2 pages)

(See chapters 15 and 19)

This section highlights the finance needed to launch your business. External funders will expect the founder to contribute some capital. Lenders will be interested in the risks they face and the security they can obtain. Equity investors will be interested in the overall return they might make and how this might be realised. This section should include:

- Founders' contribution;
- Loan and/or equity finance requirements;
- Gearing/leverage;
- Timescale and exit routes for equity investors.

Financial projections (1-page summary, plus detailed appendices)

(See chapter 15)

Typically, financial projections for three years are expected by funders, with a monthly cash flow forecast for the first year. A very small-scale start-up might only provide financial projections for the first year. Five-year forecasts might be expected for larger projects where significant commercialisation risks have not been resolved. Usually this is presented as a one-page financial summary with the detailed projections in the appendices. Financial details going into these appendices should be as long as it takes to provide all the information required. These should include:

- Income projections;
- Cash flow projections;
- Balance sheet projections;
- Key ratios;
- The assumptions on which the financial projections are based, particularly the basis for the sales projections.

Risks, critical success factors and strategic options (1 page)

(See chapter 13)

This section should identify the key risks facing the business and explain how they will be monitored and mitigated. It should identify the critical success factors (from the marketing and operating plans) and the strategic options should these key risks materialise. Strategic options are valuable because circumstances can, and do, change. They provide flexibility in a changing environment. This section should include:

- Identified risks;
- Risk monitoring and mitigation;
- Critical success factors;
- Strategic options.

Key milestones (1 page)

These milestones, often incorporating critical success factors and the metrics that measure them, highlight the progress needed to launch and grow the business. They might include prototype completion, formalisation of partnerships, obtaining finance, securing of key customers, meeting sales or profit targets etc. This section gives an overview of the sequence and timing of important events.

Appendices

Any information that is vital, but might impede the flow of the plan, should go into the appendix. One key piece of information is the assumptions upon which the financial projections are based, in particular the sales projections. These need to be made explicit and an investor is likely to scrutinise them closely. This section might include:

- Detailed financial projections;
- Financial assumptions – start-up costs, basis for sales projections, fixed/variable costs, profit margins;
- Background information (CVs) on founder and key people;
- Location information (maps, layouts etc.);
- Operations information (Gantt charts etc.)
- Details of market research;
- Details of IP protection;
- Website screenshots;
- For an existing business – historic financial statements, brochures etc.

> *Setting some milestones for you and your team to work towards will keep you motivated and driven.*
>
> Richard Branson, founder of Virgin Group, *The Guardian Media Planet*, May 2015

> *I look for previous experience, both in industry and running start-ups. It doesn't have to have been a success because people learn from their mistakes.*
>
> Mike Lebus, co-founder of Angel Investment Network (AIN), *The Sunday Times*, 4 August 2019

TIPS ON HOW TO WRITE A BUSINESS PLAN

If used for external purposes, the business plan must convince the reader that the entrepreneur has a thorough understanding of the industry, market and business they want to launch. It must convince them of the viability of the business – the commercial potential of the product/service and value proposition, and that the entrepreneur knows how to combat the competition. It must enhance their creditability and make them trust their judgement. After all, they are being asked to part with cash for little other than promises at this stage. They need to believe that the entrepreneur can turn this business idea into reality. Before showing a business plan to potential funders, test it out with as many people as possible – family, friends, professionals – and get them to give honest feedback.

Here are five very practical 'dos' and 'don'ts' to watch out for when preparing a business plan:

1. Keep the plan as short and simple as possible. Do not pad it out. The plan should be sufficiently long to cover the project adequately but short enough to maintain interest. To do this prioritise and focus on the important things for the business. If a plan is too complicated there is the risk of losing that focus and the interest of the reader.
2. Keep the plan as realistic as possible. Are sales targets, costs, milestone deadlines and so on realistic? Making unrealistic claims is likely to result in losing the trust of lenders and investors. It is better to under estimate and over deliver than vice versa.
3. Make the plan clear, specific and unambiguous. Are market segments clearly identified? Are objectives concrete and measurable? Are targets and deadlines clear? Lack of clarity is often taken to indicate a lack of knowledge or willingness to be committed.
4. Check spelling, grammar, punctuation and, most important of all, financial accuracy. Errors will damage credibility and, if noticed at a presentation, can put the entrepreneur off their stride. Computers have grammar and spelling checks – use them. Using a spreadsheet package for cash flow forecast can ensure arithmetic accuracy.
5. Anybody who is not confident about putting the financial projections together themselves should seek professional advice. However, they should always ensure that they understand the numbers and how they were arrived at.

BUSINESS PLANS FOR SOCIAL ENTERPRISES

A social enterprise is established primarily to achieve social objectives, usually using entrepreneurial approaches and commercial mechanisms. A business plan for a social enterprise needs to reflect this. And that means that the plan needs to be commercially realistic while demonstrating how the social objectives will be met. It also needs to explain how it will be held accountable for its actions. This can mean that the plan will be longer than a normal commercial plan; however, that does depend very much on the purpose of the plan and for whom it is written. Indeed, this will determine much of the emphasis, if not the content, of the plan. For example, grant funding may be dependent on the applicant's ability to demonstrate an *innovative* approach to meeting a social need by tapping into as yet unused private sector resources. To attract grant (or loan) funding for a social enterprise, the applicant will need to emphasise their social rather than commercial objectives and how this grant will be used to enable these to be met. They will certainly have to demonstrate that commercial profits will be directed towards these social objectives and/or ploughed back into the enterprise.

It is sometimes easier to write two separate business plans for a social enterprise – one commercial, the other social – and then integrate them. The commercial business model should demonstrate commercial viability – and the plan content from the previous section should do this. But there are some important additions or changes that are needed for a social enterprise:

» Executive summary – This should emphasise the achievement of social rather commercial objectives;

» Industry and market analysis – This also needs to demonstrate the gap in social provision that the social enterprise will fill. However, remember a social enterprise is not usually competing against other providers so much as complementing their provision;

- Customers and value proposition – This needs to emphasise the target beneficiaries from the provision the social enterprise is offering. What is their need? Why is this provision unique or how does it 'add value' to existing provision?
- Marketing strategy – Social provision rarely needs to be 'marketed', certainly not in the same way as commercial products/services, but target markets still need to be communicated with and a convincing communications plan outlined;
- Operations plan – This needs to show how the social objectives will be met. The contents outlined previously can be applied to both commercial and social operations;
- Financing – This needs to be tailored to the funders being approached and their funding criteria. They are unlikely to be seeking commercial gain. They will normally want to see their money being put to good (and efficient) social use and, if the funds are in the form of a loan, that interest can be paid and the capital repaid on the due date;
- Financial projections – These still need to demonstrate commercial viability; however, stakeholders will not have a profit-maximisation objective. Surpluses should go towards meeting social objectives and/or be ploughed back into the enterprise. It is also probable that a social enterprise will need to demonstrate its commercial sustainability beyond the initial period of subsidy. Commercial as well as social sustainability is important.

Case insight 17.5 Net-Works™

Scaling-up a social enterprise

In 2012, Aquafil, a leading Italian global producer of nylon yarn, and the Zoological Society of London (ZSL) embarked on an environmental project, one that has proved successful and is now looking to scale-up. Aquafil wanted to source materials in a way that would benefit communities as well as the environment. ZSL wanted to develop a new model of community-based conservation — one that would bring immediate benefits to local people and break the traditional cycle of donor dependency. The result was Net-Works™, a project to see if a solution could be found to the enormous amount of discarded nylon fishing nets that are polluting the sea and reducing fish stocks. These nets can take 600 years to break down. Currently located in rural communities in the Philippines and Cameroon where people's livelihoods are heavily dependent on fishing, Net-Works™ uses an existing process that enables the nets to be recycled into high-grade nylon yarn that can be used for other purposes. The yarn is sold to a US company, Interface Inc., to make into high-quality carpet tiles.

The project created a fair-trade business model that made the collection of discarded nets financially attractive to local communities. Net-Works™ collects and bails the nets, which are then shipped to Aquafil, who then supply the yarn to Interface. Income from discarded nets gives fishing communities a more transparent and dependable price, and provides sustainable funding for local conservation and development actions, particularly in marine protection areas with 'no-take' fishing zones. To manage local supply chains, Net-Works™ set up community banks, bringing communities together in informal cooperatives and providing them with access to financial services such as micro loans and savings plans. So far Net-Works™ has collected 224 metric tons of waste fishing nets giving 2,200 families access to finance.

Net-Works™ is now working to identify additional locations around the world, secure funding and develop on-the-ground partnerships to help with implementation. It is also developing a complementary community-based pilot project to build a global fair-trade supply chain for carrageenan (seaweed extract) – used in cosmetics, toothpaste, firefighting and food, projected to have a global market value of $1 billion in 2021.

Access the *Digital Links* booklet to visit the Net-Works™ website and to watch a video about the project.

Questions:

1. What things need to be done to scale-up the successful Net-Works™ project?
2. What are the barriers to scaling-up and how might they be overcome?
3. Should the new project (for carrageenan) be dealt with separately?

SUMMARY

- The first step in growing the business is to understand how it has survived so far – what has worked and what has not. Figure 17.1 outlines the process for a strategic review. This involves questioning all aspects of the business, including the fundamental vision for it, and builds on the information continuously being gained from the competitive environment.
- Strategic analysis involves undertaking a SWOT analysis. There are a number of tools that can be used to do this. The main ones are summarised in Table 17.1. Strategy formulation involves identifying, evaluating and selecting strategic options. Effective strategy is rooted in the distinctive capabilities of the firm.
- Strategy development in most growing small firms is likely to be incremental and adaptive – emergent rather than deliberate – with strategic intent giving direction. However, SMEs do adopt both types of strategy development, depending upon circumstances, with shifts from one mode to another precipitated by some form of crisis. This cycle of *growth* → *crisis* → *consolidation* parallels a process of *emergent* → *deliberate* → *emergent* strategy formulation.
- The business model frameworks outlined earlier are useful for developing strategy. They encourage strategising.
- Pivoting is where a company, based upon the validated learning it is obtaining from the launch of its MVP, decides to make radical changes to its business model as a result of its strategic review.
- A business plan describes what the business seeks to achieve and how it will do this. Every plan should be tailored to achieve its purpose and for the audience it is aimed at. Consequently there is no standard format, although a typical structure of a plan for external use is set out in Table 17.2. The more external finance being sought, the longer and more detailed the plan is likely to be. Plans for equity investors are likely to be the longest and best presented.
- The plan for a social enterprise needs to be commercially realistic while demonstrating how its social objectives will be met. To attract grant funding, it will need to emphasise these social objectives and how the grant will be used to enable them to be met. It will have to demonstrate that commercial profits will be directed towards these social objectives and/or ploughed back into the enterprise.

GROUP DISCUSSION TOPICS

1. In a rapidly changing world, is strategic planning really of any use?
2. Are entrepreneurs congenitally incapable of planning?
3. How do entrepreneurs develop strategy? Explain and give examples.
4. What are the advantages and disadvantages of using strategic frameworks to help develop strategy?
5. How can you make a SWOT analysis as objective as possible?
6. In different contexts strengths can be weaknesses and opportunities can be threats. Discuss.
7. How do you generate strategic options? Which techniques might help?
8. If a product/service meets all the performance metrics set for it do you need to undertake a strategic review?
9. How are the reoccurring crises facing the growing firm likely to affect the entrepreneur and what might be the consequences?
10. If your business model is constantly changing to suit changing circumstances, when (if ever) should it be formalised into a business plan?
11. What might cause you to change your core values and beliefs?
12. How can you review the effectiveness of strategy if you do not know what might have happened if it had been different?
13. What is the difference between a business model and a business plan?
14. What are the advantages and disadvantages of following pre-prepared business plan formats?
15. The best business plan is a short business plan. Discuss.
16. Lenders and investors put their money with people, not plans. Discuss.
17. For what purposes might a social enterprise prepare a business plan? How would this affect the content?
18. Preparing a business plan for a social enterprise is more difficult than preparing one for a commercial enterprise. Discuss.
19. How will a social enterprise know if it is successful?
20. What should happen when a social enterprise meets and fulfils its social objectives?

STUDENT ACTIVITIES

1. Critically analyse the business model for the low-cost airline in Figure 6.5, fleshing out the details of what the bullet points under the five headings involve. What are the model's strengths and weaknesses? Is anything missing? Looking at the 'key activities' section of the Operations plan, what are the critical success factors and are there more strategic options?
2. Prepare a SWOT analysis on a selected product/service or company/social enterprise or, alternatively, on your course, college, university or university department.
3. Undertake a full strategic review on a selected company or social enterprise. What are its core capabilities and competencies?
4. List the questions you would ask an entrepreneur in order to explore a specific crisis they have faced in managing a growing business. Based on these questions, interview a successful entrepreneur and use this as the basis for an essay describing the challenges they faced as the business grew and how the entrepreneur coped.
5. List the contents of a business plan that is drawn up:
   a) For planning purposes within the firm;
   b) For raising external finance.
6. How are they different?
7. Visit any of the websites that contain specimen business plans, select a plan and critically evaluate the business proposition.

START-UP ACTIVITIES

1. Using the start-up activities from previous chapters, draw up a business model for your product/service idea.
2. Elevator pitch exercise:

   You have three minutes – no more – to present the essence of your business idea to the class. Your pitch should do two things:

   a) It should explain or demonstrate your product/service idea and the problem it seeks to solve for clearly identified target market segments.
   b) It must explain your value proposition – the marketing benefits offered to each target market segment.

   The pitch should be clear, succinct, easy to understand, present an attractive business opportunity (profitability) and should answer any obvious potential problems (such as competitors and competitive reaction) rather than raise unanswered questions.

   Reflect on and evaluate the response you got to the pitch. What worked and what did not? Are there changes you need to make to your business model? If so, make them.
3. Using the revised business model draw up a formal business plan for your product/service idea using the structure shown in this chapter.

18

SCALING AND GROWTH STRATEGIES

Contents

- Product/market expansion
- Market development
- Selling internationally
- Product/service development
- Developing a product/service portfolio
- Cash flow, risk and the product/service portfolio
- Diversification
- Diversification and stock markets
- Diversification and private shareholder value
- Diversification and corporate acquisition
- The entrepreneurial conglomerate
- Summary
- Group discussion topics
- Student activities
- Start-up activity



Source: Getty Images/marchmeena29

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Critically evaluate the strategic options for growth and understand their implications;
- Understand what is involved in market and product/service development;
- Understand how to go about selling into new, including overseas, markets;
- Understand how the life cycle can be lengthened through product/service expansion and extension;
- Use the growth share matrix to communicate marketing strategies for a product/service portfolio and show the effects on risk and cash flow;
- Understand and explain how diversification is central to the process of corporate evolution and how the risks associated with it can be minimised and can add shareholder value.

Case insights

18.1 Monkey Music
18.2 Brompton Bicycle
18.3 Nokia
18.4 Lenovo
18.5 Amazon

Explore further links

18.1 Help and advice on exporting
18.2 Diversification and conglomerates

PRODUCT/MARKET EXPANSION

Chapters 10 and 17 explained how most firms achieve early growth by penetrating their target market(s). This could be local, national or, for some firms, international market(s). Once the business model has proved successful a point will come for many when that market is saturated and the firm needs to look to other ways to grow. It is worth remembering that over time every product/service will age and competition will increase. In time newer and better products/services are likely come to market and if the firm has not developed it may face the risk of closure. Investors are always interested in the scalability potential of a business they invest in. Unless we are talking about a lifestyle business with limited growth potential, some consideration should be given to scalability in the start-up business model or plan. The extent of planning depends on the timescale and degree of certainty for this growth.

However, before doing this it is always worth having a moment of reflection, looking back on what has worked and what has not, understanding how the original business model may have been modified to better meet the needs of customers. It is also important to look back at the strategic review and reflect on the strengths and weaknesses of the firm and whether the environment has thrown up any new opportunities or threats, and finally, whether those core competencies that helped establish the firm have changed. Strengths can be built on and weaknesses shored up. Threats create new risks that need to be countered. And new opportunities should never be ignored.

The growth options matrix in Figure 18.1 shows the three scaling-up options that can be explored:

1. Market development – selling the existing product/service into new markets.
2. Product/service development – developing the original business idea into new products/services that can be sold into existing markets (incremental innovation).
3. Diversification – selling new products/services into new markets. Often this option is pursued through mergers or acquisitions.

As a firm moves further away from its existing products/services and market, it faces greater risk. Moving into new markets involves finding new customers who may have different, and as yet unknown, needs. Developing new products/services may involve developing new processes or technologies. Both strategies may risk moving away from the firm's core competencies. Moving into new markets with new products/services simultaneously is therefore likely to be riskier still. There are so many 'unknown-unknowns'.

To some extent deciding which option(s) to pursue depends of the strengths and weaknesses of the organisation, linked to its core competencies and capabilities – replicating the process of opportunity spotting outlined in Chapter 4. This will give a strategic direction to the search for growth. However, the options shown in Figure 18.1 are not mutually exclusive. Some companies might follow all four strategies in pursuit of growth. However, the best companies tend to pursue a strategy of continuous

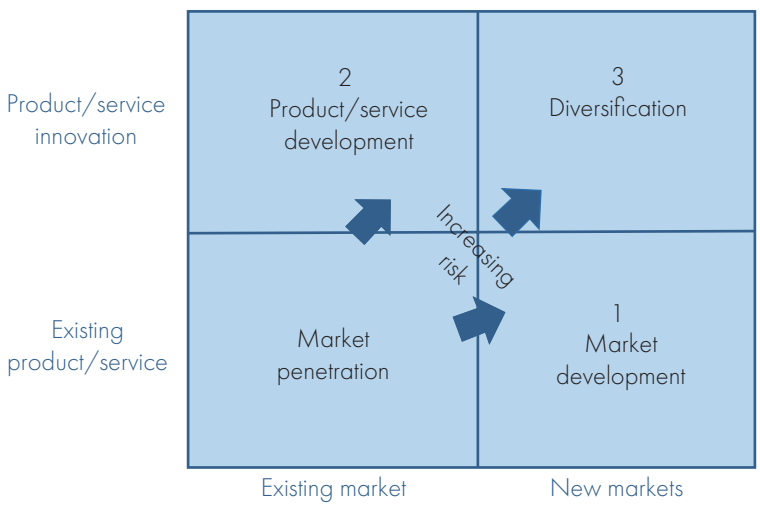


Figure 18.1 Growth options

innovation – the incremental, step-by-step development of both the product/service and market. Dynamic, continuous innovation builds upon existing products/services so that customers understand the nature of the offering, unlike discrete innovation which may address a need but one that has to be explained and accepted by the customer.

MARKET DEVELOPMENT

Market development is the natural extension of market penetration. Instead of just selling more of the same to existing customers, the firm finds new customers and new markets to sell to. The safest way to do this is to understand existing customers – who they are and why they buy – and then try to find more customers with similar profiles. Many firms start out by selling locally and gradually expand their geographic base by selling regionally and then nationally, finally selling into the global market. However, increasing numbers of businesses now sell their products/services internationally from day one. This is easiest for niche products/services, where the product/service is highly differentiated and there is a highly focused target market. Selling to a very small niche market in one country can raise issues of viability. Selling to the same niche market globally can dramatically change the equation and offer the opportunity of high profits, because of economies of scale.

Case insight 18.1 Monkey Music

Scaling through franchise

Angie Coates' mother was a teacher and her father owned a small engineering firm. At the age of 11 she won a scholarship to study the oboe at the Guildhall School of Music and Drama in London, graduating with a music degree in 1988. She went on to become head of music at Thomas's London Day Schools. So, when she had a baby daughter it was only natural that she would want her to share her love of music. However, she was not happy with the baby music classes she found locally, so, in 1993, with her daughter only a few months old, she started her own business, Monkey Music, based in London. Monkey Music started out offering music classes to infants and pre-school toddlers from a church hall in Dulwich, southeast London. By 1998 Coates was struggling with the huge demand for her classes and was teaching over 500 children a week:

> *'I was a young mum and ready to change my lifestyle completely. I wanted to stop having to get up at 6.00 am every day to then leave my baby with a childminder before travelling to work. I wanted to do something fresh and exciting, for my daughter and for me.'*

Today Monkey Music is an award-winning franchise business (see Chapter 11) generating sales of over £3 million, with around 50 franchises and over 100 teachers running classes in more than 300 venues across the UK. With the help of her brother, who was a lawyer, Coates created a teaching curriculum and blueprint for starting a music-teaching business. The Monkey Music programme is divided into four stages, each tailored to specific age groups: Rock'n'Roll (from 3 months); Heigh-ho (from 12 months); Jiggety-Jig (2 and 3 years old) and Ding-Dong (3 and 4 years old). Each class takes 10–15 children and Coates takes a percentage of the fee charged by the franchisee. This is supplemented by the online sale of Monkey Music merchandise such as soft Monkey and Baby Mo toys, class CDs and T-shirts.



Source: Monkey Music

Coates now has five daughters – and a successful growth business.

Access the *Digital Links* booklet to visit the Monkey Music website and to watch a promotional video.

Questions:

1. What were Angie's motivations in starting up Monkey Music?
2. How did she keep the costs of starting the business down?
3. How did she keep the costs of scaling-up down?
4. What are the pros and cons of franchising?

However, it is one thing to find new customers in the same market segment, but it is quite another to enter completely new markets, particularly overseas, where the existing segmentation may not be appropriate. After all, even McDonald's found that customer tastes vary around the world. Companies following this route must be adept at sales, marketing and developing close customer relationships. What is more, targeting new market segments may require a reconfiguring of the marketing mix or even the entire business model. Sometimes it may even involve incremental changes to the product/service itself. The low-risk option is always to seek out segments in the countries that are similar to the ones already being sold to. A move into new markets can sometimes be undertaken through strategic alliances/partnerships or joint ventures with others, which reduces the risks faced.

Market development is often associated with companies whose core competency lies with their product/service in which there is IP that must be exploited rapidly because of a limited window of opportunity. Many technology firms extend their markets quickly, often going global as quickly as production and funding will allow. Their aim is to gain brand recognition and market dominance quickly.

Finding new markets is often important for companies with a low-cost business model. Their core competencies lie (or should lie) in the efficiency of their existing production methods and they are seeking further economies of scale through greater sales. Most companies producing capital goods (e.g. car manufacturers) have followed this strategy, opening up new overseas markets as existing markets become saturated because of the high cost of developing new products. Finding new markets can therefore also be an important way of extending the life of a product/service.

Another reason for going into new markets might be customer-pull. Many service businesses such as accounting, consulting, advertising, insurance and banking have been pulled into overseas markets because their clients operate there. Whatever the reason for going into a new market, as well as offering the opportunity to increase sales, it also offers the opportunity to reduce the risk of over dependency on one market. This is particularly the case for geographic markets that might face similar economic cycles.

SELLING INTERNATIONALLY

Selling into overseas markets can pose additional challenges and risks particularly when market presence in foreign distribution channels is needed. But as a firm grows it is increasingly likely to be involved in international markets (Selassie et al., 2004) and there appears to be a significant relationship with improved financial performance (Chelliah et al., 2010; Kuhlmeir and Knight, 2010; Lu and Beamish, 2001), albeit with some short delay as resources are invested (Lu and Beamish, 2001). The internet has made selling internationally easier, particularly for virtual products that can be transmitted on the internet (e.g. music or apps). Many start-ups have their own website from day one selling virtual or real products/services, taking payment by credit card and using distribution networks like Fedex. But they can also use global internet retail platforms like Amazon, Alibaba or eBay to gain even wider customer awareness. Chinese manufacturing firms have secured customers around the world by promoting themselves on business-to-business sites such as Alibaba. If a firm's competitive advantage is based on resources located in their home country (such as technological expertise or cheap labour, in the Chinese example), then exporting makes a lot of sense. Whatever the nature of the product/service, the internet is a low-cost, low-risk way of testing the international market.

However, selling on the internet can be a scatter-gun approach, relying on one-off sales to customers who have to find the website themselves. If a more focused approach is needed a firm must first identify which country to target. Market research is no real substitute for good local knowledge, contacts and sales leads (Johnson, 2004). However, the two are not mutually exclusive and the tools outlined in Chapter 5 can be used to undertake some low-cost desk research. Porter's Five Forces analysis can be a useful way of gauging the degree of competition with in the industry (page 119). However, one of the issues with this analysis is defining the correct industry to look at. Industries can be segmented in many ways, not just geographically, each with differing competitive forces. Technological innovation can cause industries to converge and the boundaries to competition may shift (e.g. the camera

company Kodak went bankrupt because of the competition from mobile phones). Also, as we noted, the inclusion of a sixth force, that of complementary (rather than competitor) organisations, whose product/service enhances the attractiveness to customers of another product/service, can help identify possible strategic alliances or partnerships. There is also the need to make an economic appraisal of the environment of the country being considered – domestic demand, local laws and regulations, government policies, exchange rates, related and supporting industries etc. Of course, success in the new market depends upon competitive advantage and, as we have noted, this is achieved when there is a match between a firm's internal strengths in resources and capabilities and the key success factors of the industry – but we would add that this is in the context of the particular national environment.

Sales agents and distributors

In order to achieve market presence in local distribution channels a local distributor in the selected country may well be needed. The distributor might influence changes in the product/service or other elements of the marketing mix to suit local needs but they will expect the exporting company to undertake local advertising and promotion – and that can be difficult without local knowledge. Where local knowledge is important one option is to appoint a local sales agent. A good agent might suggest changes to the product/service or other elements of the marketing mix to better suit local needs. Sales agents are normally paid on a commission-only basis, which means that there is no fixed set-up cost. However, the risk is that sales are not guaranteed. The firm has little control over the agent and may be required to contribute to advertising and promotion even if sales are disappointing. Finding an agent can be difficult enough but if, for whatever reason, they do not meet sales targets there is little the firm can do other than to change agents – that is, if the contract can be terminated.

However, the nature of the start-up might involve being a sales agent for another firm, so it is worth looking at this relationship from the other side. Sales agents are self-employed and face a number of risks: insecure commission income, a time-limited and geographically limited contract and possible limitations on the sale of other products/services. If the firm does not provide the agent with effective promotional support or they fail to develop their product/service range the long-term prospects for the agent may be limited. If the agent is too successful, the firm may be tempted to set up in business without them. All of these things should be set out in a legal contract, and when the contract comes to an end, its terms can be renegotiated.

There are inherent dangers in both using and being a sales agent, particularly when there is information asymmetry (one party having more knowledge than another). This can make the relationship unbalanced and unstable. If the balance of power or dependency shifts too far from one party to the other, the relationship may be threatened. There must be trust based upon a mutuality of interest for any agency agreement to work effectively.

> *When expanding into different territories or creating new products, having a brand uniting them all under one roof is one of the best advantages a business can have.*
>
> Richard Branson, founder of Virgin Group, *The Guardian Media Planet*, May 2015

Licences and franchises

Another approach used extensively in the retail sector is to offer individuals or local firms a franchise or licence to produce or sell the product/service (Chapter 11). This allows the franchisee to capitalise on their local knowledge but requires them also to take on many of the business risks. Their local market knowledge and dedication is vital if the market is to be effectively penetrated. For franchisors it is a way of rolling out a business format rapidly without the need for large amounts of capital. It is popular with franchisees who are less entrepreneurial but wish to run their own business. When entering the market in another country a franchisor often appoints a head franchisee who will be responsible for finding other franchisees in their country.

Joint ventures

Another option when entering a foreign market is to form a strategic alliance, partnership or joint venture with another firm, whereby the partner brings different resources to the joint venture and shares the profits as well as the risks (Chapter 11). This can be a particularly effective way to overcome the

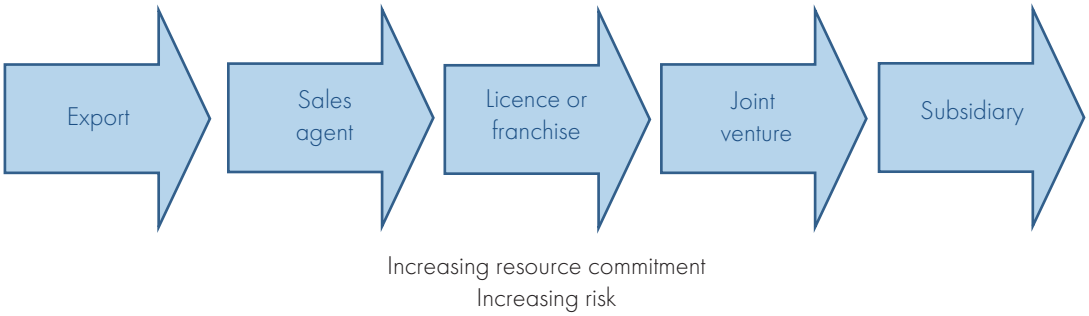


Figure 18.2 Degree of involvement in overseas markets

potential deficiencies in resources and capabilities facing a start-up (Lu and Beamish, 2001). Partners can provide vital insights into effective market entry and competitive strategies. In some developing economies, the only way to enter the market may be through a joint venture with a local firm. Used properly, strategic alliances, partnerships and joint ventures can leverage up a firm's capabilities with limited risk (Laanti et al., 2007).

Subsidiary

The riskiest and most expensive option of all when entering a foreign market is direct investment. This involves the setting up of a wholly owned subsidiary which might undertake marketing, distribution, service support and even manufacturing or assembly. Clearly this is an expensive option, normally only taken by larger companies.

These different degrees of involvement in foreign markets and the increasing risk associated with them are shown in Figure 18.2. There is no prescriptive 'best' approach to internationalisation and often the degree of involvement in the overseas market increases organically with the success of the product/service in the local market.

Explore further 18.1

Help and advice on exporting

Governments across the world are keen to encourage smaller firms to export. They offer a range of help and advice, including market intelligence and business opportunities in particular countries, much of which is free. They organise seminars, trade fairs and missions. Because they have their own network of contacts, government agencies can often put a firm in touch with potential partners or agents. Nevertheless, exporting can bring risks. It is, for example, far more difficult to recover bad debts from overseas customers. To overcome this, governments often sponsor insurance schemes like the export finance guarantee scheme in the UK. Also, if a firm is selling into an overseas market in local currency, there is the risk of currency fluctuations that mean the value of the transaction in the home currency is not guaranteed. Two possible solutions are to either price in the home currency of the exporting firm – something often done for small-value transactions – or to 'forward-purchase' the local currency, thus guaranteeing the amount received. This service is offered by most banks.

Access the *Digital Links* booklet to find web links to services providing help and advice for UK companies seeking to export.

PRODUCT/SERVICE DEVELOPMENT

Product/service development is most successful for those companies whose competencies lie in building good customer relationships, often associated with effective branding. However, of equal importance could be the ability to innovate, albeit usually incrementally. Again, one way of lowering the risks associated with product/service innovation is through strategic alliances/partnerships and joint ventures. There are four approaches to product/service development.

Product/service modification

This involves the modification of existing products where the changes are small and evolutionary. Innovation is not just about finding entirely new product/market offerings. Existing products/services and their marketing mix can be adjusted innovatively so as to counter competition, expand their potential market or extend their life. The original product/service might be modified in terms of quality, function or design so as to address any weaknesses or omissions in it, for example service levels might be improved. Competition can be a particular problem if the firm is pioneering a product/service in a market with low barriers to entry, especially if the product/service is becoming something of a commodity, selling increasingly on price. However, even successful products such as the iPhone need constant modification to keep up with the competition. Another approach, outlined in Chapter 4, is 'frugal engineering' where a product/service has non-essential features taken from it so as to reduce its cost and price. This can also be used as a strategy to help penetrate new markets in developing countries, where price is important.

Product/service expansion

Expanding the offering means developing product/service variations that meet the needs of selected new market segments. In most cases this involves incremental innovation. Most businesses will start to

Case insight 18.2 Brompton Bicycle

Growth strategies

The quirky Brompton folding bicycle was designed by Cambridge University graduate Andrew Ritchie in 1976. Ritchie intended to license the design but instead, after a number of false starts, began producing small volumes of the bike himself in 1988 from a small, cluttered factory under a railway arch in West London. It became a style icon, combining practical, lightweight design, durable engineering and careful assembly. With the bike selling at a premium price, it became a profitable niche business. In those early days demand exceeded Ritchie's ability to assemble the bike and, by 2002, the company still produced only about 6,000 each year and employed just 24 people. That all changed in that year when Will Butler-Adams joined the firm as managing director, aged 28. He introduced new ways of working and budget plans. He subcontracted parts of the manufacturing process such as the manufacture of wheels and frames to other UK manufacturers, creating more space for assembly in the small London factory. By 2013 production had increased to 40,000 bikes and the workforce had grown to 190. In 2017 it moved to a new, much larger factory on a greenfield site outside London, offering factory tours. Today Brompton is the UK's largest cycle manufacturer with sales approaching 60,000 bikes and a turnover of £42.5 million in 2019 – an 18% year-on-year increase. Will Butler-Adams is still managing director and Andrew Ritchie remains technical director. The company remains privately owned and its growth has been achieved entirely organically.



Source: iStock.com/hepjam

All Brompton cycles share the same basic design with a distinctive hinged and curved steel frame, pivoting rear triangle (in steel or

titanium), front fork and hinged handlebar system. It folds and pivots in three places. The bike's uniqueness has made it distinctive and desirable. The steel sections are joined by brazing, not welding, making them stronger. There are a range of bikes costing from £800 to £3,000; from basic to lightweight sports and electric bikes. Each one can be customised – colour, gears, handlebar styles, mudguards and other accessories such as saddle bags and panniers. The design has been updated regularly throughout its life and has received numerous awards for innovation. With over 1,200 components on the bike, 80% are designed and made by Brompton. However, the company has also exploited its premium image by producing limited editions such as the Black Brompton and adding unique touches. For example, every brazer leaves their initials stamped onto the bike they produce.

Introduced in 2017 when the company moved to its new factory, the latest top-of-the-range electric bike was co-designed with Williams Advanced Engineering, a company more normally involved with Formula One motorsport. The key challenge Brompton overcame in the design of this model was how to install a discreet motor inside the bike frame without compromising on the unique hinge design, efficient folding characteristic, or the size and weight of the Brompton. Despite its price, the model has been highly successful, selling some 6,000 units per annum. Many things in the new factory have been automated such as the new paint-spraying facility, but the 2020 pandemic taught the company a lesson about maintaining flexibility. It decided not to go down the route of wholesale automation with the associated high debt levels, preferring instead to maintain some of the old Brompton characteristics like the hand-brazing.

The move to the new factory was overdue, but back in 1992, when the company was still run by Ritchie, Brompton had looked to increase production by entering into a joint venture with a Taiwanese company. It signed a ten-year licence agreement to manufacture a copy of the bike for distribution in Eastern Asia through a joint venture company called Neobike. Brompton loaned the company tools and drawings and was paid royalties based on unit sales. Neobike started producing other folding bikes and, because of this and other quality problems, the licence was not renewed in 2002. However, Neobike did not return the Brompton-specific tooling and, one week after the expiration of the licence, Neobike was sold to another company. Then in the following year it exhibited a clone of the Brompton bike at a trade show and started to import them into the Netherlands. The ownership of these copy-bikes was transferred again ahead of them being imported into a number of European markets, including the UK, as well as being marketed across East Asia. It was not until 2006 that Brompton succeeded in the legal actions it took under copyright and industrial design law in the Netherlands. Brompton gained the right to have imported bicycles destroyed and secured an injunction against future imports. However, copy-bikes continued to be imported into some European markets and a further injunction had to be obtained in 2010, this time in Spain. This experience has left the company wanting to maintain control of production and has been the main reason that it has not considered relocating to the Far East to take advantage of the cheaper labour costs.

Brompton sells bikes directly to the public through its website, where bikes can be customised. Brompton has exported cycles from its early days – some three-quarters go to export. In the UK, USA, Canada and Ireland, it also sells through bicycle retailers. In other countries, it sells through distributors who operate their own dealer networks. The company also opened its first UK retail store in London in 2013, adding stores in dozens of cities around the world. These stores allow it to get closer to its customers and experience what works best for selling its bikes. It also launched a UK bike rental scheme in some 40 locations.

The company has made extensive use of social media to publicise itself and to engage customers around the world. It has the Brompton Community of owners. Multiple networks are used to promote the brand by showing the numerous campaigns, competitions and events it organises. It uses Twitter to link with other cycling networks and to announce events such as Brompton Urban Challenge, Brompton World Championship and Brompton Maintenance Event. It pins photos from Brompton World Championships onto pinboards on Pinterest. It responds to and 'manages' discussions about the bike on Facebook and generates content on Instagram to involve owners. It also actively uses Instagram as a platform for competitions such as #MyUnseenCity global which involved posting videos onto the Brompton Bikes Instagram channel. These interactions are aimed at brand promotion and developing customer loyalty and involvement.

Access the *Digital Links* booklet to visit the company website and to watch a promotional video that shows the new factory and features the new electric bike.

Questions:

1. Using either the New Venture Creation Framework or the Business Model Canvas (Chapter 6), sketch out as many elements of the business model for Brompton as you can.
2. Map the growth strategies used by Brompton on the matrix in Figure 18.1. Why have they been successful?
3. Undertake a SWOT analysis on the Brompton bike.
4. What options does Brompton have to achieve further growth? What are the risks associated with these options?
5. What are the pros and cons of an SME partnering with another overseas firm in the way Brompton did?

offer a wider range of products/services quickly after launch as they spot new market opportunities. So, for example, a soft drinks manufacturer might start to offer 'light', sugar-free variants or new flavours for a successful brand, a car manufacturer might start offering sports, SUV or electric variants of a model or a tablet-computer manufacturer might offer a range of wider screens. A firm might also alter other elements of its marketing mix to expand its market. For example, it might try to find new distribution channels so that more customers gain exposure to the product/service. It might move from a selective distribution network to a more intensive network. Associated with this would be a more aggressive promotion and pricing strategy that encourages further market penetration ahead of the rapidly emerging competition. Building the brand would be important and this will become a vital part of the advertising message.

Although usually a defensive strategy to counter competition, as we shall see later in this chapter, product/service expansion can also be used as a strategy to seek out new markets for similar products/services to those already offered, potentially creating completely new industries. Amazon, Apple, Facebook, Google and Microsoft are all doing this as part of a battle to become 'internet utilities', offering a complete package of internet products/services.

Product/service extension

This is where a successful brand is extended to similar but different products/services that might be purchased by the same customers. For example, a number of chocolate bar manufacturers have successfully extended their brand into ice cream. The key to success here is having a strong brand, one that actually means something to customers, and with values that can be extended onto the other products. Thus Timberland, a company well known for producing durable outdoor footwear, extended its product range to include durable outdoor clothing. Virgin and Saga are also good examples of brands that have been applied to a wide range of diverse products, mainly successfully, linking customers and their lifestyle aspirations. Many so-called 'new' products/services are in fact line extensions. This strategy is generally a less expensive and lower risk alternative for firms seeking to increase sales.

New product/service development

Although normally associated with the end of a product life cycle, a firm might introduce a completely new product/service simply because it spots a new market opportunity. This might be an innovative product/service to either replace or sell alongside an existing range. This is most successful when the firm has built up a loyal customer base and has a close relationship with customers – a customer focus – and a good brand reputation for quality or delivery that can be built upon. A customer-focused firm will have an advantage in developing new products/services because, if it understands how its customers' needs are changing, it ought to be able to develop new products/services that meet them. What is more, if there is a relationship of trust, customers are more likely to try their new product/service, provided of course they perceive a need for it. The key to this strategy, therefore, is building good customer relationships, often associated with effective branding. For example, Apple started with computers but moved into tablets, smartphones and smart watches as mobile technology became increasingly important.

Market and product/service development are not mutually exclusive strategy options. Deciding on which strategy to adopt may revolve around which is more cost-effective – increasing the volume of sales to existing customers or looking for new markets. Product/service development must be grounded firmly in the needs of the existing market. Having close relationships with customers often results in them becoming product/service advocates, bringing in new customers – which suggests that product/service development can build on this. And customer advocates may also help with product/service development. Nevertheless, developing new products/services, even for existing customers, can be expensive and risky and, if done too rapidly, it can mean resources are spread too thinly across an unbalanced product/service portfolio.

DEVELOPING A PRODUCT/SERVICE PORTFOLIO

A strategy of product/service development will lead to a firm having a portfolio of different products/services, each with different marketing strategies. One of the reasons for this is that product/service offerings, like markets, have a life cycle (see Figure 5.1) and business models and strategies need to be modified to fit with this. This complexity is increased when products/services are offered in different markets. So, for example, McDonald's may have a different marketing mix for its products in developing countries, where it is at the 'completely new' or 'emerging' phase of its life cycle, compared to the USA, where it is a 'mature' offering.

The added complexity of having a portfolio of different offerings, each at a different stage of its life, can be handled using a technique adapted from the growth share matrix, shown in Figure 18.3. This is also known as the 'Boston matrix' after the Boston Consulting Group that developed it. This is a simple tool for showing the important issues facing products at different stages of their life and the implications for strategy. The vertical axis measures the market attractiveness – the growth and profit potential (rather than historic growth rate) of the market. The horizontal axis measures the strength of the product/service in this market – its sales, relative market share etc. A product/service is launched into an attractive market (otherwise why do it?), but its market position is likely to be weak to start with and is therefore risky. This is called a 'Problem Child'. If the market continues to be attractive, sales will grow and its market position will strengthen, lowering the associated risks. This is called a 'Star'. Eventually, however, the market will mature, becoming less attractive, and the product/service will become a 'Cash Cow' – a market leader with a lot of stability but little additional growth because it is approaching the end of its life. This is the lowest risk situation, at least in the short term, but with little potential for the future. Eventually the product/service will become a 'Dog' as it comes to the end of its life cycle. Sometimes the market a product/service is launched into proves to be unattractive – then its life is very short as it becomes a 'Dog' quickly. A 'Cash Dog' might prolong its life because it covers its costs, at least for a time. The arrows show the trajectory of travel in the matrix.

There are a number of measurement issues with this simple framework. How do you define the market so that market share or market growth can be measured? You might use just one factor on each axis or a number of them weighted in some way. Nevertheless, the problem of measurement remains. The matrix is therefore probably best used as a loose conceptual framework that helps clarify complexity. Anything that simplifies complexity and therefore helps our understanding must be of value.

Product modification, extension and expansion opportunities can be represented in the growth share matrix. An example of this is shown in Figure 18.4. Again this is a useful visual aid to understanding strategy options. Each of the four quadrants requires a different business model and marketing strategy.

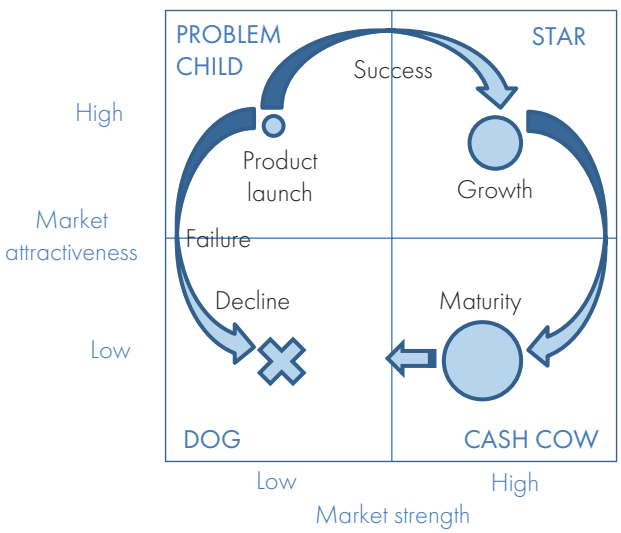


Figure 18.3 Growth share matrix

Source: Adapted from The BCG Portfolio Matrix from the Product Portfolio Matrix, The Boston Consulting Group, 1970.

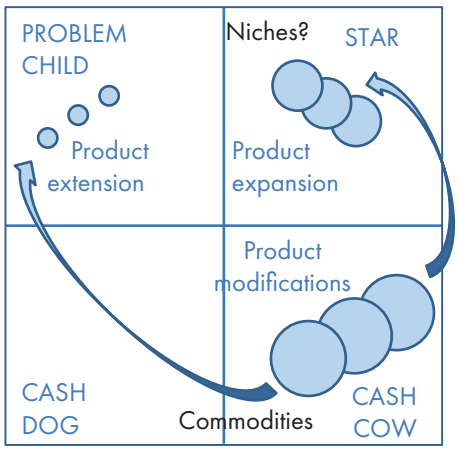


Figure 18.4 Product modifications, extension and expansion

Source: Adapted from The BCG Portfolio Matrix *from the* Product Portfolio Matrix, *The Boston Consulting Group, 1970.*

PROBLEM CHILD	STAR
Develop opportunities ➢ Be critical of prospects ➢ Invest in selected products ➢ Basic product ➢ Encourage customer trial & evaluate response ➢ Price low (encourage trial) or price high (novelty) ➢ Develop brand ➢ Selective distribution	Invest for growth ➢ Sell aggressively & penetrate market ➢ Differentiate product ➢ Promote brand loyalty ➢ Modify product & expand range ➢ Price competitively to combat competition ➢ Wide distribution
CASH DOG	**CASH COW**
Generate cash ➢ Monitor carefully – judge when to discontinue ➢ Maintain customer loyalty ➢ Reduce costs (e.g. minimise promotions) ➢ Improve productivity ➢ Price low (stock disposal) or Price high (little competition) ➢ Look for 'easy' new markets (e.g. overseas)	Manage for earnings ➢ Maintain market position with successful product(s) ➢ Differentiate & maintain brand loyalty ➢ Heavy promotion ➢ Price defensively ➢ Selective marketing with special offers & promotions ➢ Intensive push on distribution ((including trade discounts)

Figure 18.5 Strategy implications of the growth share matrix

Elements of the generalised marketing strategy for different product/service offerings within each quadrant are shown in Figure 18.5, all things being equal. But remember that, while this framework reflects general strategies that are appropriate at different stages of the product/service life cycles, it does not reflect the generic business models outlined in Chapter 7 that underpin them; price, differentiation and degree of customer focus. These need to be incorporated into any overall marketing strategy.

CASH FLOW, RISK AND THE PRODUCT/SERVICE PORTFOLIO

As a product moves through this matrix there are implications for cash flow, risk and the different business skills required. In the Problem Child phase entrepreneurial and marketing skills are of most value. This phase consumes cash for development and promotional costs at a rate of knots, without generating much cash by way of revenues. This is the highest risk phase. In the Star phase these skills

PROBLEM CHILD		STAR	
Revenue	+	Revenue	+ + +
Expenditure	- - -	Expenditure	- - -
Cash flow	- - (negative)	Cash flow	neutral
CASH DOG		**CASH COW**	
Revenue	+	Revenue	+ + + +
Expenditure	-	Expenditure	- -
Cash flow	neutral	Cash flow	+ + (positive)

Figure 18.6 Cash flow implications of the growth share matrix

are also important and marketing costs will continue to be high but at least the product should be generating revenues that should meet these costs. Risks at this stage may still be high but are reduced from the previous stage. Once the product is in its mature phase it needs to be managed as a Cash Cow – costs tightly controlled and the product milked for all the cash flow it can generate. That means high levels of efficiency are needed, probably achieved through a high degree of control and direction. This is the lowest risk stage, at least in the short term. These changes in skills reflect the changing managerial challenges discussed in Chapters 14 and 16. There are two kinds of Dogs. One is a Cash Dog that covers its costs and might be worth keeping, for example if it brings in customers for other products or services or it shares overheads. The other is the Genuine Dog which is losing money – both in cash flow and profit terms – and should be scrapped. These cash flow implications are shown in Figure 18.6. Remember, that most firms will need additional cash to finance the innovations that have not yet reached the market.

Ideally, the cash flows from a product/service portfolio should balance out so that the surplus cash from Cash Cows can be used to invest in the Problem Children – the firm is self-financing. However, few firms are balanced. The problem that arises with an unbalanced portfolio is that there is either a surplus of cash (no new products/services) or a deficit (too many new products/services). If there are too many Problem Children and Stars in the portfolio (too many good, new ideas), then further cash injections will be required, underlining the paradox that you can be profitable and still run out of cash.

The growth share matrix is a convenient way of showing the cash flow and risk implications for a product/service portfolio. Each circle in Figure 18.7 represents a different product/service offering. This is a snapshot at a point of time or for one operating period that changes over time. The size of these could be represented by the sales or profit they generate:

- Figure 18.7a shows a balanced portfolio with three new products/services, four growth Stars and three Cash Cows. This appears balanced both in terms of cash flow and risk.
- Figure 18.7b shows an unbalanced portfolio with four new products/services (Problem Children) and two growth Stars. This portfolio is unlikely to generate sufficient cash to finance the marketing of the new products/services and external finance may have to be sought. This appears a high-risk situation but with good potential for the future.
- Figure 18.7c shows an unbalanced portfolio with only one new product/service (Problem Child) but four Cash Cows. This portfolio generates a lot of cash but the launch of only one new product/service is unlikely to use it all up. It might be paying high dividends and appear low risk at the moment but the future does not look good for this company unless it has a number of innovations coming through, which do not yet feature on the matrix.

Again, the added complexity is the generic marketing strategies that need to be factored into the strategy. For example, if the Star and Cash Cow product/market offerings in 18.7a are all commodities, selling mainly on price, with low margin under intense pressure, it has implications not only for strategy but

> *Fast growth normally means being unprofitable because you have to invest heavily in staff and marketing. Then there is aiming to be profitable and living within your means, which means you are not going to grow. That's the classic tightrope for technology businesses.*
>
> William Reeve, co-founder of Lovefilm, *The Sunday Times*, 2 April 2017

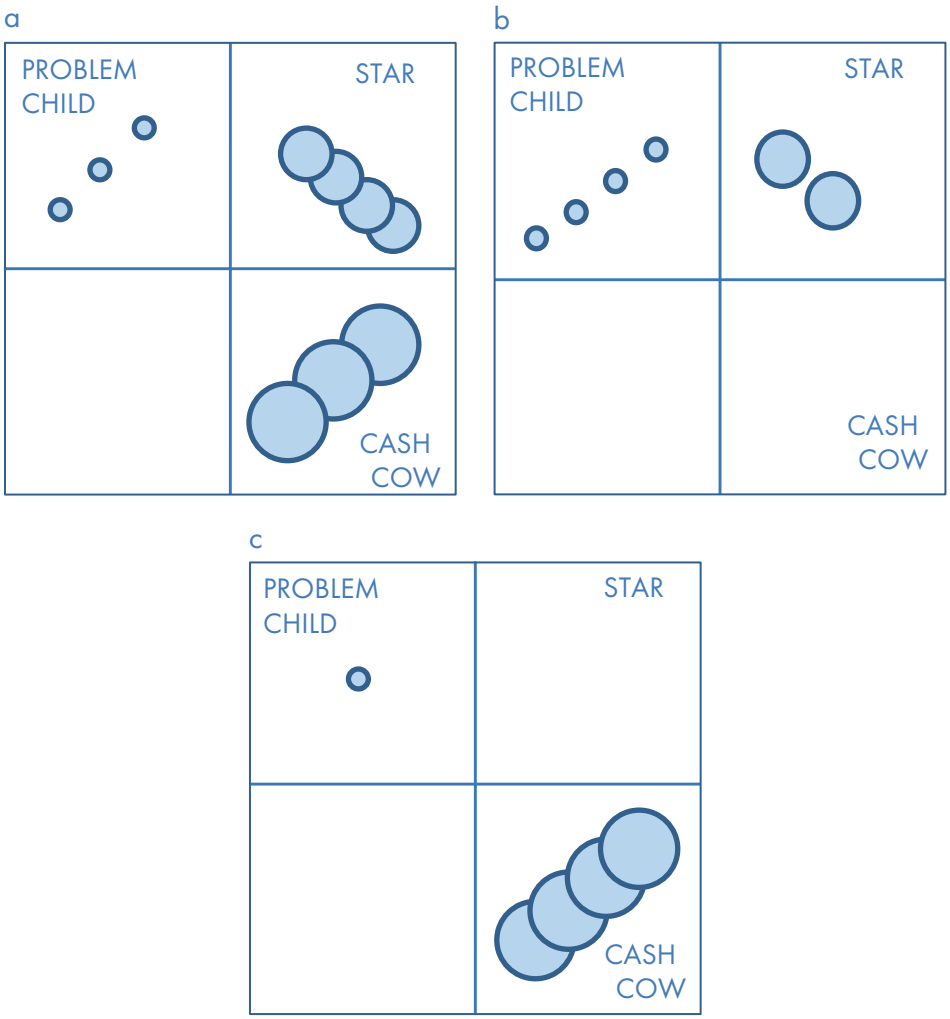


Figure 18.7 (a) A balanced portfolio (b) An unbalanced portfolio: Insufficient cash/too many new product/services (c) An unbalanced portfolio: Too much cash/too few new product/services

also for the cash flow available to invest in the Problem Children and any other innovations not yet shown in the matrix.

One company that has used a portfolio approach to risk and cash flow management is Alphabet (formerly Google). It reorganised in 2005, splitting itself into a number of subsidiaries and putting overall ownership in the hands of a new parent company called Alphabet. A newly reformed Google remained its main cash generator (Cash Cow). Within Google new products continue to be developed but the other subsidiaries were tasked with developing new product/market offering for the future – diversification. One advantage of this organisational structure is that risk has been compartmentalised within the subsidiaries undertaking the new product/market developments (Chapter 13).

DIVERSIFICATION

Diversification involves moving away from core areas of activity into completely new and unrelated product/market areas ('industries' or 'sectors') by developing new products/services that are launched into new markets. It is therefore considered to be a riskier strategy than market or product/service development. Diversified companies with operations in a range of different industries are called 'conglomerates'. The literature distinguishes between unrelated and related diversification.

Unrelated diversification

This is when the firm develops into a new 'industry' or 'sector' that, on the face of it, bear little relationship to the one it is in and there is little or no 'operational relatedness'. The risks are said to be high because the firm understands neither the product/service nor the market it is to be sold into and therefore might overvalue it and not understand how to deploy it. The further the company strays from its core competencies, the higher the risks because of problems with implementation, particularly when this is coupled with an implementation strategy involving acquisition (Bowman and Faulkner, 1997).

Related diversification

This is when development is beyond the present product/market, but within the confines of the 'industry' or 'sector' in which the firm operates. In these circumstances there is likely to be some 'operational relatedness' that offers the opportunity for economies of scale, scope (called 'synergy') or the expansion or extension of the firm's existing product/service range – in other words there is some added benefit from the move. Synergy comes about through spreading an asset (tangible or intangible) or capability over multiple activities. It is often achieved through brand extension – transferring an existing brand to products/services with related values. It is often described as '1 + 1 = 3'. This form of incremental diversification is usually considered less risky than unrelated diversification. There are three variants of related diversification:

1. Backward vertical integration – This is where the firm becomes its own supplier of some basic raw materials or services or provides transport or financing. For example, the UK supermarket Waitrose originally subcontracted its home delivery service but once it proved popular took it over itself.
2. Forward vertical integration – This is where the firm becomes its own distributor or retailer or perhaps services its own products in some way. For example, Timberland, famous for its sturdy, waterproof boots, opened a number of speciality stores and factory outlets selling its boots and Timberland-branded outdoor clothes and other products while continuing to sell predominantly through distributors, franchisees and commissioned agents.
3. Horizontal integration – This is where there is development into activities which are either directly complementary or competitive with the firm's current activities. For example, the Ford Motor Company diversified into financial services to facilitate car purchase and now earns more from this source than from the manufacture of the vehicles themselves.

The literature suggests that related diversification is more likely to be commercially successful than unrelated. There are some core managerial skills and knowledge related to the product/service and/or market and there may be some economies of scale and/or economies of scope with existing activities. Economies of scope is the term used when less of a resource is used because it is spread across multiple activities. This can arise when an intangible asset like a brand can be extended across more than one product (brand or product extension). It can also arise when organisational capabilities such as sales or technological management and their related fixed costs can be extended across more products or services. For example, the French company LVMH (Moët Hennessy Louis Vuitton) is the world's largest supplier of branded luxury goods. Its portfolio includes Moët & Chandon champagne (as well as other brands), Hennessy cognac, Louis Vuitton accessories and leather goods, Dior, Givenchy and Guerlain fashion, clothes and perfumes, TAG Heuer and Chaumet watches, and Sephora to name but a few. Its distinctive capability is its ability to manage these luxury brands through market analysis, advertising, promotion, retail management and quality assurance. Economies of scope come from these organisational capabilities. Nevertheless, while diversification is central to the process of corporate evolution, it can be viewed as something to be undertaken after very careful consideration, because it is generally considered to be high risk. While developing either a new product/service or a new market is always risky, developing both simultaneously can be even riskier – akin to another start-up.

DIVERSIFICATION AND STOCK MARKETS

It has been suggested that a strategy of diversification has probably caused more value destruction for shareholders than any other corporate strategy (Grant, 2010). Grant (2010) described it as being 'like sex: its attractions are obvious, often irresistible. Yet the experience is often disappointing. For top management it is a minefield.' This view has a long history. Researchers in the 1980s emphasised the need to focus on the core business (e.g. Abell, 1980). A firm's core business was seen as the one in which it had a distinct advantage by adding the greatest value for its customers and shareholders. Many studies have shown that firms that are more focused on their core business perform better than diversified ones (e.g. Wernerfelt and Montgomery, 1986), although some studies were subsequently disputed (e.g. Luffman and Reed, 1984; Michel and Shaked, 1984; Park, 2002). In addition, several studies have found that diversification was associated with improved performance up to a point, after which continued diversification was associated with declining performance (e.g. Palich et al., 2000). The problems seemed to revolve around managing the complexity of different products/services in different markets and an inability to realise any synergies. In the past synergies were more certain to be achieved through market or product/service development. Out of this came the idea of 'sticking to the knitting' that was popularised by Peters and Waterman (1982) who concluded that the most successful strategy involved diversification around a single skill, followed by those branching into 'related fields'. The least successful was diversification into a 'wide variety of fields', particularly through acquisition.

> *Diversification makes very little sense for anybody that knows what they are doing ... Diversification is protection against ignorance.*
>
> Warren Buffett, investor, Berkshire Hathway annual shareholders meeting, 1996

Developments in financial theory in the 1970s echoed this view. In particular the capital asset pricing model showed that conglomerates that were quoted on stock markets (public companies) did not create shareholder value by reducing this sort of risk (Levy and Sarnat, 1970; Mason and Goudzwaard, 1976; Weston et al., 1972). This is because diversification does not reduce systematic risk – that part of risk associated with how the share price performs compared to the overall market (measured by the company's beta coefficient). Shareholders can simply buy shares in undiversified companies representing the diversified interests of the conglomerate. This spreads their risk, probably with lower transaction costs. Therefore, at the corporate level diversification does not create shareholder value. Indeed, conglomerates often trade at a discount on the value of their component parts because of their perceived complexity and lack of synergy.

However, while all this may be true for companies quoted on the stock exchange (public companies) it is not necessarily true for private companies (companies owned privately, often by the founder and/or their family). Just as a shareholder can reduce or eliminate all but the overall market risk by holding a diversified portfolio of shares for companies in different industries, as we have seen, a private company can do the same by holding a diversified portfolio of projects (or product/market offerings) *that are independent of each other* – different products/services in different markets. When the company is owned by an individual or family it becomes their main store of wealth (unlike the shares in any one company owned by the diversified shareholders). Having business interests in a range of different markets or industries spreads the risk of a business downturn in any one and therefore reduces the risks associated with the individual or the family's wealth. For the entrepreneur there is the added advantage of retaining control over decision-making in the company. For example, the Virgin Group is a private conglomerate whose scope of business reaches into markets across the world and covers different industries from transport to media, from health and lifestyle to financial services. Richard Branson withdrew Virgin from the stock market some years ago, buying back its shares.

> *The approach to running a group of private companies is fundamentally different to that of running public companies. Short-term taxable profits with good dividends are a prerequisite of public life. Avoiding short-term taxable profits and seeking long-term capital growth is the best approach to growing private companies.*
>
> Richard Branson, letter to *The Economist*, 7 March 1998

Diversification and the formation of conglomerates therefore remains a powerful driver of strategy for private, unquoted companies, and even quoted companies in developing economies (e.g. Tata Group and Reliance Industries in India). In developing countries this may be because of local stock market inefficiencies such as high share transaction costs and consequent low level of trading, but is more likely to do with the high concentration of share ownership in family hands. Even in the West this can be true. LVMH, mentioned earlier, is a conglomerate of luxury brands comprising some 60 subsidiary companies, often independently managed. Interestingly, while it is a public company, some 48 per cent of LVMH is owned by Groupe Arnault, the family holding company of Bernard Arnault, who brought the company together. When a private company is the main store of wealth for a family it makes good sense to diversify the risks associated with doing business.

Case insight 18.3 Nokia

Pivoting into new industries

Nokia is a Finnish public company founded in 1865 and few companies can have pivoted their business strategy and operated in more industries than Nokia. It started life as a pulp mill, expanding into electricity generation by 1902 and then, some 20 years later, into rubber (it produced tyres and even Wellington boots). The link with these industries was electric power supply. Between the 1930s and 1990s Nokia also made respirators for both military and civilian use. In 1967 the three companies were merged into one, Nokia Corporation, with four divisions; forestry, cables, rubber and electronics. It continued to make respirators (gas masks) for the military but started to make a range of other electronic devices for it such as directional beacons and artillery rangefinders. In the 1970s it entered the radio and communications industry and started making telephone exchanges. In the 1980s it expanded into consumer electronics making televisions, minicomputers, pagers and mobile phones. In 1987 it discontinued production of cables followed, shortly after, by the production of rubber and then computers.

In the 1990s it became more telecom-orientated, selling its television business and launching the first digital satellite receivers. In the late 1990s and 2000s Nokia came to dominate the mobile phone market and even expanded into mobile gaming. It peaked in 2008 with almost 39% of the global market and in 2009 was rated as the fifth-highest-value global brand. However, Nokia was the only firm using its own proprietary operating system (Symbian OS) which was rapidly becoming outdated, and other companies such as the Apple iPhone (using iOS), Samsung and Huawei (using Android) successfully challenged Nokia's dominance. After a two-year 'strategic partnership' Nokia sold its mobile phone division to Microsoft in 2013, at which point its global brand value had fallen to 98th. After this sale Nokia focused more on production of data networking and telecommunications equipment, although it continued to allow the use of the Nokia brand to be used under licence on some consumer electronics products. Its major competitor in developing 5G networks are Huawei (China) and Ericsson (Sweden).

Questions:

1. Why did Nokia make these pivots?
2. What are the problems in changing the focus of a business so many times?

DIVERSIFICATION AND PRIVATE SHAREHOLDER VALUE

There are three reasons why diversification and a product/market portfolio constructed by an entrepreneur for their privately owned company might not only diversify risk but also add value. The first is to do with how entrepreneurial firms are able to exploit opportunities through 'diversification creep', the second is their approach to developing a product/market portfolio and the final reason is their ability to build upon the portfolio to achieve market dominance.

Diversification creep

Typically the product/market matrix in Figure 18.1 has been used to show increasing risk as a business moves away from its core business of existing products and markets. However, there is an area in the centre of the matrix where many growing entrepreneurial businesses may have a competitive advantage – facing lower risks than larger, more bureaucratic competitors because they are able to handle continuous market-related changes. This is shown in Figure 18.8 as the 'twilight zone of risk'. It is often the way new industries or markets are created – by bundling new combinations of products/services with markets to meet, as yet, unexploited market opportunities. This is where a good understanding of customer needs, combined with mechanisms for market testing, mitigates what might otherwise be called 'risky diversification'. It is the result of 'diversification creep' – where the small incremental, but not necessarily simultaneous, steps to explore these market and product/service opportunities can yield substantial future shareholder value. However, it still requires the successful exploitation of potential synergies. This strategy has been followed by many of today's tech giants like Amazon and Alphabet.

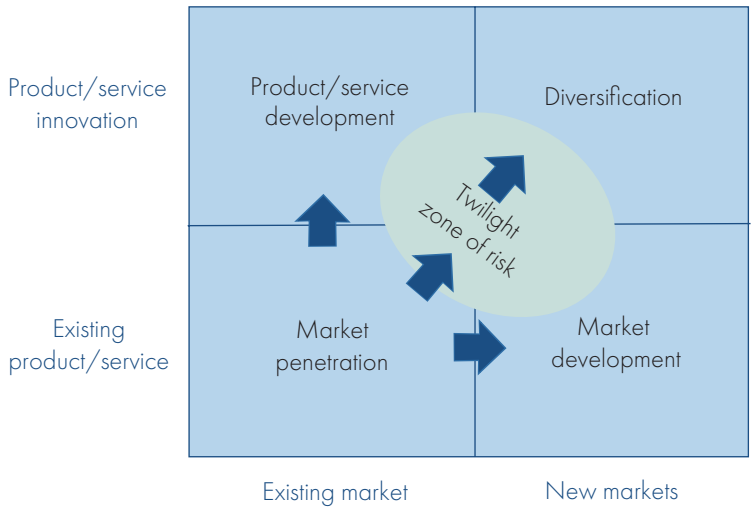


Figure 18.8 The twilight zone of risk

Entrepreneurial product/market portfolios

Chapter 3 explained how most people are biased towards risk-aversion for gains but are risk-seeking for losses – they will take a risk to avoid a loss. This tendency can result in the spread of product/market offerings in a portfolio being biased *against* riskier projects which are likely to offer higher returns. A more balanced portfolio therefore needs some higher risk projects to balance off against lower risk projects: it wins a few, it loses a few. And an entrepreneur is likely to introduce these projects because of their greater willingness to accept risk and uncertainty. What is more, if the entrepreneur is at the head of a private company they have more freedom to invest in innovative projects that promise only longer term returns, in contrast to public companies where shareholders are usually more concerned with short-term profits and dividends. Entrepreneurs are well aware of these stock market pressures and there are ways around it. When the founders of Google and Facebook floated their companies on the stock market they held onto shares with extra voting rights so as to ensure that they kept control and were not subject to short-term shareholder pressures. This practice, although criticised by investment companies, continues today. When Snap, the Snapchat social media group founded in 2011, raised $3.4 billion in a float in 2017 the new share did not have voting rights, meaning that its founders maintained control.

Market dominance

The final reason entrepreneurial companies have pursued a strategy of diversification is to do with gaining market dominance in newly emerging markets or industries that are, as yet, not clearly defined. There is no clear distinction between a company operating in diverse products/markets and a conglomerate, which is said to operate in different industries. Is Amazon a conglomerate? The distinction revolves around the degree of connection between the different markets and when they are sufficiently distinct to become separate industries. However, the new era of technology is blurring these boundaries. Hardware and software are increasingly linked, with the US tech giants (Alphabet, Amazon, Apple, Facebook and Microsoft) able to offer virtual and physical goods and services, marketed (in real time) with the benefit of information they have gained from intelligent systems (AI) embedded in the software their customers are using. Everything is linked through the internet, algorithms and AI systems. The opportunities for synergies of every kind (economies of scale and economies of scope) are enormous. And the prize is market dominance and an ability to make monopolistic profits at some point in the future. Most of the tech giants, arguably, have

already become conglomerates. The Chinese tech giant Tencent controls hundreds of subsidiaries and associates across a diverse range of businesses including internet services, social media and film production. It is also one of the most active investment corporations in the world, focusing on Asian tech start-ups. And technology can pull more traditional industries into domains that they are unfamiliar with. For example, internet-connected cars are pulling the automotive industry into the software business at the same time as autonomous vehicles are bringing the tech companies into the automotive and transport business – often resulting in partnership between companies in the two sectors.

In the past conglomerates grew up through a conscious strategy of diversification. Today conglomerates can emerge out of a strategy of promoting innovation with radical innovations spawning interconnected new-to-the-world industries and redefining the industries many companies are in.

DIVERSIFICATION AND CORPORATE ACQUISITION

Obtaining rapid market dominance can be very important for certain types of new venture. And sometimes, if funds are available, acquiring rivals is a way of consolidating market position at home and buying market share in foreign markets. One of the reasons for the early success of Lastminute.com was its aggressive acquisition strategy in European markets after its launch in 1995. It purchased similar online businesses as well as a wide range of related travel and holiday firms such as Lastminute.de in Germany, Dégrif-tour in France, Destination Holdings Group, Med Hotels, First Option and Gemstone. These acquisitions helped it to quickly gain geographic market dominance as well giving it economies of both scope and scale across product categories. In this way it consolidated its brand across Europe very quickly. All of today's tech giants have adopted strategies of rapid diversification based upon acquisition.

Clearly a growth strategy based on acquisition requires access to high levels of funding – acquiring another successful new venture in another country can be expensive. It is really, therefore, only an option for high-growth businesses that have proved their business model and where economies of scale or scope are vital. It is also risky. Acquisitions have a high failure rate. The larger the acquisition compared to the acquiring company, the riskier it is because the acquired business will be more difficult to integrate. It should only be used where there is a newly emerging market and it is the only way to gain rapid market dominance in what otherwise might become a fragmented industry. An alternative to acquisition is strategic alliances and joint ventures (Chapter 11). These are less risky, do not require such high levels of funding and keep the management of each business separate. Although profits have to be shared with the partner, it can mean that an entrepreneur does not have to spread their management time too thinly.

> *We tend to be pretty adept at identifying good opportunities when they come up. We won't make an acquisition unless we know we can integrate quickly and effectively. We would never purchase a business purely for scale. It's always about profitability and return on equity.*
>
> Adam Schwab, founder of Lux Group, Australian Anthill, anthillonline.com.au, 22 October 2013

Explore further 18.2

Diversification and conglomerates

Access the *Digital Links* booklet to watch a short video explaining what a conglomerate is and a CNBC discussion about how to increase shareholder value.

Case insight 18.4 Lenovo

Acquisitions and industry concentration

Founded in 1984, Lenovo is one of China's biggest computer firms. Unlike many Chinese firms, it is run like a private company with little state interference from two head offices, one in Beijing, China, and the other in Morrisville, USA, with its research centre in Japan. In 2005 it acquired IBM's PC arm and quickly grew to become one of the world's biggest PC makers, capitalising on its low-cost manufacturing base. In 2014 it purchased Motorola smartphones from Google for $2.3 billion. Although Google had failed to make profits from Motorola in the three years it owned the company, Lenovo felt that the potential for economies of scale and scope would enable it to consolidate its market position and threaten Samsung and Apple in the growing smartphone market. In the same year it purchased IBM's low-cost server unit for $2.9 billion, believing that these units would be needed to store ever-increasing amounts of data.

By 2018 it was clear that both of these acquisitions were unsuccessful. By 2018 it was selling 17% fewer smartphones than in 2014, despite market growth of 15%, and the smartphone business had made a loss every quarter since the takeover, a total of almost $2 billion, forcing it to shed staff. The company blamed rising costs and mature markets saying that 'component costs continue to present challenges' but that it was trying to strengthen its position in Latin America and 'drive breakthrough in mature markets' (*The Observer*, 13 May 2018). But analysts also pointed out that there had been a long internal struggle to decide which brand should drive business – Lenovo or Motorola – and selecting one brand in territories where they overlapped (China, Southeast Asia and India) lost key business for the other.



Source: *Ashkan Forouzani on Unsplash*

By 2018 the server business had also lost over $700 million, largely as a result in the growth of cloud services from Google, Amazon and Microsoft, which allow clients to store data without the need for their own hardware. Being a Chinese company, security was also an issue for Western companies. Analysts point to some $2.7 billion of goodwill related to these acquisitions that is still carried on the balance sheet and speculate whether it may have to be written off. For Lenovo, expensive acquisitions have proved very costly in a cut-throat global tech market. Nevertheless, Lenovo remains a powerful force in computing. It now commands almost a quarter of global laptop sales.

Access the *Digital Links* booklet to visit the company website and to watch a short video focusing on Lenovo's business achievements and market strength around the world.

Questions:

1. Was the company right to make these acquisitions when it did?
2. Were these outcomes foreseeable? What would you have done differently?

THE ENTREPRENEURIAL CONGLOMERATE

The arguments against diversification revolve around risk and not straying from a firm's core skills, knowledge and capabilities, applied to a relevant market so that potential synergies can be realised. However, products, markets and society are changing rapidly and in this context shareholder value can indeed be created in a systematic process that includes diversification. And stock markets seem more willing to wait for profits and dividends in the new tech companies following this strategy (e.g. Uber and Airbnb). Burns (2000) linked these opportunities to the ability of large or growing tech companies to develop an 'entrepreneurial architecture' (Chapter 22). He observed that these were the ways an entrepreneurial multi-product/market business (a conglomerate) can create real value for its shareholders:

- The distinctive capabilities of a firm with an entrepreneurial architecture create an ability to innovate, again and again. These capabilities can be extended across more products/services. In effect, the firm's core business is innovation, including acquisitions that buy in to new innovations. Operationally related innovations can be integrated into existing operations or licensed out to other firms depending on the firm's overall strategy, thus creating shareholder value. Those innovations that are not can be spun-off and sold, also creating shareholder value.
- Markets are changing rapidly and new product/market opportunities emerging, particularly with regard to new technologies. Radical innovation creates the products/markets of the future, not the past, meaning that the core skills, knowledge and capabilities needed to exploit them have still to be determined. An innovating firm with an entrepreneurial architecture should be able to combine its portfolio of core competencies in various ways to meet opportunities. What is more it will have first-mover advantage and be well placed to dominate a new product/market (industry) it creates, exploit its monopoly or oligopoly position and create shareholder super-value.
- An aggressive acquisition strategy can be combined with internally generated incremental and radical innovations to produce diversification creep, minimising the risks associated with new product/market development. The speed at which an acquisition can be executed allows rapid entry to these new product/market opportunities.
- By combining incremental and radical innovation, corporate venturing (Chapter 22), and adopting a portfolio approach to products/markets and how the business is structured the risks associated with diversification can be minimised. What is important is the ability to create synergies not just in the traditional ways but also through the technological linkages – between activities, processes, knowledge and/or information which have been previously unconnected, or where the connection has been of a different type. To justify the claim of synergy in an acquisition the acquiring company must really be able to create value by operating across multiple businesses and multiple markets and leveraging these synergies. The mere potential or existence of the linkages is not enough, they must be operationalised.

What might be described as related or unrelated products/markets is not always clear-cut, shading into grey, particularly in the areas of rapidly developing new technologies where new markets are being created where none before existed. Five of the most successful entrepreneurial companies of the last couple of decades – the US tech giants; Alphabet, Apple, Amazon, Facebook and Microsoft – have adopted strategies of diversification that are probably starting to redefine their business scope. This is happening through a combination of organic growth, corporate venturing and acquisition. Their moves into new areas have been incremental, bundling additional services to sell to existing customers, finding out about market acceptance of their new products experimentally – a form of market testing. Often they have used acquisition to buy new customers as well as innovations. To see the proof that these processes create shareholder value in this new digital era you need look no further than the stock market success of these companies. They are all becoming multi-product/multi-market businesses. In the past we might have called them 'multinational conglomerates'. In this new era where markets are redefining themselves, this is no longer a criticism.

When a market becomes too large the strategy of market domination can threaten public good. For example in 2017 Google was fined €2.4 billion by the European Commission for abusing its market position by promoting its own shopping service in search results. In the following year it was fined €4.34 billion for using its Android operating system to restrict competition by requiring smartphone and tablet manufacturers that use Android to exclusively pre-install several of Google's own applications (e.g. Google search). Market dominance usually creates oligopolies and monopolies with restrictive practices, price-setting power and high profits. It also attracts speculative investors towards innovative firms that might create these new products/markets, and with them comes the prospect of financial 'bubbles'. Indeed, Janeway (2018) believed speculation and financial 'bubbles' are a necessary part of the process of attracting the finance needed for innovation generally: 'The most powerful enabler of risk-taking at the frontier of innovation is the possibility of winning financially even if the funded project fails'.

Case insight 18.5 Amazon

Growth strategies and monopoly power

Jeff Bezos first registered a company called Cadabra in 1994, but too many people thought it was called 'Cadaver', so he quickly changed its name to Amazon (because it started with an 'A' and sounded exotic). He launched Amazon onto the internet in 1995. Amazon has become one of the great entrepreneurial start-ups of this generation. It started life selling books online and now sells – and delivers – almost everything, not to mention the gadgets you buy them on – Fire, Kindle and Echo (usefully preloaded with your Amazon account details) as well as the mechanisms you use to pay for the things you buy (it used to own PayPal). It also has an online TV and film streaming service, develops artificial intelligence (AI), offers cloud computing facility and is even developing self-driving vehicles. It is known for disrupting established markets through technological innovation. It has changed the way we shop, popularising online shopping, and even changed the high streets in which real shops are based and is now changing the way we live life. But, with sales of over $280 billion in 2019, Amazon itself has changed and is now described as a 'multinational technology company'. How did it obtain its market dominance and how does it sustain it?

Chapter 7 laid out three major strategies to help secure sustainable competitive advantage, all of which Amazon has followed:

1. Speed-to-market – Amazon and eBay were among the first online retailers to launch in the USA. Amazon started as a niche e-commerce business – selling books that could not be found easily in bookstores. A large proportion of sales went to the US military personnel based overseas. Revenues took off when Bezos was featured on the front page of the *Wall Street Journal* in 1996 and it started charging commission for referrals to other online book sites, but the real expansion came when it started selling music, videos, games and other consumer items alongside books (the strategy of 'horizontal integration'). In 1998 Amazon expanded into the UK through its purchase of Bookpages and into Germany by its purchase of Telebook, respectively the largest UK and German online book retailers.
2. Speed-to-market dominance – The purchase of the two European companies gave Amazon immediate dominance in these markets. But at the same time as it was acquiring online competitors it was also expanding the products it sold on these websites – simultaneous product and market development, using its dominance in the book sector to leverage sales in other product sectors.
3. Brand strength within that market – In 2000 Amazon greatly diversified the range of products it sold online as well as launching Amazon Marketplace, allowing businesses to sell their products directly on the Amazon website (for a commission). It also has an affiliate programme that allows anyone to post an Amazon link and earn a commission on click-through sales for that product. As Amazon increased the range of products it sold it benefited from network effects – customers became certain they could find what they wanted on Amazon, and sellers knew they could find buyers. It therefore started marketing its own brand of some more generic products, subcontracting manufacture (the strategy of 'backwards vertical integration'). In 2019 it was named the world's most valuable brand according to the Brand Z™ Top 100 Most Valuable Global Brands.

But this tells only part of the Amazon story. The company has diversified well beyond being a simple e-commerce site. Partly this came through internal, organic growth. For example, Amazon Logistics, launched in 1997, was an obvious strategy of 'forwards vertical integration'. Amazon Web Services (AWS), launched in 2002, started selling web data amassed by Amazon but, as we shall see, developed into much more. Amazon Prime Video, launch in 2006, started as an inducement to pay an Amazon Prime subscription, but the service has grown to become a full online, on-demand subscription channel making its own programmes.

Amazon has been a fierce acquirer of smaller companies. Although the full extent of Amazon's acquisitions is not public, it appears to have made over 100 (plus over 20 minority holdings) within the first 25 years of its existence – an extraordinary average of one every two months. Some acquisitions were made to help it grow and achieve market dominance in different countries (e.g. Bookpages and Telebook). Many of the retail e-commerce sites bought were closed down or consolidated into their main activities but some survived as subsidiaries or 'independent' operations (e.g. AbeBooks and The Book Depository). Some acquisitions have helped it buy into new technologies (e.g. Elemental Technologies). However, some acquisitions have taken it into new products/markets such as disaster recovery (e.g. CloudEndure), home security (e.g. Ring), robotic fulfilment systems (e.g. Kiva Systems), autonomous vehicles (e.g. Zoox) or food products (e.g. high-end supermarkets Whole Food Market and Booths, which was followed in the same year by the launch of its food division, Amazon Fresh). Some acquisitions and investments have subsequently been resold.

These acquisitions have led to new revenue streams, improved customer service and an ability to stay ahead of its competitors by offering an increasingly diverse range of products/services in the B2C market. The boundaries are blurring as technology allows companies such as Amazon, Google and Alibaba to

offer a range of products/services across multiple consumer touchpoints, using data harvested from the consumer's online interaction. They are also taking their technological expertise into the business services sector (B2B), creating new opportunities for growth in areas such as website development, cloud computing, web security, disaster recovery and AI generally.

Amazon spends enormous amounts on R&D – some $27 billion in 2018 – and then there is the money it spends on its corporate acquisitions, some of which are research companies in themselves (e.g. Annapuma Labs and A9.com). Of course it enjoys big economies of scale on its global operations, sometimes in market monopolies, as well as being able to utilise the data it has on the buying habits of its customers. Then there are the economies of scope from its e-commerce dominance. But at the same time the products/services it sells on its e-commerce sites are competitively priced, particularly considering the delivery costs. How does it do this?

The answer lies in Amazon's ability to cross-subsidise its businesses from its diversified portfolio of activities. Cloud storage offers significant advantages to users and Amazon got into this business early with the launch of AWS. Today, while e-commerce might generate the vast bulk of revenue for the company, AWS and cloud storage generates the majority of profits – 63% in 2019. This 'Cash Cow' pays for Amazon's other activities. It pays for acquisitions, allowing the company to enter lower margin sectors without having to make early profits and allowing it to keep prices low and reap the network benefits from the Amazon platform. The paradox is that the Amazon monopoly has helped keep prices low (so far).

Amazon's basic business model remains a low-cost/price one and to that end it must control its costs carefully and be highly efficient. This applies to all costs. The company has received much criticism for the poor working conditions and pay for its delivery drivers (mostly gig-workers) and the pickers in its fulfilment centres. What is more, controversially, Amazon paid no tax in the USA in 2017 and 2018, and actually received tax refunds worth millions of dollars, despite recording billions of dollars in profits.

Access the *Digital Links* booklet to visit the company website and to watch videos that explain the network effects available to Amazon by increasing its scale and how Amazon uses income from its portfolio of products (in particular the cloud storage company AWS) and its network effects to subsidise its other products/services.

Questions:

1. How many growth strategies outlined in this book has Amazon followed? Explain.
2. How many related diversification strategies has Amazon used? Explain.
3. Why has Amazon been successful?
4. Amazon is a public company. Why have shareholders allowed it to follow a strategy of diversification?
5. Is diversification a good or bad strategy? Explain.
6. Is allowing a monopoly or oligopoly to develop in e-commerce sectors a good or bad thing? Explain.

However, the enormous profits generated can also insulate the tech giants from the short-term vagaries of the stock markets and allow them to push through with innovations that might have a longer term payback. This conflicting role of oligopolists and monopolists, on the one hand creating market inefficiency but on the other hand encouraging innovation (for themselves and for others), alongside the inherent financial 'bubbles', is a paradox that is at the centre of Schumpeter's 'perennial gale of creative destruction' (Chapter 2) and the resulting volatility.

SUMMARY

- Growth comes from market penetration, market and product/service development and/or a combination of both – diversification. Diversification is usually seen as the highest risk of these strategies.
- Market development is about finding new markets. This can be geographic – going from local to regional to national and on to global. It might also be going on to sell to different market segments.
- One reason for market development is to achieve economies of scale of production. Another is that a firm's key competency lies with its product/service, for example with technology-based products, and therefore the continued

exploitation of the product/service by market development is the preferred route for expansion. A final reason might be that the product/service is nearing the end of its life cycle in the existing market.

- Finding new markets often involves entering overseas markets which can be risky and often is best done on a staged basis involving increasing degrees of commitment: export; sales agent; licence or franchise; joint venture. New markets can be assessed using Porter's Five Forces: industry rivalry; threat of substitutes; threat of new entrants; bargaining power of buyers; and bargaining power of suppliers.
- Product/service development might include product modification, extension and expansion, leading to the development of completely new products/services.
- The growth share matrix is a loose conceptual framework that helps clarify the complexity of managing a portfolio of products/services. It has implications for the appropriate marketing strategy for each product/market and the cash flow it generates. Only when the portfolio is balanced will cash flow be stable.
- Diversification involves moving from core areas of activity and competency into completely new and unrelated product/market areas. It is central to the process of corporate evolution as new markets and industries are created.
- Diversification is seen as a risky strategy. This is most risky when the firm develops beyond its present 'industry' or 'sector' into new products/services and markets that, on the face of it, bear little relationship to the one it is in – called 'unrelated diversification'. Related diversification is less risky and is when there is likely to be some 'operational relatedness' that offers the opportunity for economies of scale, scope (synergy), or the expansion or extension of the firm's existing product range. Synergy comes about through spreading an asset (tangible or intangible) or capability over multiple activities.
- Diversification does not reduce risk in a publicly quoted company, and hence does not increase shareholder value. Publicly quoted conglomerates (companies operating in many different products/markets) therefore often trade at a discount because they are seen as difficult to manage. However, diversification does reduce risk for an individual or family owning an unquoted company by spreading risk across different sectors.
- Diversification creep – continuous, incremental diversification through both market and product/service development (often used alongside corporate acquisitions) – can be a very effective way of reducing the risk of diversification. Most of today's tech giants have followed this growth path, combining incremental and radical product/market innovation with corporate venturing.
- The development of new products/markets might offer high margins because first-mover advantage allows the market to be dominated. These new products/markets might become new-to-the-world industries, offering technology-based synergies between activities, processes, knowledge and/or information which have been previously unconnected, or where the connection has been of a different type.
- Diversification can therefore create substantial shareholder value in entrepreneurial firms able to implement these strategies effectively and deliver the potential synergies.

GROUP DISCUSSION TOPICS

1. Penetrating your existing market is a low-risk option and should therefore always be the strategy you pursue first. Discuss.
2. Selling internationally is risky but not selling internationally may be more risky. In what circumstances might this be true?
3. Exporting is expensive and risky. It is therefore not an attractive option. Discuss.
4. How can you minimise your risk of exposure to currency fluctuations?
5. What is the logic of gradually increasing commitment to a foreign market? Under what circumstances might you wish to establish a wholly owned subsidiary straight away?
6. Some products – basic necessities like food and drink – do not have life cycles. Discuss. If true, outline the implications.
7. In what circumstances might product/service development be a lower risk strategy than market development, and vice versa?
8. How useful is the growth share matrix?
9. How might you go about creating a scale for the growth share matrix? Give practical examples.
10. In what circumstances might you want to 'shoot a Dog'?
11. Give examples of product/service expansions and extensions.
12. Can a 'Problem Child' be profitable? Explain with examples.
13. You never diversify. Discuss.
14. Diversification is inevitable for a company that is innovating. Discuss.
15. Under what circumstances might diversification be an attractive option? Explain.

16. In what circumstances might company acquisition(s) help you achieve market dominance? How important is speed of acquisition?
17. Why might related diversification work best for entrepreneurial companies?
18. Why might you decide to pay a premium to acquire other companies rather than to grow organically?
19. What is synergy and how can it be achieved?
20. What is the paradox between the restrictive practices and price-setting power of monopolists and Schumpeter's 'perennial gale of creative destruction'? How is it resolved?

STUDENT ACTIVITIES

1. Map the course portfolio of your university department onto the growth share matrix in Figure 18.3. What are the strategic implications of this product portfolio?
2. Use the growth options matrix (Figure 18.1) to list the options that your university department faces to grow the courses on offer. Explain your strategies for this.
3. Select a company that has grown rapidly over the last five years. Analyse the strategies it has followed to secure this growth, comparing its use of internal with external corporate venturing.

START-UP ACTIVITY

1. Use the growth options matrix (Figure 18.1) to list the options that you have to grow or scale-up your product/service idea.
   a) Lists the things you need to do to pursue these growth options.
   b) Using the risk index developed in Chapter 13, assign an attractiveness classification to these options (i.e. identifying those options that have high impact, high probability and are highly controllable).
   c) Identify the critical success factors coming out of this and determine what would be the relevant milestones.
   d) Map the product/service developments you might consider as your business grows onto the growth share matrix in Figure 18.3. Note down the marketing and cash flow implications of this product portfolio.
   e) Update both your business model and business plan from Chapter 17 (Start-up activities 1 and 3).

19

FINANCING THE BUSINESS

Contents

- Sources of finance and their uses
- Sources of finance for social enterprises
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- Bank loans and overdrafts
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- Equity investors and the business plan
- The funding ladder
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- Group discussion topics
- Student activity
- Start-up activities



Source: iStock.com/ artisteer

Learning outcomes

When you have read this chapter and undertaken the related exercises you will be able to:

- Understand and describe the principles of prudent financing;
- Describe the sources of finance available to start-ups and SMEs, and evaluate which are appropriate for different needs;
- Understand and describe how banks, business angels and venture capitalists assess and monitor lending to and investment in start-ups and SMEs;
- Understand and describe how crowdfunding works and the different platforms and campaigns available.

Case insights

19.1	Grameen Bank	19.4	Crowdcube
19.2	Savelli (2)	19.5	Co Cars and Ethex
19.3	Kickstarter	19.6	BrewDog

Explore further links

19.1	Sources of finance
19.2	Angel and venture finance
19.3	Crowdfunding

SOURCES OF FINANCE AND THEIR USES

Many new ventures require finance to get started. The more fixed assets they need, the higher their stock/inventory holding and the longer debtors/receivables take to pay, the greater their need. But, while a cash flow forecast will tell them how much they need and for how long, it will not tell them what sort of finance they require.

The first thing to realise is that not all money is the same. Different sorts of money ought to be used for different purposes and not all types of money are available to all new ventures. In fact many start-up entrepreneurs try to avoid using money at all by using other people's assets wherever possible – called 'bootstrapping'. They also use their personal credit cards, often recycling balances month by month. Where this fails, they might borrow money from friends or relatives who might agree to be 'flexible' – lending at a low or zero interest rate and without any guarantees, even helping to run the firm bringing with them valuable experience. However, in these situations most advisors would recommend that more formal loan agreements are drawn up so as to avoid misunderstandings and arguments later. Inevitably, however, most firms will need to obtain some form of external finance at some point.

Table 19.1 summarises the major forms of finance and how they *ought* to be used, in theory. The principle is that the term duration of the source of finance should be matched to the term duration of the use to which it is put. Fixed or permanent assets, including the permanent element of working capital, should be financed by long- or medium-term sources of finance, and only fluctuations in working capital should be financed by short-term finance, such as an overdraft. However, most SMEs take whatever credit they can get without any attempt to match sources with uses or term duration.

> *Strangers will not invest in zero. If you can't raise 10–20 per cent from your mates and your family first, that speaks volumes.*
>
> Julia Groves, Chair of UK Crowdfunding Association, *The Sunday Times*, 14 September 2014

Table 19.1 Matching sources and uses of finance

DURATION OF FINANCE	SOURCE OF FINANCE	USE OF FINANCE

Long & medium term	* Equity
	  • Personal, family and friends' investment
	  • Angel finance
	  • Venture capital
	* Long- and medium-term loans
	  • Personal, family and friends
	  • Bank
	* Lease and hire purchase
	* Crowdfunding (equity or loan)
		* Fixed assets: land, buildings, machinery, plant, equipment, vehicles, furniture etc.
		* Permanent working capital: stock/inventory, debtors/receivables (net creditors/payables)

Short term	* Bank overdraft
	* Short-term loans
	  • Personal, family and friends
	  • Bank
	* Trade credit
	* Factoring, invoice discounting
	* Supply chain finance
		* Seasonal fluctuations in working capital: stock/inventory, debtors/receivables (net creditors/payables)

For a limited company the money that is put into the venture can take two forms – equity or loans. Equity starts with the share capital put in by the founder. Over time that grows through profitable trading. But if the venture fails then the shareholder risks losing everything, including the share capital they have put into the venture. For profitable, fast-growing businesses with a good management team there may be the opportunity to attract further equity investment from crowdfunding, business angels or venture capital organisations.

Loans can take different forms and come from many sources, albeit mainly from banks. Loans are serviced by regular interest payments and the capital will, ultimately, have to be repaid, depending on the duration: short term (under one year), medium term (up to five years) or long-term (over five years). Interest may vary with base rate or be fixed for the term of the loan. Agreeing to a fixed rate may involve a certain amount of crystal-ball gazing, but it does ensure that a small firm knows what its financing costs will be for some time to come. Bankers are likely to look for the security of business assets to act as collateral against any loan and, if they cannot get this, they may ask you for personal guarantees from the entrepreneur, their family or friends. Many countries have government loan or mutual schemes that offer lower rates of interest to SMEs and/or guarantee provisions to replace or supplement personal guarantees.

There are two important ways of avoiding the need for a large capital outlay to purchase assets:

» Lease – Leased assets remain the property of the lessor. A firm can use the assets so long as it makes regular lease payments and no guarantees or collateral are required. Leasing therefore lowers risk and, because many leases have clauses that allow the purchase of newer, often more efficient replacement assets without penalty, they have been used extensively in industries like air transport, where capital costs are high and technology is constantly changing.

» Hire purchase – This allows the firm to purchase assets over a period of time, again by making regular payments with the assets acting as security in the event of default. Here the assets are owned by the company.

The main practical difference between the two methods is their tax treatment. Interest rates on lease and hire purchase schemes may be higher than on loans, but for a firm with little security to offer, they might be the only way to secure the use of assets.

Once a business starts trading other sources of finance become available. Most suppliers of goods and services offer trade credit terms (e.g. payment in 30 days), although they might undertake a credit check and insist on taking credit references. They will also place credit limits on accounts. Start-ups may have to establish a payment history to be offered credit and only gradually will the credit limit be extended. Trade credit is an important source of finance for most established firms – and it is free. Factoring and invoice discounting also becomes available once a firm has an established trading history. These are ways of obtaining finance against the invoices issued (typically 75–80 per cent of the value). The firm pays interest on the cash advanced, until the invoice is paid. This form of finance can be expensive and there are many restrictions but it can be a lifeline to undercapitalised, growing businesses. Most banks have factoring and invoice discounting subsidiaries and often recommend this form of finance to entrepreneurs who cannot offer collateral.

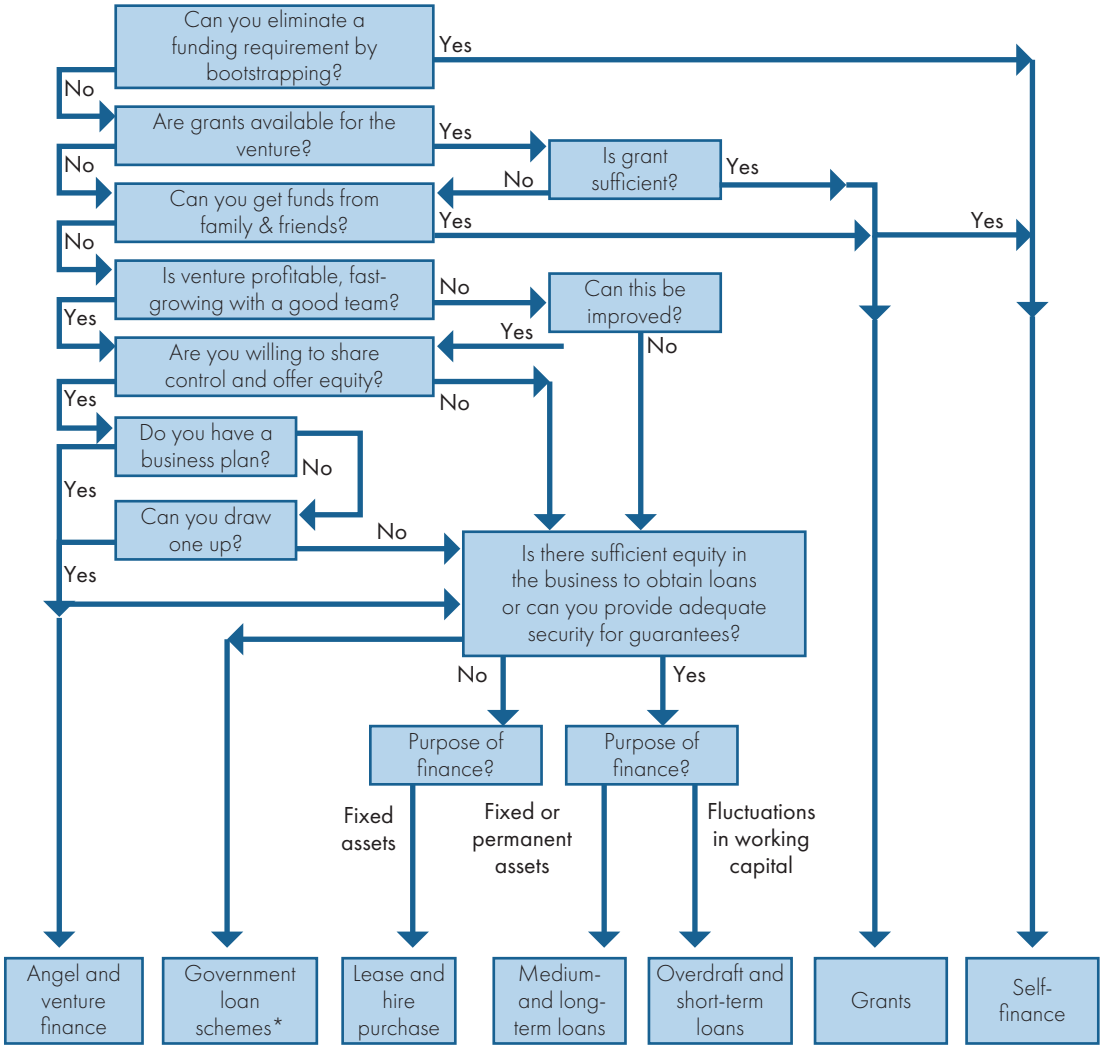
> *You have to hang on to that initial money like it is gold ... Nobody will give you money until you can prove your idea is a winner ... There's lots of money out there but only for proven concepts.*
>
> Martin Dawes, founder of Coffee Nation, *The Sunday Times*, 23 May 2004

> *To succeed in business you should never chase money. If you achieve success money will chase you. If you get too attached to the money you never reinvest. You have to treat the money in the business like it's not yours.*
>
> John Elliott, founder of Ebac, *The Sunday Times*, 10 March 2013

Supply chain finance is a new form of financing that is slightly different to factoring and invoice discounting and is available when an SME is supplying goods to a larger firm with a better credit rating (e.g. the automotive industry). It uses technology to link the supplier and buyer with a financial institution so that when an invoice from the supplier is approved for payment, say in 30 days, the supplier can request immediate payment from the financial institution, which is paid minus a discount. Because the buyer's credit rating is better than the SME supplying it, the discount is usually less than the interest rate facing the SME.

Governments are often keen to help SMEs that may be unable to raise finance for profitable projects, and are particularly keen to support innovation. Most countries therefore offer grants, low-interest 'soft' loans and/or have schemes to provide collateral support for start-ups and SMEs. These schemes vary enormously between countries and even regions, changing frequently to reflect national and regional priorities. Grants from any source are 'free money', although they all can involve bureaucracy and take time to come through.

Most new ventures struggle to find finance appropriate for their needs. It is rarely easy. The flowchart in Figure 19.1 is a guide to deciding what form of finance is most appropriate for a particular use. In practice, most firms use multiple sources of finance for different purposes. Of course, the difficult part is actually persuading somebody to offer loan or equity finance.



*These vary from country to country

Figure 19.1 Selecting the appropriate sort of finance for a new venture

SOURCES OF FINANCE FOR SOCIAL ENTERPRISES

Social enterprises have exclusive access to a number of sources of finance. What is more, depending on their legal status, many should also be able to apply for some of the sources of finance listed previously. Indeed, many use bank loans or lease assets on a day-to-day basis. However, being set up primarily to achieve social aims, they can struggle to meet commercial lending criteria or to attract equity investors.

The UK government established Big Society Capital as a wholesale supplier of capital for social investment. It invests in intermediaries who then invest directly in social enterprises. 'Front line' social investors include the Social Investment Business which manages over £400 million of funds. It provides loans, grants and other financial products to charities, social enterprises and community organisations. One of these is the Social Enterprise Investment Fund, which was set up in 2007 by the Department of Health to help social enterprises provide health and social care services in England. Many of the financing deals offered by government departments are structured as 'social impact bonds', whereby the department repays the capital loaned with a return of 7–10 per cent if agreed social targets are met.

UnLtd provides advice, training and support as well as funding for social enterprises. Established in 2000 through a partnership with several leading UK non-profit organisations, it provides grants to individuals with projects to improve their communities and access to a range of funding for social enterprises for start-ups and growth enterprises, from small amounts up to £500,000. There are also ethical banks. Charity Bank lends only to registered charities, social enterprises and

community organisations. Triodos Bank finances organisations ranging from organic food and farming to recycling and nature conservation. Both banks offer savings accounts to the general public. Commercial organisations also invest in social enterprises, using funds invested by the general public for that specific purpose. For example, Threadneedle Investment, in partnership with *The Big Issue's* investment arm (Case insight 1.7), has a fund that invests in businesses that deliver both a financial return and a 'positive social outcome'. They invest in the bonds of organisations operating in sectors such as affordable housing, community services and health and social care.

Indeed, there are a growing number of schemes that enable people to give financial (and other) backing to community-owned and run projects – anything from cafés to post offices and solar cooperatives to hydroelectric schemes. Investors usually have local links and are sympathetic to the cause. They invest by buying shares or loan-stock in the organisation, often using crowdfunding websites. There is usually a minimum investment and there can be enormous variations in the promised return. For example, the Halton Lune hydroelectric scheme is the biggest community-owned hydroelectric project in England and built a 200KW scheme on the River Lune at Halton (Lancashire).

Explore further 19.1

Sources of finance

Government loans, grants and other support schemes vary from country to country, sector to sector. They also change regularly. It is therefore not possible to provide a comprehensive universal guide. Details can usually be obtained from appropriate government websites. Access the *Digital Links* booklet to check out useful websites, including the following:

- The British Business Bank which provides an online Business Finance Guide and funds the Start Up Loans Company.
- The UK government website which provides a list of sources of finance currently available.
- The UK Social Investment Business website provides details of funding available to social enterprises.
- Helpful details of loans, grants and other support schemes that are available in the USA.

SME FUNDING

The beauty of being shareholder-owned and run with no outside capital is that we can make quick decisions.

Adam Schwab, founder of Lux Group, *Management Today*, July 2014

The reality of SME funding is simple – the vast majority of start-ups and SMEs do not rely on external finance at all. Around 95 per cent of business founders globally use their own funds to start their business and this makes up 72 per cent of their funding (GEM, 2016). Established SMEs also use retained earnings. There is a long-established 'pecking order' of funding preferred by entrepreneurs (Myers and Majluf, 1984) starting with their own funds, turning next to family/friends and only then to external finance. For external finance they prefer debt to equity. This could be partly to do with the entrepreneurs' characteristic 'need for autonomy and control' (Chapter 3) but it may also be due to other problems covered later in this chapter.

SME funding in Europe tends to conform to a similar 'pecking order', with finance from the entrepreneur's personal savings used extensively ahead of external finance. Only about 38 per cent of established SMEs in Europe use external finance and some 46 per cent class themselves as permanent non-borrowers (Andrieu et al., 2018). For external finance the top three were trade credit (35 per cent), which is free, credit cards (18 per cent) and bank overdraft (17 per cent).

However, the figures change as SMEs grow with new sources of funds opening up as they develop a credit history (Table 19.2).

Table 19.2 Use of external funds by SMEs in Europe

	ALL SMES	SELF-EMPLOYED	1–9 EMPLOYEES	10–49 EMPLOYEES	50–249 EMPLOYEES
Permanent non-borrowers	46%	51%	36%	27%	20%
Currently using external finance	38%	33%	50%	64%	74%
Trade credit	35%	30%	48%	66%	66%
Credit cards	18%	16%	21%	32%	44%
Bank overdraft	17%	15%	21%	23%	27%
Lease/hire purchase	8%	6%	11%	21%	25%
Loans & equity from directors, family & friends	7%	6%	9%	9%	8%
Bank loan	5%	4%	7%	11%	17%
Factoring/invoice discounting	4%	3%	4%	11%	15%
Grants	3%	2%	3%	5%	7%

Source: Andrieu et al. (2018).

An earlier study of 160 UK *start-ups* (under two years old) by Fraser (2009a) confirmed some of these characteristics. He found that they used multiple sources but mainly personal savings (91 per cent), also loans or gifts from family/friends (13 per cent), home mortgages (4 per cent) and personal credit cards (4 per cent). Only 13 per cent used external finance, mainly from banks. The same study looked at a random sample of 2,500 *established* UK SMEs and here *all* the firms used some sort of external finance. Citing supporting evidence from the Bank of England, Wright and Fraser (2014) also concluded that bank finance was an important element of external finance for established SMEs in the UK. Only 1.7 per cent of the UK SMEs used business angels and fewer than 1 per cent using venture capitalists (Fraser, 2009a).

A later survey of existing UK SMEs found the following 'pecking order', again with firms using multiple sources (Ipsos MORI, 2018): credit cards (44 per cent); bank overdrafts (39 per cent); loans from directors and family/friends (36 per cent); asset finance e.g. lease/hire purchase (28 per cent); term loans (23 per cent); grants and other government finance (17 per cent); equity – mainly from owner or family/friends (3 per cent); factoring, invoice discounting and stock/inventory finance (4 per cent). The survey did not include trade credit, which Fraser found was used by 37 per cent and a later survey found was used by 35 per cent of SMEs (BDRC Continental, 2017). These UK studies confirm four points:

1. Internal finance, particularly the entrepreneur's personal savings, is the most important source of finance for start-ups and SMEs.
2. Once established, external finance (particularly trade credit) can be accessed and this broadens as firms gain a credit history.
3. Entrepreneurs continue to use credit card finance, recycling balances month to month.
4. Equity finance, particularly from external sources, is not used a great deal.

SME FUNDING IN DEVELOPING COUNTRIES

Many of these sources of external finance are not available to SMEs in developing countries. Prospective entrepreneurs have meagre savings and the banking systems are just not well enough developed. It has been estimated that some 1.7 billion adults worldwide do not have access to a bank transaction account – most in the developing countries. Most businesses in developing countries are micro-businesses

generating subsistence income only and do not have retained earnings to reinvest. Many are also in the 'informal' or 'black' economy. However, all SMEs play a major role, creating about 70 per cent of new jobs. And it has been estimated that 3.3 million new jobs will be needed every month in these emerging markets by 2030 to absorb their growing workforce (IFC, 2017).

About half of formal SMEs do not have access to formal credit. The financing gap is even larger when informal enterprises are taken into account. The International Finance Corporation[1] (IFC, 2017) estimates that 65 million firms, or 40 per cent of micro, small and medium enterprises (MSMEs) in developing countries, have an unmet financing need of $5.2 trillion every year. This is equivalent to 1.4 times the current level of the *global* MSME lending. East Asia and the Pacific accounts for 46 per cent of the total global finance gap; Latin America and the Caribbean 23 per cent; and Europe and Central Asia 15 per cent. That gap represents 87 per cent of potential demand in Latin America and the Caribbean and 88 per cent in the Middle East and North Africa.

Microfinance services are designed for individuals and SMEs who do not have access to conventional banking. It includes microcredit – the provision of small loans such as savings and checking accounts, micro-insurance, payment systems etc. to poorer, socially marginalised clients, often in developing countries. Most needs are met through a mix of saving and credit, but credit unions and mutual guarantee schemes play an increasingly important part. Although microfinancing products are more accessible, unless subsidised by other agencies, they can be expensive. The average rate of interest is about 37 per cent, but can be as high as 70 per cent. The main reason for this is the high transaction costs due to the growth of informal disintermediation. These are intermediaries who split loans into ever-smaller tranches for end-borrowers, charging high rates of interest.

Case insight 19.1 Grameen Bank

Solidarity lending

Professor Muhammad Yunus established Grameen Bank (meaning 'bank of the villages' in the Bangla language) as a social enterprise in Bangladesh in 1976. In 1983 it became an independent bank providing tiny loans, called microcredit, without collateral to the poor. The aim is to leverage people's skills to help them to start and grow tiny businesses. It uses a local, group-based approach – called 'solidarity lending' – to ensure that borrowers repay their loans and develop a good credit history. Each borrower belongs to a five-member group. The group is not required to give guarantees for loans to its members, and repayment is solely the responsibility of the individual borrower. There is no legal instrument and no formal joint liability exists, the system works based on trust. However, the group and the centre ensure that everyone behaves responsibly and individuals do not get into arrears with their repayments. In practice group members often contribute any defaulted amount with the intention of collecting the money from the defaulted member at a later time. Such behaviour is encouraged because Grameen does not extend further credit to a group in which a member defaults. Grameen Bank has reported high repayment success rates of over 98%, although the size of its overdue loans has been questioned. Some 96% of its borrowers are women.

To supplement lending, Grameen requires borrowing members to save very small amounts regularly in a number of funds, designated for various purposes. It also accepts deposits. These savings help serve as an insurance against contingencies. In addition, it provides other services, and runs several development-orientated businesses including fabric, telephone and energy companies. It seeks to establish a new sort of self-sustaining rural association that reduces dependence on external finance, increases development impact and spreads risk. Funding has come from different sources. Initially donor agencies provided the bulk of capital at low interest rates but, by the 1990s, the bank was getting most of its funding from the central bank of Bangladesh. The success of Grameen Bank has inspired similar projects in more than 40 countries around the world.

Access the *Digital Links* booklet and watch a video about Muhammad Yunus and Grameen Bank.

Question:

1. How many stakeholders like the central bank of Bangladesh, each with different objectives, have to be brought together for this bank to operate effectively?

1 Part of the World Bank

Credit unions are members-owned cooperatives where borrowers come together to act as intermediaries between the microfinancier and the end-borrowers, co-guaranteeing loans and enabling more competitive rates to be offered. In 2018 there were 85,400 credit unions in 118 countries (WOCCU, 2019). The Grameen Bank was one of the first providers of microfinance and it developed a variation on credit unions called 'solidarity lending', a system now used in more than 43 countries, where no formal joint liability exists (see Case insight 19.1). A survey by Grameen Bank with two other large microfinance institutions in Bangladesh found that for every $1 these institutions lent to clients to finance rural non-farm micro-enterprise, about $2.50 came from other sources, mostly their clients' savings (Khandker, 1999).

An added problem is the low levels of literacy in some countries since most providers of finance rely on legal contracts to give them security over their loan or investment. Some countries, where formal legal mechanisms tend to be less important than relationships, are therefore at a disadvantage when it comes to the more formal provision of finance (Allen et al., 2005). Weak property rights in some countries add to the financing problem, since providing collateral may not be easy. SMEs in these countries make greater use of informal sources of finance which can bear high rates of interest.



Bonus Case Solar Power Company Group (SPCG)



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BANK LOANS AND OVERDRAFTS

Banks are the main source of loan finance to SMEs in the developed world. And so long as the return a business makes on its total assets exceeds the current rate of interest then the firm benefits by getting an extra return on the money borrowed from the bank (see Chapter 15). However, banks can be reluctant to lend to SMEs, and new ventures in particular, because they view them as risky propositions and it is worth understanding why. Banks lend a sum of money in return for agreed interest payments and the repayment of the sum borrowed. They do not share in the profits of the business and, if a firm fails, they stand to lose their capital. That bad debt is expensive to recoup. For example, if banks make a 4 per cent margin on a loan (the difference between the rate they can borrow at and the rate they lend at), then every £100 lost as a bad debt will need a further £2,500 to be lent for the sum to be recovered (£2,500 x 4% = £100). Put another way, the bank has to make a further 25 loans to cover this one bad debt. Not surprisingly, therefore, banks are risk-averse and will do all they can to avoid a bad debt. Since they are all too aware of the failure statistics for business start-ups, entrepreneurs have an uphill task convincing them of the viability of their project and obtaining a loan or even an overdraft facility.

Entrepreneurs seem naturally drawn to overdraft finance – surveys repeatedly show it to be the major source of external finance for SMEs in developed countries. After all it is flexible; once agreed with the bank the firm can dip into it when needed and will only pay interest when it is used. It requires minimal forward planning. However, it is repayable immediately should the bank demand it, and it can be expensive if the firm is in permanent overdraft as the rate of interest charged is usually higher than on term loans. Term loans (short, medium or long) are loans for a fixed period of time. They are usually not repayable on bank demand (but do check the terms). The capital repayments are fixed and known in advance. The interest rate can vary or be fixed and is usually lower than that for an overdraft.

Banks are in business to make as much money as possible with the least risk. They therefore expect higher rates of return from loans that they perceive to be higher risk. New ventures are therefore likely to face higher rates of interest than larger businesses with an established track record. However, bank managers are employees, they work in a highly regulated environment, and they have very limited discretion. Lending decisions are heavily influenced by bank lending policies and procedures and some banks use computer-based credit-scoring systems based on historical information (e.g. credit history)

> *It's far easier for a company to raise a lot of money via debt than through equity, which is at a tax disadvantage.*
>
> Xavier Rolet, former Chief Executive of London Stock Exchange, *The Sunday Times*, 1 December 2019

or financial projections to produce lending 'recommendations' for managers – 'recommendations' that are difficult to overturn. Bank lending is becoming increasingly systematised and managers' discretion constrained. Lending decisions can therefore reflect general economic conditions and the balance of the bank's lending portfolio as much as the lending proposition itself. One bank can turn down an applicant that another will accept.

Increasingly banks seem to demand an offer of personal or business collateral from the entrepreneur. Collateral is the bank's security in case the firm defaults on its loan. It usually takes the form of a guarantee on specified tangible assets which is included in the loan agreement. Collateral might come from business assets but if these are insufficient then the entrepreneur (or their family or friends) may be asked to provide personal guarantees or collateral (e.g. their house) for the loan. This can mean that the separation between the entrepreneur's personal finances and those of their limited liability company is little more than theoretical. In valuing business collateral the bank assumes that the assets will be sold on a secondhand market and this typically leads to far lower values being put on assets than the entrepreneur might expect. Table 19.3 gives a guide to what to expect. Given these asset security values, it is clear that the full cost of new fixed assets will never filter down to the collateral base of your business – an incentive to use lease or hire purchase.

Table 19.3 Typical UK asset security values

ASSET	TYPICAL % VALUE THAT CAN BE BORROWED IN UK	
Freehold land and buildings	70%	
Long leasehold	60%	
Specialist plant and machinery	5–10%	100% can be obtained through leasing
Non-specialist plant and machinery	30%	100% can be obtained through leasing
Debtors/receivables	30–50%	Depends on age of debts and 'quality'
Stock/inventory	25%	Depends on age of stock/inventory and 'quality'. In the event of business failure, raw materials will be worth more than work-in-progress or finished goods stocks.

For a bank manager, the starting point for agreeing to any loan is its *purpose*. Is it legal? Is it consistent with bank policy? Is it in the best interest of the business? Next, the bank needs to assess whether the *amount* is appropriate. Have all associated costs for the project been included? Has the borrower put in money themselves? Is there a contingency? The bank also wants to ensure that interest will be paid and the capital repaid on the due date. So are the *repayment* terms realistic? Is cash flow adequate? To make this judgement the bank will want to understand the fundamentals of the business – whether it is viable – and will usually ask for a business plan. They will scrutinise the financial forecasts paying particular attention to the cash flow forecast, margin of safety and gearing levels as well as ensuring the firm has adequate financial controls in place (see Chapter 15).

However, banks understand that most small firms are dominated by the owner-manager and usually seek to establish a good understanding of the person they lend to. They are interested in the entrepreneur's *personal character*. Honesty and integrity are difficult to judge, but most bankers still think lending is a very personal thing and making a judgement on character is vital (e.g. by looking at their credit history). Bankers will also make a judgement about the entrepreneur's *personal ability*. How likely are they to turn this business plan into a successful business? Do they have a good management team behind them? Banks often make these judgements based on the entrepreneur's education and training, relevant business experience and proven track record. Unfortunately, with all these personal judgements, one person's objectivity might just be another's prejudice.

Even after the loan is granted, banks will continue to monitor the financial performance of the business. They expect to see annual audited accounts and sometimes budgets for the next year. They will also monitor the bank account itself, looking out for irregularities and checking that throughput is in line with what would be expected from the firm's cash flow forecasts.

Despite increasing centralisation and the declining importance of local banking, an entrepreneur still needs to have a good working relationship with their local bank manager. Like any relationship,

this must be based on two elements: trust, that both parties will honour the terms of the loan, and respect, that both parties are good at what they do. It is a personal thing that is developed by keeping in regular contact. More than anything, bankers do not like surprises. Things that make them worry that all is not well within a firm include:

- Frequent excesses beyond the agreed overdraft facility make the banker start to think cash flow is not being properly controlled.
- An overdraft facility that is never in credit makes the banker believe that a term loan would be more appropriate.
- Lack of regular provision of financial information makes the banker suspicious that all is not well or there is poor financial control.
- If the owner-manager is never available for meetings or even telephone conversations, the banker will start to believe something is wrong.
- If the firm is repeatedly failing to meet forecasts the banker will eventually start to question the credibility of the firm's forecasts, particularly if there are declining sales, squeezed margins or losses.

AGENCY THEORY AND INFORMATION ASYMMETRY

Agency theory is relevant when there is an arm's-length relationship between a principal (such as a bank or an equity investor) and an agent (such as a small firm). It seeks to identify the mechanisms and costs that the principal has to put in place to ensure that the agent conforms to some legal agreement – such as a loan agreement (Jensen and Meckling, 1976). Information asymmetry is where these two parties do not have the same information on which to base their decisions, in particular where the small firm has more information than the financier.

Agency theory is often used to explain how providers of finance make decisions about new ventures. By definition, a new venture has no track record, and the provider of finance has little information on which to base their financing decision. What they have may not be reliable or relevant to this specific financing decision – for example they know, statistically, that most start-ups fail. This is when asymmetric information favours the entrepreneur who should have more or better information than the provider of finance. This means that the provider of finance must incur extra costs in obtaining and checking the information they need in order to make, and then monitor, their decision. Many of these costs are fixed, whatever the size of the deal or the return made by the small firm. The conclusion is that providers of finance are naturally reluctant to lend or invest in start-ups or smaller ventures. This can result in what is called 'adverse selection' – making bad lending or investing decisions. This is less of a problem with larger firms because they have a track record and there is so much more public information about them, with many independent analysts reviewing this information for investment purposes. Agency theory suggests that the natural response of a bank to these problems is to:

- Charge higher rates of interest (which may prove unaffordable);
- Impose conditions in the loan agreement (e.g. on use of business funds or the provision of information);
- Demand collateral from the firm or the entrepreneur.

Where sufficient collateral can be made available, the bank may feel that less information is required because the debt is more likely to be recovered in the event of default. Indeed, the bank may also feel that the provision of collateral gives the entrepreneur a strong incentive to see the business succeed. Agency theory also explains why the bank will want to be kept up to date on the progress of the business. These issues are called 'moral hazard' – where the financier cannot be certain what the entrepreneur will actually use the funds for.

Nevertheless, there is little evidence of supply-side problems with the availability of bank finance in most developed Western economies. For example, in the UK a survey showed that 82 per cent of SMEs applying for an overdraft facility were successful and 68 per cent of term loan applicants were successful, although in both cases not necessarily for the full amount requested (BDRC Continental,

2017). It also confirmed that applications for overdraft or loan renewals were more likely to be successful (96 per cent) than applications for new money (63 per cent), or applications from first-time borrowers (60 per cent). Notwithstanding this, the UK government set up the British Business Bank in 2011 tasked with leading an increased awareness of available funding options for start-ups. It has emphasised making equity funds available outside London and the southeast. There may be more of a problem with the availability of finance in developing countries where the World Bank report said that a credit reporting system was 'crucial' for determining repayment capacity and repayment willingness, benefiting both lender and SME (World Bank, 2020).

The response of an equity investor to these issues is also to look for higher rates of return. However, they will also expect the entrepreneur to maintain a controlling interest in the business so that, in the event of failure, they have more to lose than the other investors. This might impose a funding limit. The investor is also likely to want a greater involvement in the business so they can monitor their investment. Because of the fixed costs involved, many larger providers of equity finance will not get involved in small-scale start-ups because the return they can obtain does not cover their costs.

IS THERE DISCRIMINATION IN LENDING?

An issue that often raises emotions is whether bankers discriminate against certain sections of society in their lending decisions. Adequate funding is a prerequisite for business survival, let alone success, and research shows that there is a strong relationship between start-up funding strategies and business performance (Brush, 2006; Jennings and Cash, 2006; Watson et al., 2006). So is there any evidence of prejudice and discrimination causing financing gaps for groups within society?

Gender discrimination

It is true that female-owned businesses tend to attract less outside funding than male-owned businesses. In the UK women feel access to finance is the major barrier to entrepreneurship: 81 per cent feel they are less likely than men to be able to access the necessary start-up funds – a higher proportion than in the USA, Canada, Sweden or the Netherlands (Rose, 2019). This despite the fact that studies have repeatedly found that female-led start-ups need less funding (typically about a third and in the UK 53 per cent) compared to male-led start-ups (Carter and Rosa, 1998; Coleman, 2000; Coleman and Robb, 2009; Hisrich and Brush, 1984; Rose, 2019). Female entrepreneurs prefer to use their own savings or to borrow money from their families, relatives or friends at start-up (Brush, 2006; Ufuk and Ozgen, 2001). They borrow less and rarely gain access to venture funding (Greene et al., 2000; Marlow and Patton, 2003; Marlow et al., 2013). There does, therefore, appear to be a case to be answered.

> *Initially when I was first starting the business and approaching the big five banks for a corporate bank account, it was quite challenging. Their response to me becoming a consultant for improving financial services was to pat me on the head like a dog, saying 'there, there, little girl'.*
>
> Elizabeth Gooch, founder of eg solutions, *Venture online*, 12 April 2007, www.venturemagazine.co.uk

However, it is worth remembering what was pointed out in Chapter 1: that research shows that female-owned businesses are likely to perform less well than male-owned businesses albeit for some very good reasons. With this in mind, while research in the UK and USA has found differences in bank loan rejection rates by gender (in the UK: Fraser, 2006; in the USA: Treichel and Scott, 2006), it has failed to unearth evidence of a supply-side finance gap for women (in the UK: Fraser, 2006; Marlow et al., 2013; in the USA: Blanchflower et al., 2003; Levenson and Willard, 2000; Treichel and Scott, 2006; in Canada: Orser et al., 2006). What is more, once business characteristics (e.g. size, age, sector, risk rating) are taken into account, female-led businesses do not appear to pay higher rates of interest than male-led businesses (Marlow et al., 2013). Repeated studies have failed to find evidence of any form of discrimination by financial institutions. This suggests that other demand-side factors related to the personal and social circumstances of women are at play. Although not conclusive, other researchers broadly concur.

So the real question appears to be, why do female entrepreneurs seem to avoid external funding? Studies indicate the reasons are many and varied, including:

- Perceived obstacles or bias (Henry et al., 2006; Leitch et al., 2006; Neergaard et al., 2006; Rose, 2019; Watson et al., 2006);
- Lack of social capital, skills and a growth orientation (Greene et al., 2000);

- Risk aversion (Leitch et al., 2006);
- Aversion to potential loss of control (Watson et al., 2006).

It would seem that female entrepreneurs choose not to make full use of the external funding that is available but there is no firm evidence of systematic discrimination on grounds of gender in the Western countries cited. The Rose Report (2019) made a number of minor recommendations about how the flow of business finance to women might be improved but observed that 'many barriers [to funding] are cultural and societal, and will take many years to overcome'.



Souce: Getty Images/DaniloAndjus

Ethnic discrimination

In the UK, there appears to be no difference between ethnic and white businesses in their dependence on bank finance, although this is significantly less for black African and black Caribbean business (Bank of England, 1999). In the UK specialist banks have grown up to cater for the needs of different ethnic groups; for example, specialist Islamic banks which allow Muslim businesses to bank according to their principles and faith. There is also evidence of a strong preference for informal sources of finance among ethnic groups particularly among South Asian-owned businesses (Ram et. al., 2002). These informal sources are usually accessed from a wide network of family, friends and others within the ethnic community, thus combining social with financial capital. Many of these sources are not available to white entrepreneurs.

Although, as with female entrepreneurs, there is a strong feeling of prejudice from traditional banks, the Bank of England (1999) could find no evidence of this in the UK, citing sectoral concentration, failure rates and lack of business planning for rejection rates. A large-scale study of ethnic minority businesses and their access to finance broadly supported this (Ram et al., 2002), noting, however, that the issue was 'complex'. It did find evidence of diversity of experience from banker to banker and between different ethnic minority groups, confirming the existence of particular problems for African and Caribbean businesses. Not surprisingly, it found that best practice was where the banker had built up trust within their local minority community through close contact and stable relationships. More recently, Fraser (2009b) used econometric analysis on a large-scale survey of UK small business finance to look for evidence of ethnic discrimination (loan denials, interest rates and discouragement). He noted firstly that there were large differences across ethnic groups – black and Bangladeshi businesses experiencing poor outcomes compared to white and Indian businesses. For example, black African firms were significantly more likely to miss loan repayments or exceed their agreed overdraft limit. He also noted that many ethnic minorities felt they were discriminated against. However, he concluded very firmly that there was no evidence of discrimination. He felt that many in these groups needed to tackle fundamentals such as a lack of financial skills and advice, and poor levels of financial performance rather than just addressing cultural differences and the effects they might have. The broad conclusion is that there is little evidence of systematic discrimination on grounds of ethnicity in the UK.

In the USA, a review of the evidence at the beginning of the decade led Blanchflower et al. (2003) to conclude that there was evidence of discrimination. Cavalluzzo and Wolken (2005) found striking differences between ethnic groups in terms of denial of credit. They found American blacks and Hispanics had lower capital levels and were less likely to get appropriate funding than whites, even after controlling for differences in personal and business characteristics. However, more recently, based upon a large-scale survey using detailed, confidential information, Fairlie et al. (2016) concluded that, while black start-ups report a higher level of loan denials and obtained less financial capital from all sources than white start-ups (which then influences the level of funding in subsequent years), racial differences could not be attributed to simple explanations. They noted large differences between the two groups in the credit worthiness of the founder and these persistent differences in the financial health of the founder affected the ability of the start-up to raise funding. They linked this to the burgeoning

literature on household finance and financial literacy and to findings by Lusardi and Mitchell (2009). They also noted the enduring belief among creditworthy black borrowers that they would be turned down for finance, concluding that: 'Getting to the root cause of racial differences in the way that new businesses are financed likely requires changes in perceptions and financial planning behaviours as much as it requires augmenting the supply of credit to traditionally underserved borrowers.'

ANGEL AND VENTURE FINANCE

For a company with real growth potential, there may be the opportunity to get individual investors, called 'business angels', or a venture capital institution to invest equity in the business. Equity investment involves giving up a percentage of the ownership of a limited liability company, and potentially some of the control, in exchange for cash, thereby giving up some of the future wealth the business will create. It is not available to sole traders or partnerships. Investors are paid dividends, but at the discretion of the company. While the capital invested can be sold on in the form of shares, it is unlikely to be repaid by the business unless it ceases to trade and only then if other creditors are paid in full. It is therefore long-term risk finance.

> *Only a tiny number of businesses raise institutional venture capital. The rest fund their start-ups using personal savings, supplier credit, bank debt, money from family and friends or angel investors, invoice discounting and retained earnings.*
>
> Luke Johnson, Chairman of Risk Capital Partners, *The Sunday Times*, 21 July 2019

Both angel and venture financiers might expect dividends but, more importantly, they hope to see the value of their shares increase if the firm does well. They hold a portfolio of investments, probably with a wide range of returns. They will probably expect to realise their investment at some time in the future (normally 5–10 years) by selling-on their shares. Often an angel investment helps take the business to a point where it is attractive for a venture capital firm to make a larger investment.

Business angels back start-up and early-stage ventures. They invest smaller amounts of money than venture capital institutions (£10,000–£1 million) and operate in less formal ways. The average investment in Europe is €170,000 (Sohl, 2017). They are usually 'high net worth individuals', often with a successful entrepreneurial background themselves. The typical UK angel makes only one or two investments a year and sometimes works as part of a syndicate. Many have preferences about sectors or stages of investment based on their personal knowledge. Many also expect to exercise some degree of directorial control over the business. Most prefer local investments and prefer to stay anonymous. They can usually be contacted through local small business support agencies. Angel networks have been established and can be found from Cambridge in England to Mumbai in India. These networks circulate business plans among members ahead of a physical pitch or presentation. If any angels are interested in investing, then a period of investigation (called 'due diligence') and negotiation will take place before funds are committed. Often a fee is charged to the business seeking the investment and some networks take a stake in the company if a deal is successfully negotiated. Less than 5 per cent of start-ups that apply for angel finance receive funding (Mason et al., 2017). Some of the networks can also provide help in raising finance from other sources and in preparing a business plan.

Venture capital is a form of private equity financing. Whereas private equity firms are generally organised as limited partnerships and buy and restructure companies that are not publicly traded, venture capital firms provide funding for large start-ups, early-stage and other high-growth businesses. Venture capital institutions usually invest larger amounts than business angels (typically over £2 million) but, whereas business angels invest their own money, venture capital institutions invest other people's usually in the form of funds that typically last for ten years. These funds are often focused on a particular sector. Venture capitalists mainly invest in established businesses (often buying out angel investments) and management buy-outs and buy-ins (see Chapter 20), but they can invest in larger start-ups. Because they rely on financial contracts and the ability to mitigate agency problems through contracting, the most successful venture capital investments tend to be seen in countries with strong legal systems (Cumming and Johan, 2013), placing developing countries at a disadvantage. Neither business angels nor venture capitalists want to take control of the business away from the entrepreneur, and therefore usually limit their investment to less than 50 per cent of the share capital. However, because venture capitalists invest larger amounts, they often put together funding deals that involve ordinary shares, preference shares[2] and loan finance. In the past, some of the management

2 Preference shares are non-voting, with dividends at a fixed percentage of face value but with preference over ordinary shareholders in the event of liquidation.

buy-out and buy-in deals they have structured have been notable for their high leverage or gearing. Venture capitalists can also arrange a series of funding rounds as the business grows, each round raising successively more finance.

Explore further 19.2

Angel and venture finance

Access the *Digital Links* booklet and take a look at:

- A brief video animation that explains how angel and venture finance works.
- The Angel Investment Network website, which provides information for investors and those looking for funds, including a funding template. The Angel Investment Network claims to be the biggest online angel network in the world.
- The UK Business Angel Association (UKBAA) website where you can find a code of conduct for members and a directory of members. In the UK, many business angels are part of the UKBAA.
- The British Private Equity and Venture Capital Association (BVCA) website which has a free Directory of Members as well as a full list of venture capital institutions and their investment criteria.
- The Invest Europe website, formerly known as the European Private Equity and Venture Capital Association (EVCA), which represents the private equity community across Europe.

Case insight 19.2 Savelli (2)

Venture funding

Savelli was an idea for a fashionable luxury smartphone for women that was more akin to jewellery. The idea never gained traction in the market but it still succeeded in raising over €10 million in venture funding (see Case insight 5.2). The way the final round of funding was structured in 2015 – when the company was clearly in trouble – is interesting:

- The founders contributed initial funding of €150,000 in 2009–10 to develop the concept.
- Series A funding raised some €2.66 million in 2011, mainly from Innogest SGR (an Italian fund). This was used for design, branding and developing a functioning prototype. Other private investors contributed funds at this point.
- Series B funding of some €3 million was raised in 2013, mainly from Rho Ventures (a US fund). This was for production, distribution and marketing. The phone went on sale in this year.
- Series C funding of €3.8 million was raised in 2014 from Lucius Capital (an Italian fund) and a private South African investor. At this stage the company had sold about 100 phones, 30% below projections.
- By 2015 the company had still only sold 200 phones and the three investors that had led the previous rounds were unwilling to offer further financial support. Instead Savelli opted for a 'down-round' – when investors buy the shares at a lower company valuation than in the previous round. This diluted the shares of existing shareholders by 99%. They also opted for a type of down-round called 'pay-to-play' – where investors who decide not to invest in this round are 'punished' by losing certain rights. The goal of this funding round was 'to keep the boat afloat' for another six months so that another funder could be found. In the end 90% of existing investors participated and €650,000 was raised. However, despite some interest from Chinese groups, no new investors were found and the company was 'frozen' with the founders seeking a buyer.

Question:

1. What do you learn about the use of venture capital from this case?

Source: Giachetti (2018).

CROWDFUNDING

The banking crisis of 2008 saw bank lending contract as banks recapitalised and consolidated their balance sheets. The first victims of this were those 'riskier' loans to start-ups and SMEs. However, the growth of the internet has encouraged a form of funding called 'crowdfunding' – the practice of funding a project or venture by raising funds from a large number of people (the crowd). Crowdfunding has a long history but the internet allowed lenders and investors to be linked directly to individuals and businesses looking for funds over a large geographic area, using internet platforms run by moderating organisations. Internet-based crowdfunding platforms are part of the larger fintech industry that is transforming financial transactions (Case insight 5.4). Crowdfunding sites can offer debt or equity investments and finance. They can also offer non-monetary rewards. The largest crowdfunding platforms in Europe are (ranked in order of size):

1. Crowdcube (UK)	6. MyMicroinvest (Belgium)
2. Funding Circle (UK)	7. Symbid (Netherlands)
3. OurCrowd (Israel)	8. KissKissBankBank (France)
4. Ulule (France)	9. Goteo (Spain)
5. FundedByMe (Sweden)	10. Seedrs (UK)

These platforms usually charge a fee, normally a percentage of the funding raised. Registered lenders and investors can browse through funding opportunities posted by businesses and decide whether they wish to lend or invest. Different platforms have different policies with regard to assessing lending/investment opportunities and checking providers of finance. Sometimes the borrower/investee only receives the funds raised if a specified target funding level is reached within a given time frame. Being web-based, videos are used extensively to demonstrate product/services and entrepreneurs often 'pitch' a proposal themselves. However, in most cases a business plan is also required.

Peer-to-peer (P2P) lending platforms (e.g. Zopa, Lending Club)

These can be used by individuals and businesses seeking loans, usually for larger amounts and often unsecured. Applications are often assessed online using a computer algorithm to determine their credit risk and the interest rate. Lenders may choose which borrowers and how much to invest. These platforms offer advantages to both lenders and borrowers. Lenders generally earn far more than they would from a savings account – an average of over 9 per cent – however, credit risks are usually high. Borrowers who may not necessarily be approved for a bank loan might find it easier to borrow, albeit at a higher interest rate. The platform normally has registered lenders and charges the borrower a percentage of the funds raised. Borrowers and lenders will be parties to a legal loan agreement which, among other things, will specify interest rates and capital repayment. These are organised by an intermediary. This can either be a partner bank (the notary loan model) or the platform itself (the client segregation model). P2P platforms have generally been funded by institutional investors, although in 2013, Google invested $125 million in Lending Club. Zopa was the first P2P lender in the UK and generated more than £1.8 billion of loans between its launch in 2005 and 2015. In 2017 it obtained a banking licence to enable it to offer deposit accounts and overdrafts. Launched in 2010, Funding Circle was the first crowdfunding platform in the UK to offer P2P *business* lending and is now the third-largest lender to SMEs, after the more traditional banks like RBS and Lloyds. It offers loans of up to £1 million in the UK. Whole loans or portions of loans can be purchased by individuals or institutional investors. Funding Circle also has its own fund to purchase loans.

Rewards platforms (e.g. Kickstarter, Crowdfunder)

These allow projects to be funded in return for 'rewards' or 'gifts' such as 'free' products (rather than equity). The return to the individual is limited to the reward offered. Typically therefore, the more

specific and the later the stage of the project, the more popular this type of funding is likely to be. 'Niche' projects tend to be the most successful, often arts-based (such as a new music album). Outcomes tend to be skewed, with a relatively small number of projects obtaining most of the funding and many projects being unsuccessful. There are two models. In the first the 'borrower' only receives the funding if their target fundraising goal is achieved. In the second, they keep the funding, no matter what. This usually only applies for smaller projects or ones that can be scaled down. The reward platform earns its income by charging a fee on the total amount of funds raised.

Case insight 19.3 Kickstarter

Niche crowdfunding rewards platform

Crowdfunding rewards sites are proving particularly attractive to SMEs in general but in particular to specialist, niche businesses that might have difficulties raising mainstream finance. Kickstarter was launched in 2009 by Perry Chen, Yancey Strickler and Charles Adler. It is an online crowdfunding site that focuses on creative projects – films, music, stage shows, comics, journalism, video games, technology and food-related projects. Originally based in New York, USA, it started accepting projects based in the UK in 2012, Canada in 2013, Australia and New Zealand in 2013 and Denmark, Ireland, Norway and Sweden in 2014. It is open to backers from around the world.

Projects posted on Kickstarter must have a set deadline to achieve a minimum funding target. If the goal is not met by the deadline, any funds offered are not collected. Funds pledged by donors are collected through Stripe. Kickstarter charges a 5% fee on the total amount of funds raised and Stripe charges an additional 3–5% fee. Since its launch in 2009 Kickstarter claims to have received more than $5 billion in pledges from 18 million people to fund almost 200,000 creative projects, several of which have gone on to receive critical acclaim – although not all have been commercially successful. These include documentary films, contemporary art projects and music albums. Kickstarter is a public benefit corporation.

Access the *Digital Links* booklet to visit the company website and watch a video that features the ten most successful Kickstarter projects, showing how not all were successful. There is also a video which shows you how to set up a Kickstarter project.

Question:

1. Since it mainly offers higher risk creative projects for people to invest in, why has Kickstarter been so successful?

Equity crowdfunding platforms (e.g. Crowdcube SyndicateRoom)

These raise relatively small amounts compared to the P2P platforms and, because they have little regulation, are seen as the 'wild west' of crowdfunding with big issues about information asymmetry and investor risk. They offer funding in return for equity in the company. The first equity deal in the UK using crowdfunding was agreed in 2013, by Crowdcube. There are two models. Some platforms allow individuals to invest directly in shares, while others pool funds to be invested as a nominated agent. Typically each crowdfunding investor purchases only a small percentage of the company. Sometimes syndicates of investors invest using these platforms, thus pooling their risk. Crowdfunding platforms that offer equity funding opportunities charge the business a percentage of the funds raised (typically 5–7.5 per cent). Some platforms also accept a slice of the equity rather than a flat fee. Although still small, these sites have also seen a huge increase in activity since they were set up. Equity crowdfunding investors will expect a 'pitch' and to see a business plan. This is not a shortcut to raising equity finance, and a substantial proportion of offerings fail to achieve their target funding level. Nevertheless, some offerings seem to creating a momentum of their own, leading to questions about crowdfunding creating an 'auction mentality' that encourages bidding.

Equity investment is inherently riskier than lending, and crowdfunding investors probably have less expertise than business angels in making this sort of investment. What is more, the question of how and when their investment will be realised in the form of a capital gain often remains unanswered.

> *If you expect to post your pitch [on a crowdfunding website] and have people throw money at it, you're in for a disappointment. The more momentum there is the more others will join in; nobody wants to walk into an empty bar.*
>
> Jeff Lynn, founder of crowdfunding site Seedrs, *The Sunday Times*, 14 September 2014

All of this makes equity crowdfunding very risky, which is why each investor only contributes a small proportion of the total funds raised, and why the success of this source of finance – for both parties – is yet to be proved. So far, it has mainly been successful for 'quirkier' or niche businesses, sometimes with quasi-social objectives where investors are less interested in risk and return than supporting the objectives of the venture.

Case insight 19.4 Crowdcube

Equity crowdfunding platforms

The Crowdcube platform was set up in 2011 by Darren Westlake and Luke Lang. It offers investors the opportunity to invest directly or in pooled funds with a minimum investment of as little as £10 through equity, bond or reward-based investments. Entrepreneurs, with a UK-registered company, can showcase their business and its investment potential, by uploading a video pitch, images, and supporting documents such as a business plan. Only if the pitch reaches its target will the business receive its funding. Crowdcube charges a commission for successful funding campaigns and charges investors 1.5% of their investment, capped at £250, when the investment is collected. In 2018 Crowdcube received authorisation from the UK Financial Conduct Authority to offer investors the opportunity to become legal shareholders in UK businesses. As well as funding for itself through multiple investment rounds on its own site, Crowdcube is backed by Balderton Capital, Draper Esprit, Numis and Channel 4, who have collectively invested more than £19.5 million. Westlake has high ambitions for the business:

'We've dominated the democratisation of seed-stage equity investment since we launched in 2011 and we're determined to do the same for larger businesses. We want to put the Public back into IPO.' (Finextra.com, 30 July 2015)

Since 2012 Crowdcube claims to have raised some £48 million in equity funds. The largest sum raised was £20 million for Monzo in 2018. It celebrated its first company exit in 2015 when E-Car Club (similar to Co Cars), which raised £100,000 investment in 2013, was purchased by Europcar. It also claims to have raised some £8.6 million in bond (loan) finance, the most notable being £2.3 million for BrewDog in 2015.

Access the *Digital Links* booklet to visit the company website and to watch a video animation explaining how Crowdcube works. There is also the Crowdcube pitch by Petalon (Case insight 1.3).

Question:

1. What are the advantages and disadvantages of crowdfunding for investors and the businesses they invest in?

Explore further 19.3

Crowdfunding

The fintech industry is currently largely unregulated although industry bodies are beginning to be set up. Access the *Digital Links* booklet to check out the following resources:

- A BBC video on crowdfunding, featuring Crowdcube and its founder Luke Lang.
- Information on the UK Crowdfunding Association (UKCFA) website, which collectively has some 9 million investors.
- A guide to the top crowdfunding platforms in Europe.
- Statistics on crowdfunding in Europe.
- Information on current crowdfunding platforms and promotions on the Crowdfunding Center website.

Case insight 19.5 Co Cars and Ethex

Equity crowdfunding as a social enterprise

Co Cars is a not-for-profit cooperative social enterprise started in 2005. It is a car club that allows members to hire low-emission petrol, hybrid and electric vehicles in the south west of England. In Exeter it also operates Co Bikes which, when launched, was the UK's first on-street, city-wide electric bike network. All the cars and bikes are powered by renewable energy from Good Energy. Members join by filling in an online application after which they are issued with a smartcard that will unlock their vehicles. Vehicles can be selected and reserved between specified start and end times via a smartphone. The reservation PIN allows the member to drive the vehicle. It must be returned to its dedicated parking bay. There is a small annual membership fee and a charge per hour of vehicle usage. Membership fees include fuel, insurance, road tax, breakdown cover and maintenance.

In 2020 Co Cars looked to raise £600,000 (minimum £100,000) in a share offer intended to fund an increase in its car and bike fleet in Exeter and expand its membership from 1,600 to 5,000 people. The minimum investment was £250. Dividends will be paid at the discretion of the board but with a target annual rate of interest of 5%. The investment was offered through the ethical not-for-profit investment organisation Ethex, which has an investment website and is supported by a range of trusts and foundations. Ethex charges a £5,000 fixed fee, plus 2% of monies raised for community-run social enterprises such as community benefit societies, community interest societies or co-ops. It charges a £2,500 fixed fee, plus 3.5% for conventional start-ups or early-stage companies.



Source: Getty Images/Howard Kingsnorth

Access the *Digital Links* booklet to visit both the Co Cars and Ethex websites and to watch a video showing how the Co Cars scheme operates. There is also the video supporting the Co Cars Ethex crowdfunding pitch.

Questions:

1. What are the risks of investing in Co Cars?
2. What are the advantages and disadvantages of using Ethex to raise equity finance?
3. What other options might be available?

EQUITY INVESTMENT CRITERIA

While business angels and venture capital institutions may look at the same range of criteria as a banker, their perspective is very different because, unlike the banker, they are sharing in the risk of the business. If it fails, they stand to lose their investment. Consequently they are interested in both return and risk – in particular the return they will make on their investment and the operating risks facing the business rather than the security they can obtain from the entrepreneur. Since they will probably have a portfolio of investment, the return on one investment must compensate for the loss on another. They will also want to be assured that they can sell-on their investment at some time in the future and realise their profit – called the 'exit route' (UK) or 'liquidity event' (USA). Assessing these things, inevitably, will take longer than arranging a bank loan.

> *About 5 per cent of opportunities we see on the website get funded. There are a lot of ideas out there.*
>
> Mike Lebus, co-founder of Angel Investment Network (AIN), *The Sunday Times*, 4 August 2019

Return and risk

Most investors are interested more in the capital gain on the sale of their investment than the dividends they might receive. Typically they will be looking for an annual return of 30–60 per cent, depending on the perceived risk, with start-ups at the top end of that spectrum. This can also be measured in terms of a multiple of the original investment. So for example, an investment of £100,000 might be expected to

yield £400,000–£800,000 in five years' time – a multiple of four to eight times the original investment. The US venture capital firm Sequoia Capital sold its $60 million investment in WhatsApp to Facebook for $3 billion – a multiple of 50. However, while some investments may achieve high returns, others will not and sometimes the investor will be lucky to exit with their money intact.

The business plan for a start-up is very important to an equity investor – they do not take guarantees and there is no track record to rely on. They will be particularly interested to see an identified and accessible market for the product/service with scalability and strong growth potential. If it is a technology-based start-up, the technology must be market ready. Investors also pay far greater attention to the quality and experience of the management team. This is the only track record they have. And they expect this experience and expertise to be reflected in the quality of the business plan. When looking at the financial projections they will apply the full range of performance criteria, outlined in Chapter 15. They will also pay great attention to the detailed assessment of the business risks and how they might be overcome.

Exit route or liquidity event

Most business angels will want to realise their investment within about five years, venture capitalists perhaps within ten years. For a start-up that may be a problem because there may not be an established market for their shares within that time frame. So who might buy the shares? One option could be that the entrepreneur may want to buy back the shares and regain 100 per cent control of the business. A management buy-out or buy-in might be another option. Angels might sell-on their shares to venture capitalists. Another option for both angels and venture capitalists is to sell-on their shares (and perhaps those of the founder) to another company by way of a trade sale. They might also seek an initial public offering (IPO) or stock market floatation – a listing on a stock market – so that they can sell their shares to other institutional investors or the public. We explore these options in the next chapter.

> *I want to know whether it will be attractive to buyers. The only way someone like me can make money is if someone will buy me out.*
>
> Ajith Jayawickrema, business angel, *The Sunday Times*, 2 June 2013

Business angels and venture capitalists will undertake a thorough investigation of both the founder(s) and the business before investing – called 'due diligence'. They will want to be represented as a non-executive director on the board. This is their response to the issues raised through agency theory and information asymmetry. Business angels, particularly, may also expect a more 'hands-on', day-to-day involvement. It is important that the entrepreneur develops a close personal relationship with these investors. Ultimately, they invest in people rather than businesses and, since they face more risk than the banker, they need to be convinced of the integrity and ability of the entrepreneur and the management team. Trust and respect are important. Since they only make money if the firm succeeds, they are highly committed to helping the firm through the inevitable problems it will face. They can be an invaluable sounding board for sharing both problems and ideas. Many have useful business experience, sometimes in the same business sector, and bring with them a wealth of business contacts. They can provide an invaluable strategic overview, opening the door to new opportunities for the business.

BANKS AND THE BUSINESS PLAN

The cash flow forecast shows how much finance a firm needs and if it needs external finance it will probably have to produce a business plan. However, the reality is that both banks and equity investors ultimately invest in people, not in plans. The plan is just one way, albeit a very important one, of communicating with them, a way of convincing them that the entrepreneur and their team are competent and trustworthy. It will usually lead to, or be the result of, a face-to-face meeting. Before letting any potential funder see a business plan the entrepreneur should consider whether they should ask the reader to sign a non-disclosure agreement, which binds the reader to confidentiality – important where there is valuable IP.

A bank loan will probably take weeks to arrange; however, an equity investment could take months, involving numerous presentations and meetings. The investors, or their accountants, will undertake their own due diligence investigations into the business and the production of the legal documentation

will involve lengthy, detailed work. Bankers and equity investors are looking for slightly different things when they evaluate a business plan.

Bankers are in the business of lending money; in that respect they are just like any other supplier of a commodity, and there are many banks. The thing to remember about banks is that they are not in the risk business. They tend to dislike plans that they see as over ambitious since they do not share in the success and may see this as an unnecessary risk. They are looking to obtain a certain rate of interest over a specified period of time and to see their capital safely repaid. They do not share in the extra profits a firm might make, so they do not expect to lose money if there are problems. The plan therefore needs to demonstrate through the cash flow forecast how the interest on the loan can be paid, even in the worst possible set of circumstances, and how the capital can be repaid on the due date. Where a long-term loan for product development or capital expenditure is being sought and there is little prospect of loan repayment in the short term, the plan must emphasise the cash-generating capacity of the business and take a perspective longer than one year.

Bankers represent a set of values and practices that are alien to many entrepreneurs. They are employees, not independent professionals, and lend only within very strict, centrally dictated, guidelines. They often talk 'a different language' and are subject to numerous rules and regulations that an entrepreneur would probably find tedious. They often cannot make decisions on their own without getting approval from 'up the line'. In these circumstances the business plan is an essential weapon in helping them get authorisation for a loan. Any manager will only be able to lend within the bank's own policies, at acceptable levels of risk and with adequate security to cover the loan. However, each of these three constraints requires the exercise of judgement and can therefore be influenced.

A bank might ask for a formal presentation of the business plan but, particularly for smaller loans, may prefer an informal meeting to discuss the plan, perhaps coming back to discuss issues that might arise. Bankers are trained to examine business plans critically and expect the entrepreneur to have specific answers to any questions, not unsupported generalisations. They will ask about the assumptions that the plan is based on. They will ask about risks. They will ask about some of the claims in the plan. However good the plan, they are still likely to ask for collateral or a personal guarantee. After all, if they don't ask, they certainly won't get it. But the entrepreneur must be prepared to haggle and shop around. This is just a sales negotiation like any other and the banker is trying to 'sell' their loan, albeit at a certain price and with certain conditions.

EQUITY INVESTORS AND THE BUSINESS PLAN

Prospective equity investors will normally expect to see a business plan before any meeting. Most investors are inundated with business plans and less than one in twenty will ever lead to a face-to-face meeting. To a large extent, therefore, the decision whether to proceed beyond an initial reading of the plan will depend crucially on its quality. The business plan is the first, and often the best, chance that an entrepreneur has to impress prospective investors with the quality of their investment proposal. A good executive summary is, therefore, vital – many investors do not read beyond it.

Business plans prepared for equity investors tend to be longer; more comprehensive, offering greater detail; and are better presented. They need to emphasise the advantages of the product/service, particularly compared to the competition. The investor will want to know about the return they will make and the exit route they can take. In turn the entrepreneur needs to be clear about how and when the return is expected – dividend or capital gain – and over what timescale. The plan requires a careful balance between making the proposal sufficiently attractive, while realistically addressing the inherent risks, in particular how rapid growth will be handled. It is often said that the single most important element in the investment decision is the credibility and quality of the firm's management. The business plan can address this to some extent but the crunch will come in the face-to-face meetings.

The most difficult aspect of any deal is deciding on the split of equity between the various parties. There is no set of rules and the final result will depend on the attractiveness of the proposal, what the investor brings to the company (contacts, industry knowledge etc.) and the negotiating skills of the individuals concerned. Investors will normally not want control of the business (i.e. over 50 per cent

> *I always back the jockeys because they can ride any horse. That's fundamental. I think 'If things get difficult, will they still be there?'*
>
> Ajith Jayawickrema, business angel, *The Sunday Times*, 2 June 2013

of the shareholding) as this might affect the entrepreneur's motivation, but they will want a sufficiently large say to influence important decisions. Since the entrepreneur may already be sharing ownership of the business with partners and/or key managers, they need to consider how much equity they want to be left with, not just at this point, but also when the equity investor seeks to sell-on their shares.

The entrepreneur also needs to be sure they can work with the investor, particularly if a non-executive director is to be appointed by the investor. A business angel is likely to have a 'hands-on' approach but can bring considerable experience and a network of contacts to the business. Other, mainly institutional, investors have a more 'hands-off' approach, preferring not to interfere once they have invested, perhaps meeting once a year to review the progress of the business.

If they are interested in a business proposal, investors are likely to require a number of meetings with the first involving a 15–20-minute formal presentation of the business plan, using PowerPoint, followed by questions which could easily go on for twice as long. If this is successful the entrepreneur will be invited back for at least one further meeting to sort out details about the investment. If asked to make a presentation the entrepreneur must follow the instructions given – if asked to keep to 15 minutes, they should do so, and that means ten slides, maximum. It is always a good idea to bring a laptop computer and projector (if one is not available) so as to minimise the potential for mistakes. If there is only one investor a projector may not be necessary as it can create a barrier – use hard copies. Professional slides are expected – clear, uncluttered and 'branded' with the company name. They should focus on key messages – not the detail – and engage the investor, encouraging them to ask questions. Beware boredom by PowerPoint! It is wise to prepare additional slides containing some of the details, should the investor ask. Highlights to be covered include:

» The financing being sought and the deal on offer – This places a valuation on the business which financiers may ask to be justified (e.g. 20 per cent for £50,000 means the business is valued at £250,000). Investors will ask what the money will be spent on.

» The product/service offering and the value proposition to customers – The product/service should be explained, or better still demonstrated, outlining the problem customers currently have and how the product/service will solve it for them.

» Target market and opportunity – The target market segments and their characteristics should be described and how they will be persuaded to buy the product/service (the marketing communications plan). If there are already orders for the product/service this will add credibility.

» The competition and the firm's competitive advantage – Competitors should be named and their product/service strengths and weaknesses outlined, emphasising, of course, why this product/service is better. If there is IP on the product/service it should be highlighted.

» Marketing strategy – This is where the entrepreneur can sketch out how they intend to achieve their sales targets, demonstrating their understanding of industry sales processes and distribution channels. Primary market research information can add to the credibility of these plans.

» The management team – What is important is the team's background and experience. If there are skill gaps, how they are to be filled should be explained.

» Financial highlights – These are highlights, not financial details – forecast sales and profit, when profitability is achieved, capital investment, cash flow and breakeven. Investors will ask about the details, in particular how the forecasts were arrived at, so it is wise to prepare some additional slides to go back to.

There is a danger that presentations can be 'over-rehearsed' and too formal. They should be viewed as a means to an end; cementing trust and creating a relationship. The entrepreneur needs to demonstrate motivation, integrity, knowledge of the market and managerial ability. They need to make eye contact (in the West this conveys honesty) and invite discussion, which is the first step in developing a relationship. It is always good to bring in samples or examples of the product/service, website etc., so that the audience can see and/or touch it. This can break down barriers. First impressions are important, but an in-depth knowledge of the key areas in the business plan will go a long way towards generating the confidence that is needed. Finally, the entrepreneur should never try to weasel their way out of questions to which they do not know answers. They are better saying they do not know the answer but

will get back with it in a few days. An experienced investor once admitted that, while discussions with the entrepreneur might centre on the business plan, the final decision whether or not to invest was really the result of 'gut feeling' – a personal 'chemistry' between them and the entrepreneur.

Case insight 19.6 BrewDog

Equity crowdfunding

Founded by James Watt and Martin Dickie in 2007, BrewDog is now the UK's leading craft brewer, with its Punk IPA the country's most popular craft beer. The pair started brewing small-batch beers at home. They scaled-up the business, being adept at gaining PR. Now with sales of some £170 million, it has breweries in Scotland, Germany, USA and (soon to open) Australia as well as some 80 bars worldwide, including a BrewPub in London and a hotel and beer museum next to the brewery in the USA. It also now distils its own gin and vodka. In 2017 it pledged to give 10% of annual profits to employees and a further 10% to charity.

BrewDog has been funded largely through a series of novel crowdfunding campaigns – what it calls 'Equity for Punks' campaigns. The first was in 2011 when £2 million was raised (equivalent to 8% of the company's capital). The shares were sold at £23.75 and offered additional benefits such as discounts at BrewDog bars and for online beer purchases as well as the opportunity to attend the annual shareholders meeting – which is more like a party. Subsequent rounds have been equally successful with the fifth round in 2018 raising over £126 million and breaking the world record for equity crowdfunding. 'Equity punk' shareholders now own 25% of the company (Watt still owns 25%, Dickie 22%). In 2017 it raised £213 million of private equity investment through TSG Consumer Partners, giving it a 22% equity stake in the company.

BrewDog said that anyone who invested in the first funding round in 2011 would have made a return of 2,765% after the TSG investment. However, aside from being allowed to sell 15% at the time of the deal, 'equity punk' investors are only allowed to trade with other equity punk investors on trading days set by BrewDog. What is more, TSG shares enjoy 18% annual compound interest and are preferential, meaning that in the event of liquidation or sale they rank above other shareholders for payment. This means that BrewDog would have to sell or list at a valuation of £2.4 billion by 2022 to avoid other shareholders being diluted. In 2019 it was valued at £1.8 billion, a valuation described as 'frothy', exceeding those of similar businesses in the light of a reported loss of £576,000 in 2018 compared to a profit of £1.4 million in 2017, adding:



Source: Photo by Evan Dvorkin on Unsplash

> *'Craft beer is no longer a niche interest. [BrewDog's] model of brewing beer and selling through bars in essence makes it no different to traditional pub groups.' (Sabah Meddings and Peter Evans,* The Sunday Times, *23 June 2019).*

In September 2020 BrewDog launched what it said would be the last equity punk crowdfunding round aimed at raising £75 million, saying that it was preparing for an IPO in 2021. Again, the financial press questioned BrewDog's valuation. It said the funds would be used to invest in sustainability projects, including direct wind power, CO_2 recovery, electric vehicle fleets and converting waste into energy.

Access the *Digital Links* booklet to visit the company website and watch a TED talk by BrewDog's founder, James Watt, explaining why BrewDog's culture aligns with its customers and why that has enabled it to be so successful in raising finance. There is also an example of one of BrewDog's successful crowdfunding pitches.

Questions:

1. What are the pros and cons of becoming an 'equity punk' investor?
2. Why has BrewDog financed its growth this way?
3. Why might BrewDog be preparing for an IPO in 2021?

THE FUNDING LADDER

Deciding on the form of funding for a start-up and when it will be sought are important strategic decisions. But getting started on the funding ladder can be difficult, particularly in a recession. Many sources of funding are not open to start-ups. Getting that first tranche of finance involves persuading the funder that the business will be a success, despite the risks and the competition. Once the business has a proven track record, new avenues of finance open up. Figure 19.2 shows the range of finance that typically becomes available in developed countries as a business grows. The faster it grows, the quicker these sources become available. However, a unique business idea will always find backing, particularly if there is a good business plan to explain it.

> *Get your funding strategy right and keep your investors informed. If you do that they will forgive you a lot more.*
>
> William Reeve, co-founder of Lovefilm, *The Sunday Times*, 2 April 2017

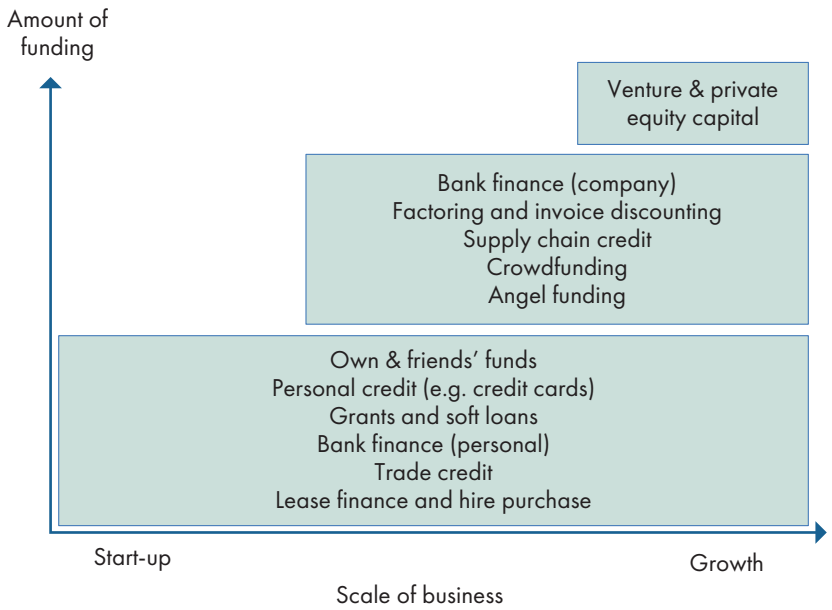


Figure 19.2 The funding ladder

The advantages and disadvantages of different methods of financing a business are summarised in Table 19.4.

Table 19.4 Advantages and disadvantages of different sources of finance

SOURCE	ADVANTAGES	DISADVANTAGES
Equity Personal, family and friends	* Good, secure long-term finance * No interest or capital repayment * Can be used to lever further loan finance	* Dividends may be expected * Selling shares to outsiders dilutes your stake in the business and may lead to loss of control * Outsiders providing equity may want to interfere in the business
Equity Angel finance	* Good, secure long-term finance * Can be used to lever further loan finance * Small amounts of equity available * Investment based on business plan rather than security * Investment usually made for 5 to 10 years * Often offers hands-on expertise	* Only really available to businesses with growth prospects * A significant proportion of the profits and capital growth of the business will go to the angels * Dividends may be expected * Angels will want to sell on their stake in the business at some point in the future to realise their profit * Hands-on expertise may be seen as interference in the business

Equity Venture and private equity finance	* Good, secure long-term finance * Larger amounts of equity available – often used as second-stage finance rather than at start-up * Investment based on business plan rather than security * Investment usually made for 5 to 10 years * Can offer longer term strategic advice * Not normally involved in day-to-day running of business * Should be able to arrange loans to go with equity investment, if required * No interest or capital repayments, unless loans are part of the package	* Only really available to businesses with very significant growth prospects and with a view to stock market floatation * A significant proportion of the profits and capital growth of the business will go to the investor * Dividends may be expected * Investors will want to sell on their stake in the business at some point in the future to realise their profit, usually through a stock market floatation * Will require very detailed information about the company * Takes time to arrange
Equity Crowdfunding	* Good, secure long-term finance * Can be used to lever further loan finance * Small amounts of equity available * Investment based on business plan rather than security	* Investors will need to see an exit route (liquidity event) – how they can dispose of their equity investment * Dividends may be expected * Crowdfunding website will expect a fee based on funds raised
Term loans Personal, family and friends	* Security unlikely to be required * Loans may be 'informal' – capital repaid as and when cash flow improves * Interest payments may not be required or may be deferred	* Interest payments may be required * Can strain relationships if repayments are not made as expected * If business fails, family and friends may suffer * Family and friends may interfere in the business
Term loans Bank and crowdfunding	* Term of loan is fixed – usually not repayable on demand (but do check terms) * Capital repayments fixed and known in advance * Interest rate can vary or be fixed and is usually lower than for an overdraft	* Usually secured against business or personal assets (collateral) * Can be refused because of lack of security * Requires good cash flow to pay interest and meet capital repayments * Crowdfunding website will expect a fee based on funds raised
Lease and hire purchase	* Guarantees not required – security is on assets purchased	* Expensive compared to rates of interest charged on loans * Requires adequate cash flow to meet regular payments
Bank overdraft	* Flexible – once agreed, available on demand * Can be cheap if you dip into and out of it – you only pay interest when you use it * Good solution to short-term financing needs	* Repayable on bank demand * Interest rate is variable * Can be expensive if you are in permanent overdraft as the rate of interest charged is usually higher than on term loans * Usually secured against business assets (collateral) and can be refused because of lack of security * Personal guarantee may then be required

SUMMARY

- The finance needed for a start-up can be minimised. Entrepreneurs have a 'pecking order' of funds they prefer to use starting with their own or family/friends' money before external finance. Table 19.4 summarises the advantages and disadvantages of different sources of finance.
- Deciding on the nature and source of finance is an important strategic decision. To be prudent the term duration of the source of finance should be matched with the use to which it is put (Table 19.1).
- Banks are risk-averse. They do not share in the success of the business but stand to lose all their capital should the business fail, and therefore they will do all they can to avoid a bad debt. Because of issues around agency theory and information asymmetry SMEs and start-ups in particular present a riskier lending proposition than larger firms. Therefore banks are likely to charge higher interest rates and seek personal or business collateral.
- Angels and venture capitalists are equity investors and share in the success or failure of the business. They therefore expect high returns – an annualised return of 30–60 per cent, normally realised as a capital gain within five to ten years. They will expect a seat on the board of directors.
- Bankers and equity investors look at a range of financial indicators but also pay great attention to the experience and personal qualities of the entrepreneur and their team. Banks are particularly interested in the cash flow forecast because this shows the ability of the firm to make its interest payments and repay capital. Investors are more interested in the growth prospects of the business, the financial return and exit route they can expect.
- Internet-based crowdfunding has emerged as a way of matching lenders and investors with SMEs in need of finance. It is too early to evaluate its success, but 'quirkier' businesses, often with a social aim, have found it a useful mechanism.

GROUP DISCUSSION TOPICS

1. Why might owner-managers not like external finance?
2. How can you tell whether there is sufficient provision of finance for SMEs?
3. How can banks improve the services they offer SMEs?
4. Since it costs so much to recover a bad debt, it is little wonder that banks are reluctant to lend without collateral or a good knowledge of the loan applicant. Discuss.
5. If you were a bank manager, what would you be looking for in a loan applicant?
6. Why are bank lending decisions being automated and centralised?
7. There is no such thing as limited liability for an owner-manager. Discuss.
8. Is there discrimination in lending?
9. Lending is about discriminating between 'good' and 'bad' borrowers. Discuss.
10. Why do so many women not want to seek external finance and, if they do, then seek so little compared to men?
11. Should peer-to-peer funding and crowdsourcing be regulated? If so, how and by whom?
12. What are business angels looking for in an investment?
13. If you were a business angel, what would you be looking for in an investment?
14. What are the advantages and disadvantages of having a business angel invest in a firm?
15. Where might the interests of the owner-managers and external investors conflict?

STUDENT ACTIVITY

1. This role-play exercise is designed to help you understand the relationship between a banker (or any provider of finance) and an entrepreneur seeking finance for a start-up. One person assumes the role of banker, the other the role of entrepreneur seeking finance, with a third person observing the exercise. Decide on the business and the size and nature of loan being sought.

   Banker: Before starting decide what is important for you to do your job well; what you need to know and how you might find this out; the nature of any future relationship. Do not make these known to the entrepreneur.

   Entrepreneur: Before starting decide what you want to tell the banker and the best way to do this; how you can convince them to lend you the money; the nature of any

future relationship. Do not make these known to the banker.

The interview should take about 10 minutes. At the end the banker, entrepreneur and observer should discuss how the interview went, disclosing decisions made prior to the interview. What are the learning points about relationships that you take from this exercise?

START-UP ACTIVITIES

1. List (and quantify if possible) the different sorts of capital you have access to: social, human and financial.
2. List (and quantify if possible) the different sorts of capital you will need to launch your new business: social, human and financial.
3. Compare the results and consider how you might bridge any gap.

PART 4

MATURITY

These final chapters look at how the small numbers of SMEs that survive start-up develop into maturity. Many are or become family firms and some become the large corporations of tomorrow.

Chapter 20 Maturity: Success and failure

This chapter looks at two extreme outcomes – the firms that do not survive long and those that grow. It explores why firms seem to have a limited life. Often growth firms are sold off, allowing the entrepreneur to harvest their years of investment. For successful businesses it looks at the sale options and the approaches to company valuation. It also covers the legal aspects of business failure.

Chapter 21 Family business

This chapter looks at the most enduring of SMEs, the family firm, exploring the advantages having a family firm confers and the conflicts inherent within it. As many family firms grow they become more bureaucratic, requiring agreement from the family on strategic decisions. They become more risk-averse because the family expect a regular, secure income. The chapter outlines some approaches to resolving these conflicts so as to ensure longevity.

Chapter 22 Corporate entrepreneurship and intrapreneurs

This chapter explains how large firms can maintain an entrepreneurial orientation by developing an organisational architecture that blends appropriate structures, cultures, leadership/management styles and strategies. It looks at the role of intrapreneurs and venture teams and how they can be encouraged and facilitated as well as other mechanisms for encouraging innovation before exploring how innovative venture outcomes are best structured.

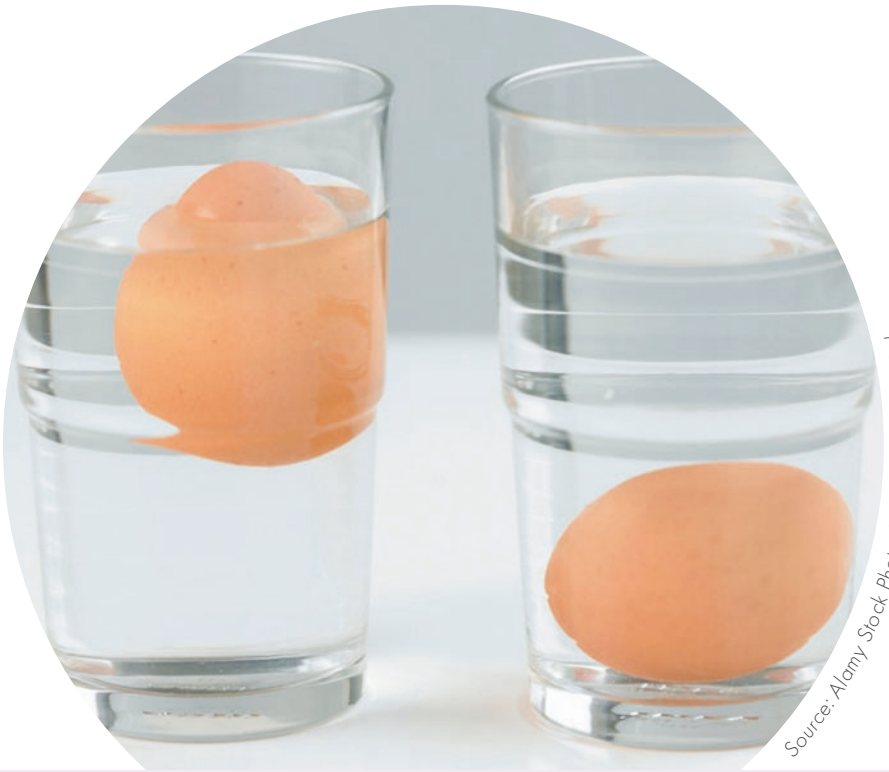
MEET THE ENTREPRENEURS

Access the *Digital Links* booklet via the companion website to watch interviews with various entrepreneurs on how they developed their business to maturity.

20 MATURITY: SUCCESS AND FAILURE

Contents

- Born to stagnate and die
- Reasons for business failure
- Decline and failure in large companies
- Growth of bureaucracy
- Decline of innovation
- Business failure – insolvency in the UK
- Selling a successful business
- Sale options
- Valuing the business
- Beyond business – entrepreneurial philanthropy
- Summary
- Group discussion topics
- Student activities



Source: Alamy Stock Photo/Dorling Kindersley Ltd

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Understand the reasons why businesses might cease trading and the causes and consequences of business failure;
- Explain what legal options are open to an insolvent business;
- Explain how the value of a business might be realised for the founder and the basis for company valuations;
- Understand how entrepreneurial philanthropy differs from charitable donation.

Case insights

20.1 Kennedy City Bicycles

20.2 Monsoon Accessorize

20.3 Facebook: Instagram and WhatsApp

20.4 Timberland

20.5 Titus Salt

20.6 Bill and Melinda Gates Foundation

Explore further link

20.1 Information and advice on insolvency

BORN TO STAGNATE AND DIE

Most small firms are born to stagnate and die. As we observed in Chapter 1, in the UK most do not grow to any size – almost two-thirds of businesses comprise only one or two people, and often the second person is the spouse. Some 95 per cent employ fewer than 10 employees and 99 per cent fewer than 50 employees. From the VAT statistics we see that half of businesses cease trading within three years of being set up, although, as pointed out, this does not necessarily mean that the closure has left creditors unpaid, and it can be viewed in a positive light as part of the dynamism of the sector as it responds to changing opportunities in the marketplace. What is more, when the number of start-ups increases, the number of businesses ceasing to trade tends to do so as well. The pattern is broadly similar internationally. The younger and smaller the business, the more likely it is to cease trading – a conclusion supported by a review of 34 business closure studies from around the world (Storey and Greene, 2010). A cynical observer might conclude that, in such a turbulent environment, mere survival is a badge of success.

Many entrepreneurs start a business without thinking about their exit route – whatever that might turn out to be (King, 2002) – and a survey of fast-growing, privately held companies showed that almost half of those who expect to leave their company in the next ten years had not undertaken any exit planning (Dahl, 2005). There are many reasons why an entrepreneur might leave the firm they founded. It could be that they see other better, more lucrative, commercial opportunities, or their personal or family circumstances change and they decide to wind down the business. Perhaps they can sell the assets or the entire business as a 'going concern' (one that functions without the threat of liquidation for the foreseeable future) and reap the harvest of their years of investment in the business. Based on a literature review, Levie et al. (2011) said that as many as half of firms that 'disappear' from the market are voluntary closures. Indeed, studies suggest that many firms are profitable at the point of closure as these owners have a planned exit or sale strategy (Bates, 2005; Headd, 2003; Storey and Greene, 2010). But, even with a sale, definitions are not straightforward because it could be that the sale was prompted by the business making continuing losses which could ultimately have led to failure. Nevertheless, even this form of 'distress sale' might still yield a capital gain for the entrepreneur.

The 2019/2020 GEM report listed as 'positive' reasons cited by respondents for ceasing to trade: opportunity to sell; another job or business opportunity; planned exit; retirement. The 'negative' reasons were: not profitable; financial problems; family/personal reasons; incident; taxes/government bureaucracy. In all 50 countries (other than Sweden and Norway) negative reasons far outnumbered positive reasons (Bosma et al., 2020). And not being profitable is likely to lead to financial problems, in particular running out of cash

Insolvency is the term used when an individual or company cannot pay its debts, although as we shall see, there are a number of ways even this might be resolved. Insolvency, at its worst, might lead to the personal bankruptcy of a sole trader or partnership (which can only be discharged by a court of law) as creditors pursue their debts by claiming the personal assets of the entrepreneurs. Only a tiny number of business closures involve bankruptcy. This might lead to the liquidation of a limited company, when a liquidator is appointed to dispose of the assets of the business, with their value going to the creditors. For statistical purposes, total insolvencies are defined narrowly as the total of personal bankruptcies plus corporate liquidations. Even with this definition there are problems of interpretation. It is not uncommon for a bank to foreclose on its debt, forcing a company into liquidation, knowing that it will secure repayment of its preferential debt at the expense of other creditors, and then to provide support for a 'new' company set up by the owner-manager undertaking exactly the same type of business. Is this a business failure? The liquidation of a company, in itself, may be a natural way of bringing the business to an end. This is called a 'voluntary liquidation'. If there are surplus assets, then the company is not insolvent and the owner-manager may make a capital gain after creditors are paid.

So ceasing to trade is not necessarily something to mourn, so long as the entrepreneur is not left out of pocket and creditors left unpaid. It is when this happens that failure might be viewed as a bad thing – and even here there may be positive consequences (not least because the entrepreneur ought to learn from that experience). In the USA, business failure can be seen as a worthwhile experience

> *They say success is a lousy teacher and it's true. When things fall apart you are left very exposed ... It's really difficult when all the negative things are coming at you, but adversity is not a bad thing.*
>
> John Stapleton, co-founder of New Covent Garden Soup Company, *The Sunday Times*, 25 August 2019

for entrepreneurs provided they are perceived as having learned from it (as we shall see later in this chapter, this is a view that is questioned by researchers). In the UK there is still a stigma attached to it. Being associated with a failed company can lead to problems when it comes to raising cash for another start-up. Bankers, in particular, still need some convincing to persuade them to give an entrepreneur a second chance – particularly if they lost money on the first attempt.

Case insight 20.1 Kennedy City Bicycles

Reconciling lifestyle and business

Case insight 1.3 looked at Petalon, a business Florence Kennedy started at the same time as her then boyfriend, James, started a bicycle company. This case looks at the business he started. Since James Kennedy had graduated from university in 2008 he had been in five office jobs in four years. He hated it. In 2012 he sat in a mountain café in Italy and decided to start a bicycle business. He wrote a business plan around a bike selling for £435. Kennedy explained:

> *'I was so worried nobody would want to buy the bikes that I'd offered too much for too low a price … I just needed it to be made in the right conditions, of the right quality and somehow fit within my ridiculously tight margins.'*

A few months later he assembled his first bike based on parts he imported from Taiwan and entered the London Night Ride. The bike worked. So he re mortgaged his two-bedroom flat which he shared with his girlfriend Florence (who he later married) and bought enough parts to assemble 150 bikes. These were stored in the second bedroom and the bikes assembled in the living room. He took some photographs, which he put on a website he designed himself. He opportunistically took a six-week lease on a recently closed local shop and, in 2013, Kennedy City Bicycles was launched. He started posting on Instagram, attended bike festivals and races, making connections with the local cycling community (the shop was on one of London's cycle ways) and got a lot of free PR, even writing some articles himself:

> *'I never felt like I switched off, working on bikes until late at night.'*

Sales took off – by 2014 he had sold some 200 and the price had risen to £505 – so he started selling accessories … and started a PhD. He also went to the Bicycle Academy in Frome to learn how to weld bike frames and decided to try building rather than assembling a bike. The problem was that, while Kennedy was interested in this new copper-plated premium model, customers were buying more of the old bike, and this was paying the bills. So he decided to stop assembling the old bike completely.



Source: James Kennedy

> *'The insecurities that seem to motivate me were refreshed in the form of a new challenge to my skill set and I felt like I had something new to shout about for the first time in a long time.'*

Income from the new 'copper' model never really compensated for the loss of income from the cheaper old model and by 2016 Kennedy was drifting into other things – two children, finishing the PhD, becoming commercial manager of his wife's business. So he let bike stocks run down and quietly wound up Kennedy City Bicycles. In 2020 he moved to Cornwall with his wife Florence and children to open a new chapter of his life.

We shall revisit James and Florence Kennedy in Case insight 21.2.

Access the *Digital Links* booklet to see a video from 2015 about the business and to see the final postings on the Facebook page.

Questions:

1. Was this business a failure?
2. What do the reasons James Kennedy had for starting this business, but more importantly, moving on from it tell you about lifestyle businesses?

REASONS FOR BUSINESS FAILURE

The observation that younger and smaller businesses are even more likely to cease trading than their older, larger counterparts is of little use to entrepreneurs. They are more likely to want to know why this occurs and, therefore, how it can be avoided. Figure 20.1 provides a simple framework, showing some of the internal and external influences that can cause an SME to cease trading gleaned from numerous academic studies. These influences interact. Individually they are present in many firms, often manifesting themselves as personal or business weaknesses, but it is only when they combine and interact that the potential for failure is realised. The recessions caused by the banking crisis of 2008 and the coronavirus outbreak of 2020 precipitated many failures, but for many businesses there were already inherent weaknesses that meant they were struggling. So, timing and luck play their part. But it is usually the weak firms that fail first. The most entrepreneurial can even find opportunity in adversity.



Figure 20.1 Influences on a business ceasing to trade

Figure 20.1 reinforces many of the lessons of success. What makes the small firm different from the large one is the disproportionate importance of the entrepreneur. Bad and untimely business decisions have been frequently shown to contribute to business failure (e.g. Stokes and Blackburn, 2002). These can originate from managerial deficiencies in the entrepreneur, but they may also stem from their personal character traits. However, the crisis that triggers the decline into failure is often brought about by some external factor such as an unexpected change in the economy or marketplace. This may lead to further bad decisions being made by the entrepreneur, for example a decision to overtrade or borrow too much. Again this might originate from the inherent optimism of the entrepreneur – part of the reason they started up in the first place. These decisions, in turn, result in symptoms of failure such as running short of cash or declining profitability. The paradox is that the asset of the entrepreneurial character can become a liability in certain circumstances.

External influences

Economic downturn

Most SMEs are 'market-takers' rather than 'market-makers' – meaning that they have little influence on a market. What is more they usually have small, if any, financial reserves – meaning that when there is an economic downturn they have no cash reserves to help see them through and have to turn to banks, who may themselves be feeling the pressures of an economic downturn. It's little wonder then that the general economy is a major influence on their well-being. Everett and Watson (2004) estimated that external economic factors are associated with between 30 per cent and 50 per cent of SME failures. Changes in overall consumer demand, interest rates and inflation can have a disproportionate effect on SMEs. The recession of 2008 saw many SMEs cease trading because of the combination of an economic downturn and a drying-up of finance to support them.

> *A recession is essentially a time for rebalancing ... If you've got a business with either a great product or great brand or offering a great service, all that happens is a lot of things come to challenge you ... but if your business has momentum it can help.*
>
> Will King, founder of King of Shaves, RealBusiness, 1 July 2009

Bad luck

Some external influences are clearly due to sheer bad luck – 'acts of God' like a strike, fire or the loss of the major customer. A larger company might weather such events, but SMEs with fewer resources cannot. You can add to this the impact of random personal events such as sickness and ill-health that impact disproportionately on an owner-manager. But sometimes entrepreneurs make their own bad luck and

find themselves in the wrong place at the wrong time because they decided to pursue an obviously risky course of action. Economists have suggested that these external influences can be likened to a game of chance – an approach called 'gambler's ruin' (Cressy, 2006) – with the entrepreneur as the roulette-wheel gambler betting resources on the outcome of each business decision they make. This model stresses 'luck' together with resource levels as the key determinant of the outcome. The gambler with the least resource is the least likely to weather a period of bad luck. This offers an explanation for why younger, smaller businesses are more likely to fail – they simply have less resources. It also dismisses the influence of the entrepreneur and their skills and abilities on the final outcome – success or failure in this 'game'.

Competition

Perhaps the most significant influence on an SME's success or failure is the structure of the market or industry in which it operates. We looked at this in Chapter 5. The greater the competition the lower the profitability and the more likely they are to fail. Porter's Five Force model is often used to explain the degree of competition in an industry. Lack of resources and 'gambler's ruin' also offer another insight into why younger, smaller businesses are more likely to fail in the face of competition from larger companies.

Other opportunities

It is not always the case that an SME ceasing to trade is a bad thing. The personal circumstances and aspirations of entrepreneurs change over time. Other opportunities offering an attractive income, either from employment or from another business opportunity, can also persuade the entrepreneur to close their current business. This means that it may not always be the least profitable businesses that close. Closure is influenced by personal factors such as the enjoyment the individual might get from self-employment, their minimum income 'threshold' and the alternatives available to them. It is therefore difficult to predict at the individual level.

Internal influences

Entrepreneurial character

Certain of the character traits of entrepreneurs can have very negative effects. For example, the strong internal locus of control can lead to 'control freak' behaviour such as meddling, an inability to delegate, a mistrust of subordinates or unwillingness to part with equity in the business. Similarly, the strong need to signal achievement might lead to unwise overspending on the trappings of corporate life, or the 'big project' that is too risky. Their strong self-confidence can, in extremis, become 'delusional' behaviour evidenced by an excessive optimism, an exaggerated opinion of their business competence and an unwillingness to listen to advice or seek help. Excessive optimism is a personal characteristic associated with entrepreneurs generally (Forbes, 2005) but also with failure (e.g. Berryman, 1983). This can cloud decision-making, particularly as entrepreneurs typically make extensive use of cognitive heuristics, often based upon past experience (which may be inadequate) rather than objective evidence (Chen et al., 1998). Beaver and Jennings (2005) found evidence of 'non-rational' behaviour by entrepreneurs in failed businesses. On top of this can be layered the emotional issues associated with decision-making in family firms – an issue we return to in the next chapter. These combine to produce a potent set of behavioural ingredients which might become underlying causes of failure.

Managerial deficiencies

Much of the literature suggests that it is a general lack of management competency in entrepreneurs that underpins business failures (Baldwin et al., 1997; Kiggundu, 2002; Knotts et al., 2003). Underpinning this is a lack of strategic planning. Saridakis et al. (2008) and Stearns et al. (1995) highlighted the importance of business strategy showing that an over-reliance on inappropriate strategies such as price competitiveness was more likely to lead to business closure. Delmar and Shane (2003) showed

that those businesses that prepared business plans were more likely to survive than those that did not. The frequently cited managerial deficiencies and/or business weaknesses do not seem to have changed much over the years despite the advent of the internet. Poor, infrequent financial information, lax debtor and/or stock control and an inability to manage cash flow are frequently cited causes of closure, as are marketing problems such as a lack of understanding of customer needs, failure to identify target customers, and poor selling skills (e.g. Baldwin et al., 1997; Berryman, 1983). In his review of the literature on small business failure, Berryman (1983) listed numerous examples of management deficiencies as reasons for failure: inability to delegate, reluctance to seek help, unawareness of the environment, inability to adapt to change and thinness of management talent, excessive cash drawings and pure negligence. Table 20.1 summarises these deficiencies. They are many and varied and their importance probably depends on the particular circumstances facing individual firms.

Table 20.1 Managerial deficiencies cited as leading to business failure*

» Poor planning	» Overdependence on a small number of customers
» Inappropriate business strategies	» Inability to delegate
» Poor financial control	» Thinness of management talent
» Inadequate/infrequent financial information	» Too narrow product range
» Inability to manage cash flow	» Reluctance to seek help
» Poor debtor/receivables and/or stock/inventory control	» Unawareness of the environment
» Lack of understanding of customer needs	» Inability to adapt to change
» Failure to identify target customers	» Excessive drawings
» Poor selling skills	» Negligence

**Listed in no particular order*

An interesting related issue is what (if anything) an entrepreneur learns from the bad decisions they make. And you might expect that they would learn from these mistakes if they go on to start another venture. Metzger (2007) found that, while German entrepreneurs who went bankrupt were just as likely to start up again in business as those who had voluntarily closed their businesses, they were then more likely to face closure again. It was not 'failure' as such but how they failed that was significant. Indeed, in a review of the literature, Storey and Greene (2010) concluded that the empirical evidence that entrepreneurs learn from failure was weak, possibly being submerged by their over optimism. The reason for this may lie in the emotions generated by failure and in particular the grieving process which can interfere with the learning process (Shepherd, 2003; Shepherd and Kuratko, 2009).

Financial resources

Insolvency and the lack of financial resources generally is frequently cited as a cause of business failure, although almost by definition a failing firm is bound to have inadequate finance. Cash flow will be poor and further funding may be unavailable. However, this is usually simply a symptom of the problem rather than a root cause. The cause is more likely to be undercapitalisation at start-up and subsequent overtrading (too-rapid expansion). Related to this are the financing risks associated with high levels of gearing. And the root cause of these issues may well be the lack of management capability of the entrepreneur.

DECLINE AND FAILURE IN LARGE COMPANIES

Even if SMEs survive to grow into large companies, there is no guarantee that companies can live forever. New start-ups grow to threaten existing companies, developing new markets and new technologies, innovating to better meet customer needs – the process of 'creative destruction' understood all too well by Schumpeter (1911) and outlined in Chapter 2. As a result, yesterday's start-ups can become tomorrow's business closures. In the UK, VAT statistics show that almost 50 per cent of businesses will deregister within the first three years of existence (i.e. VAT registration) – a statistic that remains fairly constant. Companies managing to survive this danger period do not fare much better. De Geus (1997) quoted a Dutch survey that showed the average corporate life expectancy in Japan and Europe was only 12.5 years. Even companies that are successful and grow have limited life. De Geus also showed that the average life expectancy of a multinational company – the Fortune 500 or equivalent – was only 40–50 years, with wide variations in life expectancy and many ceasing to trade much earlier than others. Many studies paint the same picture. Daepp et al. (2015) cited a major study of US publicly traded companies that found that their half-life (the time needed for their share price to fall to half its initial value) was only ten years. Another study of US publicly traded companies by Reeves et al. (2016) found that these companies have a one-in-three chance of being delisted within five years and their life expectancy had dropped to 31 years. This may not necessarily mean that they fail, but that they are taken over by another company. But corporate failures are also increasing. In 2016 public bankruptcies in the USA rose by more than 25 per cent, a quarter of which were large corporations with assets in excess of $1 billion and over 40 per cent in energy-related businesses.

Indeed, Daepp et al. (2015) found a remarkable mathematical consistency in the life span of companies. They applied scaling laws to a number of phenomena and found that there were patterns to the life span of animals and even cities. They then studied some 30,000 US public companies across many sectors from 1950 to 2009 and found that 'sublinear' scaling laws applied, similar to those for animals. This is shown in Figure 20.2. In both cases, as they get older and grow bigger, growth eventually stops and they eventually die. The larger companies became, the lower the revenues per employee and the lower the profits as a percentage of sales. For companies that survive long enough to go public, the researchers found there was a period of rapid initial growth – represented by the classic 'hockey stick' graph often used by entrepreneurs for their initial public offerings (IPOs) – however, after a period it then stabilised and stayed roughly the same, until the company eventually ceased to exist (specifically these companies stopped reporting financial results, but this could, for example, be because they have been taken over or acquired by another business). In other words, they became less effective at producing profits as they got older and bigger.

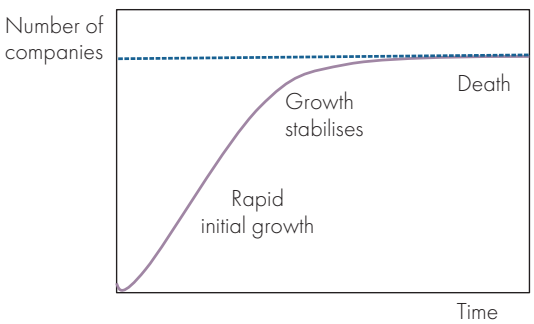


Figure 20.2 Sublinear scaling

GROWTH OF BUREAUCRACY

The researchers speculated that the reason for this decline was two fold: a growth in bureaucracy within the organisation and a decline in innovation. Companies become more bureaucratic, dominated by notions of economies of scale. The success of large companies forces them to focus on the parts of the

business that generate the biggest profit, emphasising a search for efficiency, and neglecting the newer parts of the business and potential innovations. Many researchers have come to this conclusion:

> It is no accident that when you become a massive company your R&D is a tiny part of the enterprise. The lifecycle of the company then tends to follow, ironically, much more that of an organism, growing quickly at the beginning and then turning over and becoming static … dominated by economies of scale … Then, like you and me, they eventually die. (West, 2015)

> Companies die because their managers focus exclusively on producing goods and services and forget that the organization is a community of human beings that is in business – any business – to stay alive … The long-lived companies in our study tolerated activities in the margin: experiments and eccentricities that stretched their understanding. (de Geus, 1997)

This notion that firms become less entrepreneurial and more bureaucratic as they grow is far from new. Greiner's (1972) model of growth stages showed bureaucracy as the final crisis facing the growing business, albeit after a crisis of leadership (Chapter 16). The core of the problem is that traditional management focuses on efficiency and effectiveness rather than creativity and innovation – control rather than empowerment – and that leads to the growth of bureaucracy. Foster and Kaplan (2001) argued that control processes can deaden the company to the vital and constant need for change. They wanted to abandon outdated, ingrown structures and rules and adopt new decision-making processes, control systems and mental models:

> Managing for survival, even among the best and most revered corporations, does not guarantee strong, long-term performance. In fact quite the opposite is true … Unless companies open up their decision-making processes, relax conventional notions of control, and change at the pace and scale of the market, their performances will be drawn into an entropic slide to mediocrity.

> *Corporations have to dismantle bureaucracies to survive. Economies of scale are giving way to economies of scope, finding the right size for synergy, market flexibility and, above all, speed.*
>
> John Naisbitt, (1994), *Global Paradox: The Bigger the World Economy, the More Powerful its Smallest Players*, London: BCA

While few experts would dispute the need to avoid too much bureaucracy and the importance of continuing innovation, it is worth noting two things. Firstly, the same degree of bureaucracy (or lack of it) may not be appropriate for all organisations (or the divisions and departments within them), since they might involve different tasks and face different environments. At the same time not all organisations (or the divisions and departments within them) may require or be able to innovate to the same extent. One solution does not suit all, and the issue is how to organise and manage to achieve the differences. Secondly, while accepting that companies, like animals, might have a natural life span, they may also, like animals, have spawned new offspring during that time – new ventures that have spun out of the old, all part of the never-ending cycle of birth and death. So it may well be that big companies can extend their lives by innovation, but while many will die – going into administration or, more likely, being taken over by another big company – the most successful will probably morph into some other form through spin-offs from the original company.

DECLINE OF INNOVATION

As we have observed, big companies tend to look for cost savings through scale efficiencies rather than differentiation through economies of scope (synergy). They look for uniformity rather than diversity and stress discipline rather than motivation. They discourage what they see as the risk-taking associated with a market opportunity without the information to evaluate it, by which time the opportunity may have been seized by a small firm. And all this is understandable. After all, the core business, which probably generates the greatest profitability and represents the greatest corporate value, needs to be run efficiently and safeguarded. However, you disregard the future and how markets and industries might change at your peril. Innovation is essential to survive, never mind prosper. Innovation and its journey to the market is clearly a complex, collaborative process and one in which both the public sector and large organisations still have an important part to play. Indeed, it has been suggested that the real contribution entrepreneurs make to innovation can be overestimated.

In a study across a number of industries, Christensen (1997) characterised company mortality as happening in stable markets where firms become too focused on their existing products and established

markets – making a change in direction more difficult. He observed that with each generation almost all of the previously successful large firms failed to make the transition effectively and were often squeezed out of the market or into bankruptcy, despite the fact they were often exemplars of good practice – ploughing a high percentage of earnings into R&D, having strong working links with their supply chain, working with lead customers to better understand their needs and develop product innovations, and delivering a continuous stream of product and process innovations that were in demand from their existing customers. The problem they had was their inability to identify and capitalise on the emergence of new markets with very different needs and expectations – one aspect of the problem of market disruption. Essentially these firms were too close to their existing customers, suppliers and technologies – trapped in the dominant logic of the industry. The result was that they failed to see the long-term potential of newly emerging markets. What might have begun as a fringe business – often for something simpler and cheaper – moved into the mainstream and eventually changed the rules under which the mainstream businesses operated, so by the time the mainstream businesses realised this, they had lost their competitive advantage. Often, with the benefit of hindsight, the industry seemed to be driven by technological developments rather than market demand.

So the question arises, when will today's US tech titans (yesterday's start-ups) – Alphabet, Amazon, Apple, Facebook and Microsoft – die? And how will this happen? Will it be through too much bureaucracy or too little innovation? Or could it come about through anti-trust legislation that breaks them up because of monopolistic market practices (it has happened in the past)? Indeed, would the Chinese state allow their Chinese equivalents – Alibaba, Tencent and Baidu – to die? Chapter 22 looks at the steps large companies are taking to at least delay their decline and death through organisational design. In some cases this involves creating new companies, involved in new markets and new areas of activity, leaving the old business to decline peacefully. For private family companies this regeneration might be the result of a new generation of the family taking over from another. We look at family business in Chapter 21.

BUSINESS FAILURE – INSOLVENCY IN THE UK

There can be many reasons for the failure of a business, not all the fault of the owner-manager. However, the likely consequence is that the business is unable to pay its debts – called 'insolvency'. If the business cannot pay its business debts when they fall due, or if its assets are less than its liabilities, then it is technically insolvent. The consequences depend on whether the business is a sole trader or partnership (personal insolvency) or a limited liability company (company insolvency), although in both cases owners and directors may also face personal liabilities.

Personal insolvency

For an individual struggling to pay their debts – as a sole trader or a partner or as a director of a limited company who has personally guaranteed the company's debts – there are a number of courses of action open in England and Wales. Most other countries have similar legal arrangements, but even those in Scotland differ and need to be checked and the advice of a professional accountant or lawyer sought before proceeding.

Informal 'family' arrangements

This is where family or friends agree to provide funds on a short-term basis and creditors agree not to take action. However, getting other members of the family involved in the business may present other problems.

Formal voluntary arrangements

For this course of action all the creditors must agree to a proposal the insolvent person and their advisors (which must include a licensed insolvency practitioner) put forward. This proposal will typically specify the amount (or proportion) of debt to be repaid and the timescale. If accepted, the creditors are bound by the proposal.

Partnership voluntary arrangements

Partnerships can propose this arrangement. It is similar to the individual arrangement above, but to remove the individual partners' joint and several liability to meet the partnership debts, the partners will either have to pay off the whole partnership debt or propose an individual voluntary arrangement.

> *You feel a lot of shame. I had 200 staff. You feel you've let them down [on the bankruptcy of his* Cosmetics to Go *business].*
>
> Mark Constantine, founder of Lush, *RealBusiness*, 26 May 2009

Bankruptcy

If a person is unable to pay their debts they can be made personally bankrupt. Either they or their creditors can apply to the courts for this to happen. The court will appoint an official receiver to take over their affairs (an insolvency practitioner may later take over) and sell off any assets – both their own personal assets and those within the business – so as to discharge the debts as soon as possible. Until the debts are discharged, the receiver will manage all the bankrupt person's affairs and there are restrictions on the financial arrangements they might enter into. If the bankrupt person is a sole trader or partner their business will normally be closed down and the assets sold off. Until they are discharged as bankrupt they cannot be a director of a company. Unless they are seen to be not cooperating with the receiver, they will usually be discharged from bankruptcy within a year; however, they may not regain full control of their own finances straight away. A major consequence of bankruptcy is that personal credit ratings will be badly affected for some years to come, which means that obtaining credit will become more difficult and more costly. Most individuals seek to avoid bankruptcy.

Company insolvency

For a limited liability company struggling to pay its debts and facing possible failure, there are a number of courses of action open in England and Wales. Most other countries have similar legal arrangements (again, rules in Scotland differ), but these should be checked and the advice of a professional accountant or lawyer sought before proceeding.

Refinancing

This involves bringing in new debt and/or equity finance to support the business. This may mean that the owner-manager will lose some of their equity in the business and may lose control. Refinancing will usually require the company to be restructured and may involve a pre-packaged sale of the business.

Company voluntary arrangement (CVA)

This course of action is best suited to companies which are fundamentally profitable, or which have the potential to be profitable, but which have serious cash flow problems. The existing company continues but is given protection from its creditors. For a CVA all creditors must agree to either accept a longer payment term or a reduced amount, or both. A typical CVA may defer payments for between two and four years and, in England, must be administered by a licensed insolvency practitioner who will report to the court.

A pre-packaged sale

This allows the profitable part of the business to restart without being weighed down by the company's existing debts. Pre-packaged sale, or 'pre-pack', is the name given to the process of buying the assets of a business from the old failing company. Some 18 per cent of US public bankruptcies in 2016 were pre-packs. Typically, a new company owned by the existing management will take over some or all of the assets of the business but not the debts. This structure allows a new business to rise from the remains of the old, often referred to as 'phoenix-like', with the effect that the business and jobs are saved. Once the transaction has taken place, the old company is placed into liquidation. These pre-arranged sales have come in for much criticism from smaller creditors. As a result the Pre-Pack Pool was set up in 2015 whereby deals that involved 'a connected party' could be reviewed. Referrals are voluntary and the responsibility of the connected-party purchaser, not the insolvency practitioner or creditors. Not surprisingly, since then only about 10 per cent of eligible cases have been referred to the pool; it is widely believed to be ineffective.

Administration

This is appropriate for companies that urgently need protection from creditors. Unlike with a CVA, a company can be placed into administration almost immediately by the court, if the court considers it appropriate. The approval of creditors is not needed. A company placed into administration is instantly protected from its creditors and, probably most importantly, from any pending legal action. In England, the company will be administered by a licensed insolvency practitioner, although this is often delegated to the existing management. The administration process is designed to provide protection for a limited period of time while the business is restructured and rescued.

Creditors voluntary liquidation (CVL)

A CVL takes place if the directors and shareholders decide to liquidate the company. In the UK a licensed insolvency practitioner is appointed by the directors. He then sells the assets of the company and pays the remaining funds to the creditors. The process is regulated by the court. CVL can be a relatively quick process and can provide an effective way to shield directors from the pressures of a failing company.

Compulsory liquidation

This is the final option. It is a process begun by the court at the request of a creditor. In England the creditor applies to the court for the company to be wound up, and if the court approves this it will appoint a liquidator. Compulsory liquidation is most commonly a result of action taken by government

Case insight 20.2 Monsoon Accessorize

CVAs and 'pre-pack' sales

Born in Sri Lanka, Peter Simon started selling hippie woollen coats in London's Portobello Road in 1973 at the age of 23. He opened the first Monsoon shop later that year. Over time he repositioned the shop to sell more mainstream fashion. In 1984 he opened the first Accessorize store, selling fashion accessories. The two stores were often combined into one larger store. At its peak there were over 260 Monsoon Accessorize stores across the UK.

Starting life as a private company, Monsoon Accessorize was floated on the London Stock Exchange in 1998, but in 2007 Simon bought back all the shares for £185 million making it a private company once more. He had previously tried to do this in 2003 and 2004. Between 2008 and 2013 he received £116 million in dividends from the company. Simon subsequently loosened his personal control of the business, appointing a CEO in 2013. However, like many high-street retailers the company has seen its sales decline in recent years in the face of online competitors. The company was 'restructured' in 2016, with many stores closing. After the 2017–18 results showed profits falling from £24 million to £6.1 million, he loaned the company £30 million to keep it alive. In 2019 it recorded a loss of £22.5 million and Simon stepped back in to become joint CEO. In the same year most of the company's landlords agree to rent-cuts following a threat to place the company into administration with a CVA. However, in order to gain the agreement of creditors (mostly landlords and suppliers) he put a further £12 million into the company.

The company continued trading but, with the coronavirus pandemic closing all its stores in 2020, it finally went into administration in June. However, almost immediately Simon bought back the company in a pre-arranged 'pre-pack' through another company he controls called Adena Brands, which injected £15 million into the business. The buy-back was not referred to the Pre-Pack Pool. Simon announced that at least 35 stores would be closed immediately and the fate of others depended on negotiations with landlords over rent reductions. It was thought that the company's larger, unprofitable stores would close and the company would focus on keeping its smaller Accessorize shops in transport hubs. Simon commented on the buy-back:

> *'This business has been my passion and my life and I do not want to see it fall victim to this unprecedented crisis.'*
> *(The Times, 11 June 2020)*

Questions:

1. What were the causes of the Monsoon Accessorize failure?
2. Did Peter Simon do everything he could to prevent administration?
3. Are pre-packs a good idea?
4. What should be done to make the Pre-Pack Pool more effective?

Bonus Case Cobra beer

Visit the companion website at bloomsbury.pub/burns-esb-5e to access this bonus case on business failure.

agencies to recover taxes, although it can be initiated by any creditor. A court-appointed liquidator, which may sometimes be the official receiver, will look very closely at the actions of the officers of the company and in some circumstances, such as in mishandling of tax payments, the directors may become personally liable and may face legal consequences. The company will then be sold off, in whole or in part, as a going concern, or the assets of the company will be sold off, often at a discount, to pay the creditors as soon as possible. Most companies would seek to avoid compulsory liquidation.

SELLING A SUCCESSFUL BUSINESS

Business success usually brings with it wealth. It also brings the opportunity to either sell-on the business as a going concern, harvesting the investment made in its growth and development, or pass it on within the family, forming the foundation for the family's wealth in the future (see Chapter 21). Indeed, some entrepreneurs set up their business so that they can sell it on quickly once it has proved successful, making a swift capital gain and possibly going on to start another. They might realise that they are at their best as 'serial entrepreneurs', launching start-ups rather than managing a large business, with all the problems that entails.

The opportunity to sell-on a company can happen earlier than you might expect. Only a small percentage of high-growth firms reach maturity with the founder still in place (Haveman and Khaire, 2004). Research by Nesta (National Endowment for Science, Technology and the Arts) showed that the average time from first-round funding to founder exit through IPO internationally for technology start-ups was around seven years in 2009. In the UK, the period was around six years in 2008, although the number of exits, either through IPOs or acquisition, has been decreasing each year since the peak in 2006 (Pierrakis, 2010). But not all entrepreneurs want to leave the business quickly. Increasing numbers want to take money out when the firm gets its second or third round of funding, only exiting some years later when the capital gain is maximised. They want to share in the success of the firm as it grows.

For an entrepreneur to be able to sell their business, it must be of value to somebody else. That means it must have good potential and a good financial track record that demonstrates success so far. If the entrepreneur intends to leave the business, then they must be able to demonstrate that it can function effectively without them. That means it must have good control systems and a good management team. The departure of the founder may infuse a firm with cash and/or new resources, including new management and renewed energy. Conversely it may have negative effects – disrupting routines, interrupting lines of command, increasing employee insecurity and generally leading to declining performance (Haveman and Khaire, 2004). The timing of any sale can make an enormous difference to the price paid for the business. Normally the better the general economic prospects, the higher the price paid. It might also be just the right time to get a very good deal, for example because

Explore further 20.1

Information and advice on insolvency

Information and advice on insolvency is available from accountants and solicitors. Access the *Digital Links* booklet for links to the UK government and Companies House sites that provide information and advice.

of consolidation in an industry. But there are also circumstances that are particular to the founder or their company – and plain luck can play a part in all this.

DeTienn (2010) argued that the exit from the business is just as much part of the entrepreneurial process as the start-up and that founders of entrepreneurial firms are more likely to develop an exit strategy than founders of lifestyle or salary-substitute firms. This is simply because they are more likely to develop strategy generally. This propensity depends upon their equity ownership and their psychological commitment to the firm as well as a number of other external influences. DeTienn goes on to develop a profile of the entrepreneurs who are likely to exit in the firm's infancy, adolescence and mature phases and the circumstances that might contribute to this.

SALE OPTIONS

An entrepreneur or an investor such as a business angel or venture capitalist looking to realise cash from the whole or partial sale of a business has a number of options.

Trade sale

The most attractive sale option is probably to find a trade buyer – another company in the industry that understands the business and wants to run it as a going concern or simply consolidate its own market share. They are likely to place a higher value on the business than others because they can see ways of 'adding value' through the purchase, perhaps by synergy. This is particularly the case with high-growth and technology start-ups, where the smaller business offers innovation and the bigger company offers resources to take the innovation to a mass, global market much more quickly than the smaller business might be able to (see Chapter 22). It has been estimated that over a third of high-growth firms can expect to be acquired, many by larger firms (Department for Business Enterprise and Regulatory Reform, 2008). This is an important option which allows the firm to access finance and support infrastructures which enable further growth. The larger firm may be willing to pay cash or shares to the founder. They might require the founder to stay on for a period of time or require them to sign an agreement that limits any competitor businesses they subsequently start up. However, they may allow the founder to walk away from the firm on the day of sale. Cash may be attractive if it is needed for retirement or other family reasons. If there are already other equity investors like business angels or venture capitalists, they will probably have to agree to the sale in advance. Indeed, they are likely to be able to help with it.

> *You need to allow plenty of time, not just to find the right buyer, but to consider the implications of the sale ... Do your research and plan to sell in a market that's rising but hasn't yet peaked.*
>
> Julian Harley, founder of Harley West Training, www.businesslink.gov.uk

Management buy-out (MBO)

If there is a strong management team in the firm they might be interested in bidding for the company if they can arrange funding. Although managers are unlikely to have the necessary capital, many venture capitalists look very favourably on management buy-outs and are keen to provide funds for them, provided the terms are right. However, managers are likely to know as much about the firm as the founder and can negotiate a tough deal. Some management buy-outs fail because managers know the business too well and are unwilling to meet the asking price. One potential drawback of MBOs is that the founder may have to wait several years before the full balance of the sale price is paid.

Management buy-in (MBI)

An external management team, often with experience in the industry, might be persuaded to bid for the firm, again as a going concern. It is difficult to know where to turn to find managers interested in this sort of option. However, some accounting firms keep confidential registers of just such managers

Finding a buyer, valuing the business and negotiating its sale are a daunting series of tasks that really should not be undertaken without professional advice and help. Many larger firms of accountants can help find buyers, just as they can help find companies to purchase, and they can act as a confidential 'front' in the search process. They are also likely to take a more objective view on

Case insight 20.3 Facebook: Instagram and WhatsApp

Founders selling their business

Launched in 2004 by Mark Zuckerberg, Facebook is probably the most successful of the so-called 'Web 2.0' start-ups. It has over two billion active users and revenues of over $40 billion. Over the years Facebook has made relatively few corporate venturing acquisitions compared to other internet firms. In 2012 it purchased Instagram, the photo- and video-sharing social networking site, for $1 billion in cash and stock, keeping on its founders Kevin Systrom and Mike Krieger. In 2014 it purchased WhatsApp for over $19 billion in cash and stock, also keeping on its founders Jan Koum and Brian Acton. Founders from both companies were attracted by the prospect of their companies being able to grow more quickly with the resources of the social media giant behind them. However, despite their companies' continuing success and lucrative salaries, in 2018 the founders of both of these companies decided to leave because of disagreements with Mark Zuckerberg, chairman and CEO of Facebook.

Instagram's founders said:

> *'We're planning on taking some time off to explore our creativity again ... Building new things requires that we step back, understand what inspires us and match that with what the world needs; that's what we plan to do.' (*The Observer, *30 September 2018)*

However, speculation soon spread a different story. By 2018 it was estimated that Instagram generated $6 billion in revenue for Facebook – its second-largest income stream after News Feed. Originally Zuckerberg had promised that Instagram would be allowed to grow independently. However, events were leading the founders to believe that this might be changing as Zuckerberg tightened his control over the company. Zuckerberg started 'meddling' in design decisions, despite this being seen as one of Systrom's strengths. Earlier in the year Facebook removed a shortcut link to Instagram from its bookmarks menu inside the Facebook App, eliminating the traffic flow from Facebook to Instagram. At the same time Zuckerberg stopped the founders reporting directly to him, instead having them report to Chris Cox, the chief product officer. After their departure, Adam Mosseri, former head of Facebook's News Feed, was appointed head of product. At the same time, Facebook absorbed Instagram's marketing department. It also removed the Instagram branding from photos shared on Facebook.

When Koum and Acton left, not only did they leave behind lucrative salaries, they also forfeited unvested stock options reportedly worth $millions. The trigger this time was one of principle. With its end-to-end encryption, WhatsApp is synonymous with message safety, security and privacy. Even after joining Facebook Koum had undertaken to keep users' data private:

> *'Respect for your privacy is coded into our DNA and we built WhatsApp around the goal of knowing as little about you as possible. You don't have to give us your email address. We don't know your home address. We don't know where you work. We don't know your likes, what you search for on the internet or collect your GPS location. None of that data has ever been collected and stored by WhatsApp and we have no plans to change that.' (*The Observer, *30 September 2018)*

However, once again things seemed about to change as Zuckerberg wanted the app to start making money by merging Facebook and WhatsApp data, thereby ditching all Koum's assurances. Acton's response was to plough $50 million into another end-to-end encrypted messaging service called Signal. The funds were used to establish a not-for-profit foundation, making Signal free from advertising and monetisation pressures.

The motivation behind Facebook's actions seems to be financial – allowing it to generate even more advertising revenue by assimilating even more data about its users. But is this what its customers want? And will entrepreneurs in the future be willing to sell their companies to Facebook, knowing how it is likely to operate?

Access the *Digital Links* booklet to visit the website and to watch a CNBC discussion about the reasons behind the integration of Instagram and WhatsApp with Facebook.

Questions:

1. What do you think were the motivations behind these decisions to resign?
2. What does this say about Facebook?
3. What does this say about the ability of founders to stay on when their company has been bought out by Facebook? Is this generally the case? If not, why?

company valuation than the founder and are essential in sorting out the details of the deal, including the inevitable warranties and indemnities that will be requested by the purchaser. There is also the important consideration of taxation, where planning can considerably increase the money actually pocketed by the vendor.

Case insight 20.4 Timberland

Selling-on

Founded in Abington, Massachusetts, USA, in 1952 by the Swartz family as a durable boot manufacturer, until 2011 Timberland was a third-generation family firm. The strong retail brand image developed by Timberland allowed it to extend its footwear range as well as moving into outdoor clothing. Manufacturing was subcontracted and it opened a number of prominently sited retail outlets selling its Timberland products. The family business was famously based on strong ethical foundations which it said was 'grounded in the values that define our community: humanity, humility, integrity and excellence'.

Until 2011 Jeff Swartz was president and chief executive, and his father Sidney was still in post as chairman. Like his family, Swartz was an orthodox Jew and the values of the business reflected those of the family and its religion. It had a motto: 'Doing good by doing well', stating that 'community has been synonymous with the ethic of service – the desire to share our strength for the common good. Our approach to building and sustaining strong communities includes civic engagement, environmental stewardship and global human rights.' Employees were allowed a one-week paid holiday to undertake volunteering work. *Fortune* magazine recognised it as one of the best companies to work for in the USA.

However, by 2009 the company was facing increasingly competitive markets and rising materials costs squeezed profit margins. In 2011 it reported a 30% drop in first-quarter profits and the share price started to tumble. Shortly after this, Timberland was sold to VF Corporation for $2 billion in cash – a 40% premium on the share price. Swartz did not negotiate a contract to stay on either as CEO or as an advisor. Unusually, the share price of VF rose by 10% when the deal was announced.

VF is a very large retailer which owns a range of well-known lifestyle/activity brands such as Wrangler, The North Face, Vans, Reef, Jansport and Eastpak. At the time of the purchase VF said that the brand fitted well into its existing portfolio and it intended to keep Timberland's social and sustainability commitments, grow sales and make the company more efficient. Many observers were sceptical but VF seems to have kept to its word, realising this important part of the Timberland brand image. VF believes in what it calls 'sustainability at scale', which is fuelled by collaboration among its brands with VF playing the role of enabler, facilitator and accelerator.

Commenting on the merger Stewart Whitney, then president of Timberland, agreed, saying Timberland's environmental and sustainability standards had been maintained; although centralising sourcing had initially been an issue,



Source: Tom Sodoge on Unsplash

relying on VF's back office and operations function had definitely been beneficial.

> *'I'd say the biggest challenge ... was related to process and operations. We each had our own approach to setting metrics, gathering data and measuring progress. We each had our own reporting processes and cadence.'**

Fast forward to 2020 and VF turnover had risen to $10.5 billion (operating income $928 million). However, the Timberland brand was not performing as well as expected, with its men's footwear range particularly disappointing. The company had been trying to diversify its men's product offerings while maintaining its environmental product standards. As a result, the global brand president, Jim Pisani, was fired. But VF was more concerned with the products rather than the brand image. Steve Rendle, VF president and CEO, explained:

> *'What we have to do is not only to diversify the product, but we have to elevate the product. And we need to really think about the aesthetic; we need to think about the finish. We're opening up new sourcing avenues [and] accessing better manufacturing, which will put an elevated offer from both the materials and aesthetic into the consumer frame.'***

Access the *Digital Links* booklet to visit the website and watch a short 2020 Timberland video promoting the brand image.

Questions:

1. Why might a family have decided to sell the business it had run for three generations?
2. What changes have there been at Timberland since the takeover? Has the brand image changed?
3. Has the company's commitment to ethical, environmental and sustainability changed?

Sources: * GreenBiz, 24 February 2016. Available online at: https://www.greenbiz.com/article/timberland-and-vf-tale-merging-two-sustainability-programs

** Footwear News, 23 January 2020. Available online at: https://footwearnews.com/2020/business/earnings/timberland-sales-vf-corp-q3-2019-earnings-1202909265/

Floating the company and selling shares

Owner-managers of sizeable companies can unlock personal liquidity and raise additional capital by selling shares. The most obvious way to do this is by 'going public' – floating the company on a stock market which then allows the founder to sell their shares. There are two 'junior' markets in the UK that offer limited trading – Off Exchange (OFEX) and the Alternative Investment Market (AIM). Listing on these ultimately leads to a full listing on the Stock Exchange Main Market. For a company new to the stock market this is called making an initial public offering (IPO). This can be expensive (a trade sale is far cheaper) and means that the business will have to comply with a whole range of regulations and disclosure requirements designed to make trading in their shares fairer. It also means that the firm needs a track record of solid profitability and good growth potential. This option can also be problematic if the entrepreneur wishes to retire because the stock market's assessment of IPOs centres on the future potential of the firm, and if the float is simply intended to provide an exit for the entrepreneur it is unlikely to be popular. The same applies if the business already has a stock market quotation. If the entrepreneur is looking to sell up completely or relinquish operational control, the share price is likely to drop. This option is therefore probably best for the entrepreneur who wants to take some money out of the firm but wishes to continue running it and seeing it grow. The downside of this is that many entrepreneurs do not like the public accountability and loss of control that goes with a publicly quoted company. And, as we shall see in the next chapter, placing the company on the stock market can be particularly problematic for a family business.

> *The history of the City is littered with entrepreneurs who hold onto their creations for too long, failing to recognize the changing needs of the company. I am a serial entrepreneur ... It is all part of growing up. I've built something and now it is time to move on.*
>
> Stelios Haji-Ioannou, founder of easyJet, *The Times*, 19 April 2002

Other factors such as declining stock market liquidity, the shift towards more algorithmic share trading, a lack of analysts offering research on mid-sized company shares and evidence that stock markets are unwilling to take a long-term view have combined to make stock markets unattractive. In 1999 there were 2,292 companies on the London Stock Exchange. By 2019 there were only 1,679. Not only is going public becoming less attractive, an increasing number of companies are delisting, financed by venture or private equity capital companies using borrowed money fuelled by low interest rates. Companies such as the aerospace company Cobham, the cyber-security business Sophos, the pub-chain Greene King and the entertainment company Merlin all de listed in 2019, financed by private equity firms. This trend of 'de-equitisation' is worldwide with more shares being taken off stock markets than new shares issued.

Selling some shares to a venture or private equity capital company as part of a refinancing deal can be a way of realising part of the entrepreneur's or family's investment in the firm, at the same time as raising additional funds for growth without necessarily losing control. However, it begs the question of what the venture or private equity capital company will do with their shares in the future.

These options can become more complicated if there are other shareholders in the company. Business angels, venture capitalists and other commercial investors may have their own plans for the company and how they intend to liquidate their investment. However, the fundamental problem of ensuring the continuing success of the business after the founder's departure remains. Few entrepreneurs plan properly how or when to sell-on their business so as to maximise its value at the point of sale. Most rely instead on their instincts for sorting out an opportunistic deal at the last minute. And yet they are far more likely to achieve the best price for their business by planning ahead and building into the business plan any steps that are needed to help them exit with minimum disruption and reap the best possible harvest from their

investment. That almost certainly involves bringing in effective management structures so that the business can survive after the entrepreneur has left – a topic we address in the final two chapters. It also probably involves taking professional advice sooner rather than later.

VALUING THE BUSINESS

Valuing an established business can be difficult. Valuing a start-up is even more difficult because of the uncertainties involved and the lack of any track record on which to evaluate forecasts of future income. However, whether the founder is seeking a further equity investment or offering the entire business for sale, any new investor will try to place a value on the business before making an offer. The previous chapter highlighted how early-stage investors might be looking for a valuation based on a multiple of four to eight times their original investment over a period of five years. The value of the business determines how much equity the founder or early-stage investor might need to dispose of to raise a certain amount of money. Sale of 20 per cent of a business valued at $500,000 would yield the entrepreneur $100,000 ($500,000 x 0.20). Company valuation is not a science. It is based primarily on expectations about the future, and those are uncertain. So for example, information asymmetry (Chapter 19) might lead to investors being unaware of some information in the possession of the company and therefore placing a lower value on the business. There are two widely used ways of valuing a business:

» Market value of assets – Businesses that are asset-rich, such as farms or freehold retail premises, are often valued in this way. Tangible assets such as debtors/receivables, stocks/inventory, equipment, fixtures and fittings and particularly property are valued at their market rate, although even this is not objective and is uncertain. Sometimes intangible assets such as brands and IPR can form part of this valuation. For certain kinds of businesses this might give a higher value than the second approach, but for any business the asset value provides a minimum valuation.

» Multiple of profits – Many firms, particularly those with few tangible assets, are valued based upon some multiple of net profit. For example, if an appropriate multiple of profits were 5, a company making $100,000 per year would be valued at $500,000. If the multiple were 20, its value would be $2 million. If you look in the financial press (e.g. The Financial Times), every public company has its price-earnings or PE ratio quoted. This is the multiple of net profits (from the previous year) that the current share price represents, defined as share price divided by earnings per share.

Companies can also be valued using a mix of both methods. Where there are tangible assets, such as property, these might be valued at market rates and then an element of 'goodwill' added based upon a multiple of profits. Often this is based upon the popularity or resonance a brand has with customers and, as we shall see in the next chapter, long-established and successful family businesses can often command a premium for this. The often-used term 'goodwill' is therefore a loosely defined concept that describes the difference between asset values (often taken as the net tangible asset value from the balance sheet) and the perceived or stock market value of a business.

While the PE ratio in the financial press is based on actual reported profits, start-ups only have forecast profits to work on. This is not an issue, in principle because buyers of shares are interested in the future profits of the business and only use actual profits as a proxy measure. However, one factor that influences the size of the multiple is the 'quality' of earnings. The longer the firm's track record of profitable trading, the higher the multiple is likely to be. So start-ups, with no track record, tend to command a lower multiple than established firms. Other factors can increase the size of the multiple because they make the forecast of profit more credible, for example the experience of the management team or the existence of substantial pre-launch orders. Different industry sectors tend to have different multiples that reflect the risk they are perceived as facing: the lower the perceived risk, the higher the multiple. So, the higher the risks an investor perceives a venture as facing, the lower the multiple they are likely to apply.

The notable exception to all this is the high valuation put on many technology companies – many of which have still not achieved profitability. Often these companies have developed radical innovations that *may* disrupt whole markets and industries – a risky gamble. They may not have

achieved profitability because it takes time to enter markets or to find customers other than the 'early adopters'. It could be that they have not yet developed a business model that is able to monetise the innovation. What investors are gambling on is that the company may achieve substantial first-mover advantage by creating a whole new market or industry that they are able to dominate and then reap monopoly profits from. Alternatively, they may be bought at a higher valuation by another competitor eager to consolidate their own market dominance. This is a gamble and these valuations often prove to be unfounded. For companies in this situation there are no established ground rules for valuation.

As well as company-specific factors, company valuation is affected by external factors over which the company has no control. The general economic climate has a major effect on valuations. The recessions of 2008 and 2020 saw private company valuations plunge as forecasts of economic activity were cut back. In times of economic boom stock markets tend to flourish and company valuations are high. Interest rates also affect company valuations. Because most companies have borrowings, lower interest rates tend to mean higher profits, flourishing stock markets and higher company valuations. Since the purchase of a business often necessitates a buyer borrowing funds, the gearing of the purchased firm, in its final form, can be a factor. If borrowings are high, as they often are in management buy-outs, the company is vulnerable to changes in profitability as it will have high, fixed interest charges. As explained in Chapter 15, if the return on total assets falls below the rate of interest, it can be in trouble, and the higher the borrowing, the greater the trouble. This is what happened to the highly geared SMEs in the early 1990s when interest rates soared at the same time as profits tumbled.

The key question, then, is what multiple of profits to use. There is no straightforward answer to this. It is all a matter of judgement. Just like the price of any product or service, it requires a willing buyer and a willing seller – and a company can be 'marketed' in the same way as any product or service. In any given industry, the longer the business has been in existence and able to demonstrate consistency of earnings, the higher the multiple is likely to be. However, for a start-up risks are high, there is no track record and if a private buyer wishes to sell their shares, there may be no established market to sell them on (unlike for a public company).

These factors mean that PE multiples in single figures are currently quite normal for a start-up. However, if a venture is involved in disruptive innovation or has an established brand and market share with a proven track record, as is often the case for a family business, the multiple can be very much higher. Another factor may be the quality of the management the owner will be leaving behind to continue running the firm. Different industry sectors tend to have different multiples that reflect the risk they are perceived as facing: generally, the higher the perceived risk, the lower the PE multiple. Companies with privately held shares typically command lower PE multiples than public companies in the same industry because there is a market for shares in a public company. Multiples in single figures are usual for small firms but, at the end of the day, it depends how much the buyer wants the firm. The multiple can be very high if a larger company perceives it as strategically important for some reason. For example, when the giant Avis car rental firm bought the US car-share start-up Zipcar in 2013 it paid $500 million – a multiple of 34 times the net profits of $14.6 million.

One way of dealing with the problem of early valuation – particularly for fast, high-growth businesses – is to delay valuation but set out the details of how it will be determined at some point in the future. The initial investor then receives equity based on a discount of that future valuation. This is particularly effective when equity funding is to be sought in tranches and valuation is easier at these later stages. For example, a new venture receives equity funding of $100,000 on the understanding that the valuation will be based on a 50 per cent discount on the next investor's valuation, when $200,000 is needed in one year's time. If this valuation turns out to be $2 million and the investor receives 10 per cent of the equity, then the original investor will also receive 10 per cent, reflecting the 50 per cent discount.

For the founder of a business, planning is the key to a successful exit. Selling at the right time can have a significant impact on the value of the business. The business will be worth most when profits are at their highest and can be seen to be growing. The founder needs to consider the impact of the business cycle upon sales, profits and the order book. The general state of the economy – and in particular the sector the business is in – can have an effect on valuation. It is easier to find a trade buyer when a sector is doing well and interest rates are low with bankers willing to lend. Other factors – like

strong internal controls and an effective management team – need to be in place. Consideration needs to be given to the legal, tax and pension consequences of the sale. Most entrepreneurs will need advice on this and help in finding buyers. And finally, as we shall see in Chapter 21, even if the entrepreneur is hoping to pass on the business to other members of the family, this is also likely to need careful planning and advice. All this means that the exit of the founder needs to be planned at least three to five years ahead. Accountants and solicitors can provide advice on taxation, raising equity and selling companies, providing advice on the 'going rate' for PE multiples in particular sectors.



Bonus Case Xtreme SnoBoards (4)

Visit the companion website at bloombury.pub/burns-esb-5e to access this four-part bonus case that covers pricing, the preparation and evaluation of financial forecasts, and an estimated company valuation.

BEYOND BUSINESS – ENTREPRENEURIAL PHILANTHROPY

Many entrepreneurs pursue environmental and social objectives alongside their business ones as part of their CSR (e.g. Cotton On Group, Case insight 8.4). Many entrepreneurs also give money to social and environmental causes. Wealthy entrepreneurs have long been involved in philanthropy, sometimes underpinned by religious beliefs. In the UK, the Quaker movement has inspired many social initiatives by entrepreneurs. In the USA, Andrew Carnegie, founder of the Carnegie Steel Company which became the US Steel Corporation, gave almost 90 per cent of his wealth – worth about $350 million – to charities and foundations. His 1889 article advocating 'The Gospel of Wealth' called on the rich to use their wealth to improve society, and it stimulated a wave of philanthropy. So it is hardly any surprise that entrepreneurs might want to involve themselves more in the philanthropic projects they sponsor.

The term 'entrepreneurial philanthropy' means something altogether more powerful than just charitable giving. It means that they bring their skills as well as their wealth to bear on the charitable cause. The distinction between charitable giving and entrepreneurial philanthropy is the difference between giving people food to alleviate hunger and giving them the training and the means to produce the food themselves. Entrepreneurial philanthropy is about donating resources but also the active involvement of the entrepreneur in directing how those resources are used for socially good purposes. For many entrepreneurs it is a way to do something socially or environmentally useful with their time and the wealth they have accumulated that may have a longevity after their death.

Entrepreneurial philanthropists have been called 'philanthropeneurs'. Entrepreneurs like Bill Gates (Microsoft), Richard Branson (Virgin), Steve Case (AOL), and Jeff Skoll and Pierre Omidyar (eBay) have helped recalibrate what exactly philanthropy can mean. Often they do this because of their dissatisfaction with how conventional charities approach a problem. Philanthropeneurs bring a practical, entrepreneurial approach, a network of contacts and sometimes near-celebrity status to a project that can open doors at the highest levels of government. They can bring cash, passion, creativity and leadership to a cause. But entrepreneurial philanthropy requires a level of engagement beyond traditional philanthropy. Invariably it involves solutions based upon the market and free enterprise and it often involves imposing performance measures and accountability alongside the desire to achieve transformational change, impacting on people's lives in ways that are sustainable. Gordon et al. (2015) describe them as:

> would-be hyper-agents who seek to fashion the world ideologically and practically in ways that seem desirable to them … [which is] not about relieving the symptoms of social problems but about addressing root causes such as disease, ignorance and lack of employment.

Alto (2013) suggested that entrepreneurs thinking of engaging in this activity should take a six-step approach, which you may say can be applied to most social enterprise projects:

Case insight 20.5 Titus Salt

Entrepreneurial philanthropy

Entrepreneurial philanthropy has a long history. Titus Salt (1803–1876) made his fortune in the Bradford textile industry manufacturing woollen fabrics and became one of the greatest Victorian philanthropists, donating liberally to local and national good causes. However, today he is probably best known for the model village he built, called Saltaire, which became a UNESCO World Heritage site in 2001. Because of the employment offered by the wool mills, Bradford attracted workers from all over the country – but it was not a good place to live or work. Working conditions in the mills were bad and Bradford itself was insanitary and overcrowded with poor housing conditions. Salt decided to relocate his mill and his employees to a site outside Bradford on the banks of the river Aire alongside the Leeds Liverpool Canal and the railway so that he could distribute his products quickly and cheaply. But he also wanted his workers to be healthier, happier – and more productive.

He employed local architects Henry Lockwood and Richard Mawson to build the mill and village. Work started in 1851 and continued until 1876. When the Salts Mill opened in 1853 it was the biggest factory in the world, employing some 3,000 workers on 1,200 looms, producing 30,000 yards of fabric every day. The village grew alongside it, designed in the classical style and inspired by the Italian Renaissance, importantly located upwind of the smoke and pollution coming from the factory chimneys. Allotments, where workers could grow their own food, separated the factory from the town, heralding the zoning approach to town planning used today. The housing was laid out in a grid fashion and, although close together, was of the highest quality. Each house had a water supply, separate living and cooking spaces, several bedrooms and a garden, varying in size depending on the status of the worker, foreman or executive. Green spaces were dotted around the village, something normally found only in the most affluent of Victorian towns. The village had its own well-equipped factory school. The Victoria Hall housed a library, dance hall and lecture hall, meeting rooms, billiard room and gymnasium. The finest building was the Saltaire United Reform Church, now a Grade 1 listed building. Salt also provided rent-free almshouses for the elderly or infirm 'of good moral character' which overlooked a small green and came with a pension, some 40 years before the first state pension in the UK.

The UK textile industry was in steep decline by the late twentieth century and the mill finally closed in 1986. Rescued by Jonathan Silver, it today houses an art gallery exhibiting the work of Bradford-born artist David Hockney, as well as shops and the 'Salts Diner'. Saltaire influenced town planning around the world and is one of the earliest, largest and best-preserved Victorian model villages anywhere in the world.

Access the *Digital Links* booklet to visit the Saltaire website and watch a video telling the story of Titus Salt and the town he built.

Question:

1. Was Titus Salt an entrepreneurial philanthropist? Explain.

1. Research the social issues that are of interest and decide on underlying causes of the problem.
2. Decide upon the nature of their personal involvement (time, money etc.).
3. Assess the time needed to make an impact and whether this is acceptable.
4. Decide on the tipping points when making timely and targeted philanthropic interventions – this can have a disproportionately large impact beyond traditional giving methods.
5. Decide on and assemble the resources needed.
6. Decide on performance measures and track progress.

Of course, social and civic entrepreneurs can bring these things too, but they usually give their time instead of money or the money earned through the social or civic enterprise. And money can make a difference to what is possible, leveraging ambitious ideas. However, the boundaries between social enterprise and entrepreneurial philanthropy are often unclear. Entrepreneurs might set up separate trusts, foundations or other non-profit organisations to work alongside their commercial business and leverage resources (e.g. Cotton On Group, Case insight 8.4). There are often tax advantages to this. However, there can also be strong commercial synergies, creating a win–win situation for both the business and the philanthropic cause.

Case insight 20.6 Bill and Melinda Gates Foundation

Entrepreneurial philanthropy

In 2000 Bill Gates stepped down as full-time chairman and CEO of Microsoft, the software company he founded in 1975, a self-made multi-millionaire. In the same year he and his wife launched the Bill and Melinda Gates Foundation (BMGF) and in 2006 they took up full-time roles in the Foundation. In 2010 the couple created the Giving Pledge, declaring their intention to dispose of most of their wealth philanthropically and inviting others to do the same. Funded mainly by Bill Gates and Warren Buffett, BMGF is reportedly the largest private charitable foundation in the world with some $47 billion in assets. To maintain its status as a charity it must donate funds equal to at least 5% of its assets each year.

BMGF's primary goals are to enhance health care and reduce poverty in the world and, in the USA, to expand educational opportunities and access to information technology. It builds partnerships that bring together expertise and resources, using BMGF funding for leveraging to identify issues, find solutions and drive action. To that end, it has invested $ billions combatting infectious diseases, malaria, HIV/AIDS and tuberculosis control around the world. It is a major donor to GAVI (the Vaccine Alliance) and the World Health Organization (WHO). As well as funding research, it works with partners to deliver vaccines, drugs and diagnostics. For example, it used its funding to kick-start the production of drugs to fight malaria and now works with Global Fund, the UK government and other leading donors as well as WHO to deliver a more coordinated support which includes research, surveillance and data use. It helped fund vaccinations against measles in Africa that saw deaths from the disease fall by some 90% since 2000. It is a major supporter of the Global Polio Eradication Initiative, contributing technical and financial resources, with the aim of eradicating polio completely. In 2020 it used its financial leverage to persuade five vaccine manufacturers to commit to increase the supply of vaccines to help prevent cervical cancer for up to 84 million girls worldwide.



Source: Markus Spiske on Unsplash

In 2021 Bill and Melinda Gates announced that they were to separate. It is unclear whether this will affect their Foundation.

Access the *Digital Links* booklet to visit the Foundation website and watch a video interview with Bill and Melinda Gates about taxing the wealthy and another about the Covid-19 crisis, which the Foundation donated some $250 million towards fighting.

Question:

1. Is this entrepreneurial philanthropy? Explain.

SUMMARY

- Most firms are born to stagnate or die and not to grow to any size. A business might cease to trade for many reasons, not all of them bad. However, when a sole trader, partnership or company is insolvent then there will be unpaid creditors.
- The main factors influencing the statistical likelihood of failure are age and size of business: younger and smaller businesses are the most likely to cease trading.
- The causes of a business ceasing to trade involve a coincidence of external and internal influences, some of which might occur simultaneously.
  - External influences include: the general economy, luck (and resource levels), competition influenced by market/industry structure, and other opportunities that present to individuals.
  - Internal influences include: personal character flaws, lack of managerial capabilities and lack of financial resources leading to cash flow problems.
- As firms grow they become more complex to manage and more bureaucratic. They tend to become more risk-averse and less innovative, defending their major income streams rather than trying to find new ones – a characteristic that can lead to their decline and closure.
- There are a number of legal courses of action for individuals or companies that become insolvent. They may involve

refinancing, some form of compromise with the creditors and/or sale of all or part of the business. This can involve compromising the position of creditors so that the business can survive as a going concern.

- Founders can harvest their investment by selling the business as a going concern either to a trade buyer or through a management buy-out or management buy-in. All these options need careful planning and professional advice. Another option may be selling shares – 'going public' – but the entrepreneur may then find it difficult to leave the business in the short term.
- Company valuation is not a science. It depends on how important the purchase is to the buyer, and therefore what they are willing to pay. Companies can be valued based upon their assets or a multiple of earnings or net profits (or both). Tech businesses may achieve high valuations because of their perceived future potential.
- There is no set formula for judging what a PE multiple should be. It depends on the quality of earnings, the quality of management, the industry sector and the general economic climate. Few private companies, other than tech businesses, command a multiple into double figures.
- Rather than valuing a business straight away, another approach, particularly suitable for fast, high-growth businesses, is to delay valuation but set out the details of how it will be determined at some time in the future. The initial investor then receives equity based on a discount of that future valuation.
- Timing of the sale is important and therefore careful planning is essential. To maximise the value of the business, profits need to be high and rising, the sector needs to be booming with interest rates low, and good controls and an effective management team need to be in place.
- Entrepreneurial philanthropy is more than just charitable giving. The distinction between charitable giving and entrepreneurial philanthropy is the difference between giving people food to alleviate hunger and giving them the training and the means to produce the food themselves.

GROUP DISCUSSION TOPICS

1. Why do most small firms stagnate or die?
2. Is it good that so many small firms cease trading?
3. What constitutes failure in business?
4. What do you think of the observation that younger and smaller SMEs are more likely to fail than their older, larger counterparts?
5. How do you distinguish between causes and symptoms in business failure?
6. When will Google 'die'? How is it likely to 'die'? How might it be able to sustain itself?
7. In the context of corporate life cycles, is history bound to repeat itself?
8. What is involved in bankruptcy? What are its consequences?
9. What is compulsory liquidation? What are its consequences?
10. How is a CVA different to administration?
11. How is a CVL different to liquidation?
12. Is a pre-packaged sale fair?
13. If luck plays such an important part in determining failure, do entrepreneurs really make their own luck? If so, how?
14. The entrepreneurial character is as much a liability as an asset. Discuss.
15. You cannot distinguish between bad business decisions and managerial or business weaknesses. Discuss.
16. How do you think you would feel emotionally if the business you set up faced failure?
17. How might planning to sell your business affect your plans and strategies?
18. There is no such thing as company valuation, only a willing buyer and a willing seller negotiating a price. Discuss.
19. What are the reasons, other than just money, that you might want to sell a business that you have founded?
20. Why might a large company want to buy a smaller one? What safeguards regarding the founder might it want to put in place?
21. An entrepreneur could never relinquish control of the company they founded, whether to private or stock market investors. Discuss.
22. What personal issues might an entrepreneur encounter when facing retirement?
23. Why should an entrepreneur consider setting up a charitable foundation?

STUDENT ACTIVITIES

1. Find a business that has recently failed and try to fit the circumstances of its failure into the framework of the failure model shown in Figure 20.1.
2. Using desk research, write a case study on a failed business.
3. Using desk research, write a case study on a recent IPO and the justifications for its PE ratio.

21 FAMILY BUSINESS

Contents

- The importance of family business
- Defining a family business
- The advantages of family
- Characteristics of a family business
- Conflict between family and business cultures
- Generational succession
- Relationships with siblings
- Relationships across the family
- Identifying and resolving conflict
- The family constitution
- Succession planning
- Summary
- Group discussion topics
- Student activities



Source: Getty Images/Westend61

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Explain the economic significance of family business;
- Explain the advantages and disadvantages of being part of a family business;
- Identify points of conflict within the family business and understand the mechanisms that might resolve them;
- Describe what goes into a family constitution and how it might be developed.

Case insights

21.1	Adidas vs Puma	21.5	Morgan Motor Company (2)
21.2	Florence and James Kennedy	21.6	Ferrero Group
21.3	Fisherman's Friend	21.7	Timpson Group
21.4	Mars Inc.	21.8	Wates Group

Explore further links

21.1 Strengths and weaknesses of family business

21.2 Family business membership organisations

THE IMPORTANCE OF FAMILY BUSINESS

Family businesses are the oldest and most common form of any business organisation. At this stage let us define a family business simply as an organisation in which decision-making is influenced by multiple generations of a family. Using this definition most firms are family businesses. In the UK in 2019 family businesses represented 85 per cent of all private sector firms (a total of over 4.8 million firms). They employed 13.4 million people (including self-employed) making up 50 per cent of private sector or 38 per cent of all employment. They generated £1.7 trillion in revenue, representing 42 per cent of private sector turnover or 28 per cent of the UK economy (Institute for Family Business, 2019). Their importance is estimated to be even greater across the EU and the USA. What is more, the stereotypical image of the family living above the shop does not do the sector credit. They are not all small, lifestyle firms. Many of the strongest brands in business today are family businesses: for example, in the USA Walmart and Mars, in India Tata and Reliance Industries, in Korea Samsung and LG, in Germany Volkswagen and BMW, in the UK INEOS and JCB, in Denmark Lego and Møller-Mærsk. In the UK family firms represent almost half of all mid-sized businesses (50–249 employees) and 20 per cent of large firms (Institute for Family Business, 2019). Family-owned companies account for a substantial proportion of the value of the stock market. In the USA, family firms – where family members own more than a quarter of the shares – represent more than a third of the Fortune 500 (Clark, 2014). And many companies that have become public companies still have links with the founding family: for example, the Ford Motor Company and the Walt Disney Company. In Europe the pattern is similar. But most family firms – of any size – are privately owned or family-controlled and the family have a strong hand in influencing management decision-making.

The family firm has been the backbone of many continental European economies for decades. None more so than in Italy where names like Agnelli, Pirelli and De Benedetti have long controlled large parts of Italy's industry. Because of the historically strong family networks, Italian owner-managers have been loath to surrender even part of the equity capital of their firms to investors, and non-family managers have rarely received shares or share options. And in Germany family firms make up the majority of the Mittelstand that contribute so much to employment, exports and GDP. However, China is catching up quickly. In a ranking of the top 750 family firms (with annual revenues of $9 trillion, employing 30 million people) 57 companies were from China and Hong Kong (41 from mainland China) compared to 119 from Germany (Bain, 2019). Most of these companies are little known outside China.

However, most family firms – like most businesses generally – are small, and traditionally they are characterised as less innovative than non-family firms (McCann et al., 2001), although more recent studies link innovation with the larger, more established family firms (Craig and Moores, 2006). Traditionally, family businesses have been important in many primary sectors, such as farming. They also tend to thrive in areas such as hotels and restaurants, where high levels of personal service are required. The retail sector – butchers, bakers, florists, convenience stores and so on – also boasts a large number of family firms, with members of the family helping to staff the shop. Family firms are also to be found in the cash-generating food-processing industry. Finally, there are many in the supply industries like transport and distributorships, especially in the motor sector.



Bonus Case Kongō Gumi



Visit the companion website at bloomsbury.pub/burns-esb-5e to access this bonus case.

DEFINING A FAMILY BUSINESS

All this begs the question: what precisely constitutes a family business? We defined it at the beginning of the chapter simply as an organisation in which decision-making is influenced by multiple generations of a family. However, much of the academic literature is concerned with defining this more precisely.

Essentially, a family business is one that is owned or controlled by one family, related by blood or marriage. However, academics have suggested many more precise definitions, for example:

- An owner-managed enterprise with family members predominantly involved in its administration, operations and the determination of its destiny. Family members may include parents, children and grandchildren; spouses; brothers, sisters and cousins (Poutziouris, 1994).
- A company in which majority ownership (in terms of shares) or control lies in a single family and in which two or more family members are, or at sometime were, directly involved in the business (Rosenblatt et al., 1985).
- For a quoted company, one in which 25 per cent of voting shares are controlled by the family (Nelton, 1986).

A widely used definition is provided by Chua et al. (1999): 'a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families.' This then begs the question of what constitutes 'a dominant coalition'. The authors say it is the 'powerful actors in an organisation who control the overall organizational agenda', but that, in turn, begs the question of how do you judge 'power' and 'control'.

Case insight 21.1 Adidas vs Puma

Family rivalry

On 21 September 2009, two football teams came together in the town of Herzogenaurach in Bavaria, Germany, to play a game of football. The game was preceded by what was described as a 'historic handshake' in support of the Peace One Day organisation, which was celebrating its annual day of non-violence. The teams were from the footwear companies Adidas and Puma – whose commercial rivalry is famous – and the story behind the game is a remarkable tale of how family businesses can break up and, in this case, split a town in two.

For over 60 years Herzogenaurach has been a town split into two factions, separated by a river and two major employers – Adidas and Puma. Townsfolk were either 'Adidas' or 'Puma' people, even if they did not work for either firm. Stores and tradespeople proclaimed their loyalty to one brand or the other. Two soccer teams emerged – ASV Herzogenaurach and FC Herzogenaurach – each sponsored by one of the firms. Rival gangs fought each other and intermarriage was out of the question. This curious split in the town can be traced to a family squabble in the 1940s between two local shoemakers – brothers Adolf and Rudolf Dassler. They had made shoes together since the 1920s, starting in their mother's kitchen, and had set up a family business called the Dassler Brothers Shoe Factory. For some reason that has melted into the mists of time, the pair fell out and set up rival companies on either side of the town's river. Rudolf set up Puma, and Adolf renamed the company Adidas. It was this falling out that spawned decades of fierce business rivalry, split a town in two, and led to the establishment of two of the best recognised sporting brands in the world. Once the Dassler brothers died in the 1970s and the companies gradually fell out of the control of the founding families, the tensions between the two firms started to ease. However, the handshake on 21 September 2009 was important for Herzogenaurach residents, whose psyche has been shaped for years by their choice of footwear and its consequences.



Source: Tevarak Phanduang on Unsplash

Access the *Digital Links* booklet to watch a short animation which charts the family rivalry and the trailer for a full-length feature film that was made in 2016 about the family rivalry.

Question:

1. Is this form of rivalry good for the company? Explain.

Gersick et al. (1997) suggested this could consist of a single individual, as is often the case in a founder-controlled family business, or many individuals, as might be the case in sibling partnerships or cousin consortiums. But then this means all sole traders might be classified as family businesses. Chua et al.'s definition is significant because it introduces the issue of the family influencing the vision and therefore the strategic direction of the business. Astrachan et al. (2002) attempted to address this issue by developing an instrument called the Family Influence on Power, Experience, and Culture (F-PEC) scale for assessing the extent of family influence in the three dimensions of power, experience and culture. However, the resulting scale is a continuous one and therefore provides a subtle answer rather than a simple yes/no as to whether an enterprise is a family business or not.

The problem is that family firms are heterogeneous – each one seems different in so many ways – and the search for a precise definition could be endless and rather fruitless. Westhead and Howarth (2007) distinguished between first- and multiple-generation firms, professional family firms, average family firms, diluted family firms, open family firms and transitional family firms. Probably the real answer is to ask the family. If family members are involved in the firm and feel a responsibility for it, then that is a good indication that it is a family business. They will probably say it is anyway. One of the overriding characteristics of the family business is the atmosphere of belonging and common purpose. Just as the personality of the owner-manager is imprinted on the small firm they own and manage, so the culture of the family is imprinted on the family firm. Rather than entrepreneurial 'two arms, two legs and a giant ego', you have many arms, legs and egos. It is no wonder that *Spectator* magazine once described the family business sector as 'an endless soap opera of patriarchs and matriarchs, black sheep and prodigal sons, hubris and nemesis'. And there you have the problem.

THE ADVANTAGES OF FAMILY

Starting up a business on your own can be a stressful, lonely way to make money. Many people start a business with friends – they are known and trusted and may well possess complementary skills. So why not start up a business with the family? Trust is something that there is in abundance – particularly between husband and wife – and if all the family's income depends on the success of the venture then there is no doubting that the motivation to succeed will be strong, although this should be tempered with the recognition of the risk of depending on only one source of family income. What is more, getting the whole family to help with the work brings an added resource to the firm – and one that may not have to be paid a wage. Davis et al. (2010) talked about the 'stewardship culture' in family firms and how it encourages pro-organisational or collectivist behaviour from all family members. Leach (1996) suggests that family firms have a number of advantages over others:

- Commitment – Family enthusiasm and family ties can develop added commitment and loyalty;
- Knowledge – Special ways of doing things in the business can be coveted and protected within the family;
- Flexibility in time, work and money – Putting work and time into the business when necessary and taking money out when the business can afford it rather than according to the dictate of a contract;
- Long-range planning – Because the firm is seen as the family's main store of value, something to be passed on to the next generation, family firms are better than others at taking a long-term view, although this may not involve formal planning processes;
- A stable culture – Relationships in family firms have had a long time to develop and the company's values, beliefs and working practices are therefore stable and well established;
- Speedy decision-making – Like owner-managed companies, family firms can make decisions quickly because of the short lines of responsibility;
- Reliability and pride – Because of the commitment and the stability of their culture, family firms can be very solid and reliable structures. Over time, they can build trust with all stakeholders and a reputation that the family guard with fierce pride.

Case insight 21.2 Florence and James Kennedy

Reconciling lifestyle and business

We looked at the two businesses that Florence and James Kennedy set up in Case insights 1.3 (Petalon) and 20.1 (Kennedy City Bicycles). James wound down his business to focus on Petalon with Florence, as the couple moved to Cornwall. Both took the GET2 test (see Explore further 3.2) and their results are set out below. Neither was surprised by their results, nor for the results of their partner.

Florence Kennedy achieved an overall score of 56% which, the report said, indicates she is 'occasionally enterprising' and suggests: 'that you are likely to have strengths in some of the enterprising characteristics and may be enterprising in some contexts. At this time in your life you may find that you are content to work on a limited number of projects and may be happy to be enterprising either within employment as an intrapreneur, or in your leisure time through voluntary community projects.' Her detailed results are shown in Figure 21.1.

James Kennedy achieved an overall score of 93% which, the report said, indicates he is 'highly enterprising'. It produced a summary report identical to that of Julian Thomas (Case insight 3.1). The detailed results are shown in Figure 21.2.



Figure 21.1a Overall GET2 result

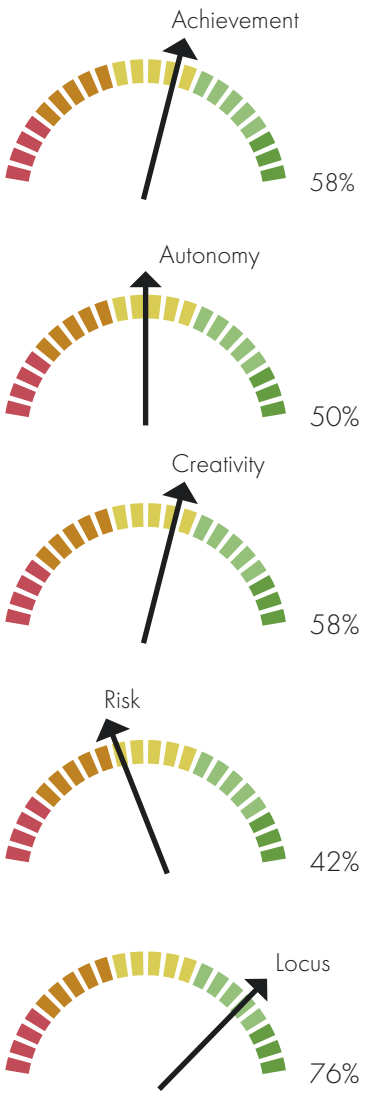


Figure 21.1b Detail GET2 results

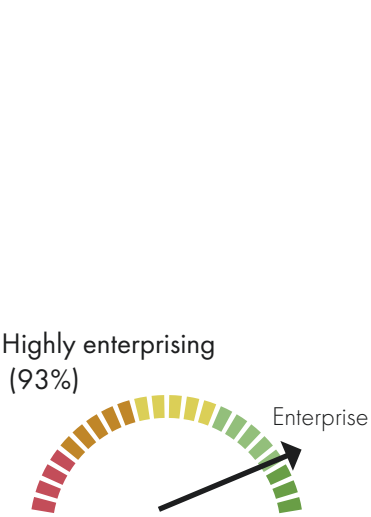


Figure 21.2a Overall GET2 result

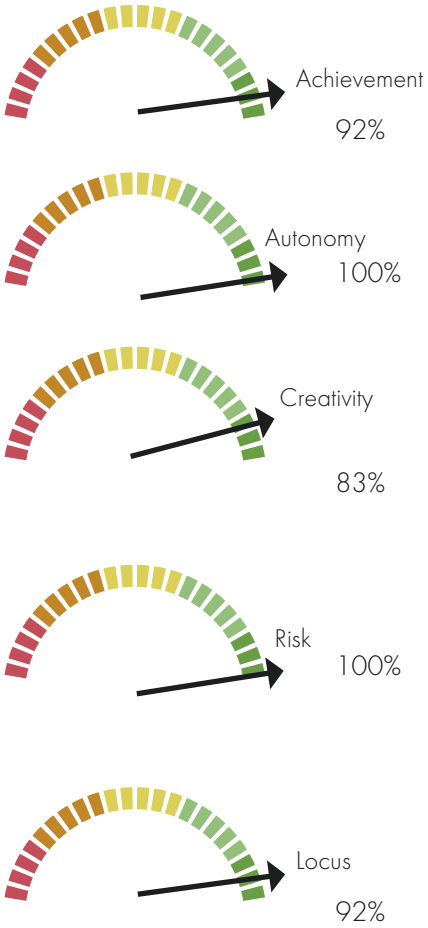
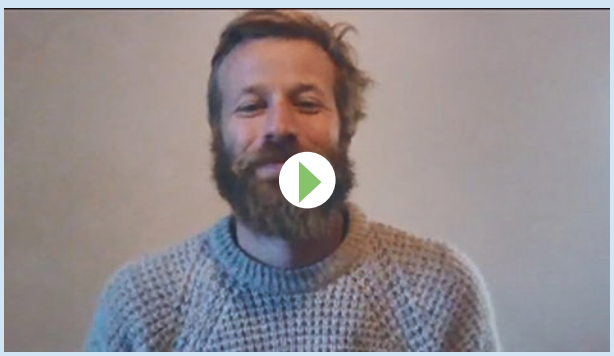
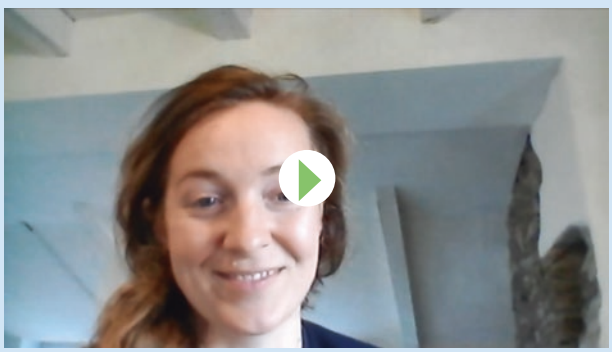


Figure 21.2b Detail GET2 results





Get into the entrepreneurial mindset. Access the *Digital Links* booklet to watch interviews with Florence and James Kennedy exploring their mindset and reactions to the GET2 results and their 2018 video about business and their lifestyle.

Questions:

1. Were these results what you expected when you read Case insights 1.3 and 20.1? If not, how do you reconcile the results with your expectations?
2. What might this tell you about the entrepreneurial mindset and partnerships?
3. Do you think the Kennedys make a good lifestyle and business partnership?

> *We are a family-owned, private business. We do what's right for the business. We do not have to prove anything to anybody.*
>
> Gary Grant, founder of The Entertainer, *The Guardian*, 7 April 2015

Many family firms started out as or remain husband-and-wife teams. For example, in the UK Mark and Mo Constantine founded and run Lush Cosmetics (Case insight 10.5) and Doug and Mary Perkins founded and run Specsavers (Case insights 11.3 and 14.2). There is the added advantage for husband and wife of giving each other support and friendship, and working long hours may not be such a grind when with your partner. For some couples, being together all the time can help in their personal as well as business relationship. However, for others it might be a recipe for divorce and business failure. Michelle and Michael Mone founded the bra maker Ultimo in 1996 but Michelle has written about how boardroom meetings were 'constantly interrupted by one or other of us walking out'. The couple split in 2011, three years later the business was sold.

Emotional intelligence is as important for a successful marriage as it is for business leadership. As with many issues relating to the family firm, there are few hard-and-fast rules. Conflict is most likely to arise in making decisions, and here clear role definitions and a separation between work and home are important. Based upon interviews with husband-and-wife teams in the USA, Nelton (1986) suggested that the successful teams shared the following characteristics:

- Partners believed that marriage and children came first;
- Partners had enormous respect for each other;
- There was close communication between partners;
- Partners' talents and attitudes were complementary;
- Partners defined their individual responsibilities carefully;
- Partners competed with other companies, not each other;
- Partners kept their egos in check.

CHARACTERISTICS OF A FAMILY BUSINESS

Family business can be characterised as having both economic and non-economic goals. There is no theoretical justification for or clear evidence that family businesses can outperform non-family firms. However, one meta-analysis by van Essen et al. (2015) showed that publicly traded family businesses outperformed non-family businesses, although an earlier study suggests this is explained by the influence of the founder rather than the family (Miller et al., 2007). Katchaner et al. (2012) studied 149 publicly traded, family-controlled businesses with revenues greater than $1 billion, based in the USA, Canada, France, Spain, Portugal, Italy and Mexico, during the period from 1997 to 2009 – a period when economies across the world moved from expansion to recession. They made some interesting observations. Compared to their peer groups throughout this period, these large family businesses:

- Had leaner cost structures – Consequently, they entered the recession with lower fixed costs and were therefore better able to survive;
- Had a higher cut-off for capital expenditures – Consequently, they missed out on some profitable investment opportunities that their peers might have invested in and therefore under performed during periods of expansion, but this worked to their advantage in recession;
- Had lower levels of gearing – Consequently, they were better able to survive the recession;
- Made fewer (and smaller) company acquisitions – They preferred organic growth and often pursued partnerships or joint ventures instead of acquisitions;
- Were more highly diversified – Companies such as Cargill, Koch Industries, Tata and LG were far more diversified than the average corporation – 46 per cent of family businesses were highly diversified, compared to only 20 per cent of the comparison group. This is an important point that we shall return to in the next chapter;
- Were more international – They generated more sales from abroad than their comparison group but they achieved this foreign growth organically or through small local acquisition, without big cash outlays.
- Had lower staff turnover – They focused on 'creating a culture of commitment and purpose, avoiding layoffs during downturns, promoting from within, and investing in people'.

Katchaner et al. (2012) observed that in times of economic boom these family businesses underperformed financially but in times of recession they over performed, compared to their peers. They concluded that these businesses were taking a longer term view focusing on financial resilience rather than short-term performance, thus increasing their chances of survival during recession:

> A CEO of a family-controlled firm may have financial incentives similar to those of chief executives of nonfamily firms, but the familial obligation he or she feels will lead to very different strategic choices. Executives of family businesses often invest with a 10- or 20-year horizon, concentrating on what they can do now to benefit the next generation.

This long-term focus on family continuity and legacy is supported by a large-scale survey that also concluded that this affects both long- and short-term decision-making (Clinton et al., 2019). It also concluded that the firms attempted to balance 'the desire to retain the core elements of the family tradition with the need to adapt and innovate', while acknowledging that this balance often caused tension. This tension is about balancing investment in currently secure and apparently low-risk income streams with investment in innovation – a topic we return to in the next chapter.

Case insight 21.3 Fisherman's Friend

Family firms

Back in 1865 a pharmacist called James Lofthouse, who lived in the fishing village of Fleetwood in Lancashire, England, made a few jottings in his recipe book for a lozenge that cleared the nose and throat when blocked with mucus from colds and flu. For the next 100 years the lozenge was sold to the fishing community in Fleetwood and it was the fishermen that coined the name 'Fisherman's Friend'. But when Doreen Lofthouse married into the family things started to change. She was the driving force behind Fisherman's Friend, now a global brand worth £165 million and selling over five billion lozenges a year in more than 120 countries. Almost all (97%) of production is exported and the firm has won the Queen's Award for Export Achievement three times. Still based in Lancashire, in 2013 profits were £1.9 million on turnover of £43.4 million and the company employed some 280 staff.

The lozenge's strong distinctive taste comes from its blend of liquorice, menthol and eucalyptus oil. The 'inventor', James, never made much of the lozenge and the book of recipes passed to his son, Charles, and then to Charles's son, James, who married Frances, daughter of a Yorkshire miner. Tony was their only child. The family ran a small pharmacy in Lord Street in Fleetwood, and in the summer they would open a seafront gift shop for the visitors from nearby Blackpool. It was here that the lozenges became popular, so much so that people would write to the shop ordering more. These were sent off by Frances Lofthouse, Tony's mother, complete with a hand-typed label. Tony was working in the gift shop when he met Doreen. It was Doreen who, seeing that so many people went to the trouble of ordering the lozenges by post, realised that there was an untapped market beyond the town. She went to the nearby towns and persuaded shops to stock it. The breakthrough came when Doreen persuaded Boots, the high-street pharmacy chain, to stock the lozenges. It was actually Doreen who registered the name 'Fisherman's Friend', although the family had been using it for some time.



Source: *Nel Botha from Pixabay*

These days the lozenge comes in 11 flavours, from blackcurrant to mandarin (popular in the Far East) as well as the distinctive original, although only seven can be found in the UK. Two-thirds of the company's shares were held jointly by Doreen and Tony Lofthouse (until his death in 2018), and the remaining third by a family foundation and their son Duncan, who is managing director. Duncan is the youngest of the Lofthouse family and has no heir. What will happen to the famous brand when the family retire remains an unanswered question.

Access the *Digital Links* booklet to visit the company website and to watch a video that tells the story of Fisherman's Friend, showing how the lozenges are made.

Question:

1. What are the advantages and disadvantages of Fisherman's Friend remaining a family-owned business?

CONFLICT BETWEEN FAMILY AND BUSINESS CULTURES

There are some disadvantages associated with family business. At the heart of a family firm are its distinctive values and beliefs – its culture. As we have observed, often a strong family culture can strengthen the business, reinforcing brand identity. A survey of UK family businesses found that 81 per cent were guided by their founder's guiding values in deciding their future direction and the same percentage emphasised the importance of the firm's social responsibilities within society (Clinton et al., 2019). This family culture impacts all stakeholders, not just customers. Many successful family firms were originally built around strong religious ethics whereby the success of the firm was shared with the workforce – the notion of reciprocal obligation. In many ways the workforce becomes an extended family, and relationships are cemented with trust and respect for the founding family. For example, John Cadbury built Bournville model village for his workers, just as Titus Salt built Saltaire (Case insight 20.5). Families can display their values and beliefs in all sorts of quirky ways in the family firm. Sometimes these are good for the firm. They can bring clear values, beliefs and a focused direction. However, they can also bring a lack of professionalism, nepotism rather than meritocracy, rigidity and family conflict or feuding into the workplace. Any consultant who has worked with family firms realises how important it is to understand the family politics if they are to understand how the business operates.

While family culture can be a tremendous asset for the firm, if it is not aligned with the values, beliefs and culture of the business it can also create friction and the potential for conflict. The problem arises because families exist primarily to take care of and to nurture family members. Families value this emotional capital. Family culture is typically instinctive, based on a right-brain emotion emphasising loyalty, caring, sharing and collectivism. It is based on trust. It is inward-looking and lasts a lifetime. In contrast, business exists to profitably generate goods and services and therefore business culture is typically left-brain logical, unemotional, task-orientated, individualistic and based on self-interest. It is outward-looking, rewarding good performance and penalising the lack of it. Conflict between the two cultures is unlikely at start up, but, as the firm grows and time passes, the potential for conflict increases. This is shown in Figure 21.3.

Family cultures can be complex and the clash between individualism (e.g. the 'rebel' child doing what they want) and collectivism (doing things together or doing what is good for the family) within it can cause disputes, disruption and even the disintegration of some families. Lansky (2016) talked about 'familyness' being essential in providing support for personal development efforts, but too much can 'stifle personal development by ignoring or even suppressing individual beliefs and needs, motivating members to seek greater distance from the family, for fear they will be subsumed or even consumed by it'. This balance between self- and collective-interest is essential in taking a family firm forward. There must be reciprocity and recognition of mutual self-interest for it to survive.

Gomez-Mejia et al. (2011) argued that the socioemotional wealth (SEW) of the family affects decision-making within it. SEW characterises the emotional value associated with a family firm. It

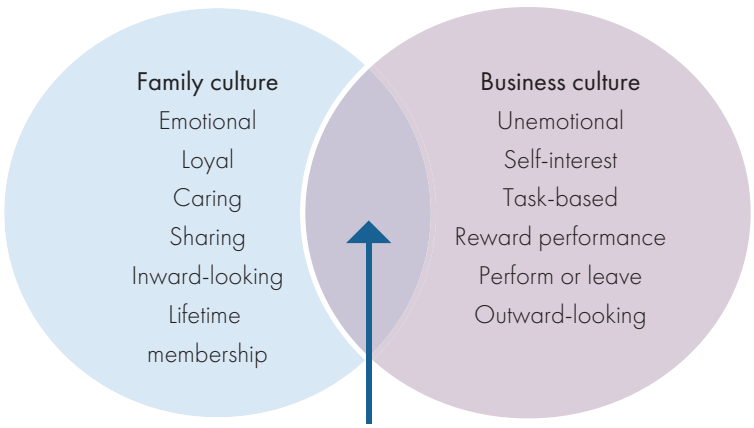


Figure 21.3 Family vs business cultures

serves to meet the family's affective needs like identity, influence and perpetuation of the family dynasty, and means that decisions can be made for seemingly irrational, specifically non-economic, reasons which are not always in the best interests of the business. On the one hand, high levels of SEW in a family firm might be universally beneficial, for example by prompting the firm to act in philanthropic ways or by showing high levels of social responsibility. However, it could also become a driver of selfish and self-serving behaviour by the family, for example by appointing incompetent family members to managerial posts in the company. The point is that these decisions might reflect the politics of the family. A non-family firm might make very different decisions. And the complexities around SEW grow as the family involvement in the business becomes more diffuse with each succeeding generation.

SEW is used to explain why and how business and family identities can be closely linked. At its best this can work to the benefit of both the family and the business. The business can become not only a source of income for the family but also a framework for family activity and an embodiment of the family's pride and identity (Zellweger et al., 2013). The family's values and identity can benefit the company by becoming part of its brand and culture. The point is that it is important that there is a close identity fit between the identity and culture of the family and the firm, and in particular the family's reputation and that of the company.

The three circle model of authority in the firm shows the overlap of interests in the family firm: family, owners and management (Tagiuri and Davis, 1996). Owners tend to be interested in financial capital: business performance, dividends and wealth creation. Managers are employees and tend to be concerned with strategy, social capital (professional reputation) and emotional capital (career opportunities, bonuses, fairness). Neither of these are necessarily the SEW that interests the family. However, members of the family might also be owners and managers. Kets de Vries et al. (2007) used the model to point out that where roles overlap it can cause conflict between individuals – owners, managers and members of the family – and that only the founder or a senior family member may hold all three roles, in which case they must resolve the conflicts within themselves (see Figure 21.4).

The emotion-based family culture operates at a subconscious level. There are deep emotional ties that create love, trust and loyalty; but equally there can be disruptive influences like divorce, rivalry between siblings or conflict between a parent and son or daughter. While families are based on permanence and stability, entrepreneurial firms are based on opportunity and change. Even the positive influences of the family may be bad for the business; for example, when parental pride and loyalty gets in the way of objectivity and a son or daughter is appointed to a management position they do not have the skills to undertake. If there is a conflict of interest between the family and the firm, for example in making the dividend payment that the family expects but the firm can ill-afford, whose interest comes first? And the very closeness of the family can create an impenetrable barrier for the

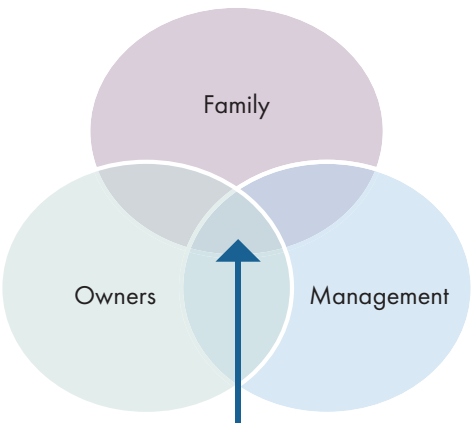


Figure 21.4 Three circle model of authority

> *You have to work with the family in a professional way. The most important thing ... is to give them the job and resist interfering ... If someone doesn't come up to expectation, then you get rid of them, don't allow it to drag on.*
>
> Gulam Noon, founder of Noon Products, *Family Business*, The Story Centre for Family Business, 8(1), 2000

non-family manager who might feel 'passed over' for promotion in favour of family or feel left out of the decision-making that seems to take place 'around the kitchen table'.

Not surprisingly, family culture can influence the management style within a family firm. Research by Ram and Holliday (1993) suggested that family firms tend to adopt a style of 'negotiated paternalism', although Alderson (2011) argued that it changes as one generation succeeds another. Because of the relationships between family members, family businesses tend to use fewer formal management techniques. Family influence acts to dilute managerial power and discretion, with family members often able to negotiate their duties. In the researchers' opinion this can constrain operating efficiency and lead to management practices that are 'sub optimal'.

While generally it is family that influences the business culture (Denison et al., 2004; Fletcher et al., 2012), business can also influence the family culture. Indeed, business can exact a toll on family life. The separation between the two can become very blurred in a family firm. Building a successful business can become an obsessive, single-minded occupation that drives family life into the shadows, creating tensions at home as well as at work. Married couples working together may feel unable ever to 'get away from the shop' and let the stress and tension of growing a business damage their personal relationship. Conflict at work – and there will be conflict in any growing business – may continue at home, feeding on itself and intensifying. A husband-and-wife team that divorce will find it difficult to continue working together. To survive, a family must learn to separate family and business life. Business and family issues need to be addressed directly, in an open and balanced way that allows the business to be run properly while not disrupting family harmony. Good communication is the key to a successful family and business. This is not always easy.

Case insight 21.4 Mars Inc.

Family and business values

Mars is the sixth-largest private company in the USA. The company is home to global food brands such as Mars, Milky Way, Snickers, Twix and M&Ms as well as Whiskas, Pedigree and Uncle Ben's. It is also a family firm and the Mars family is one of the richest in the world with an estimated wealth of some $126 billion. The company's founder, Forrest Mars (Snr) was born into a confectionery-making family in 1904. His father, Frank, ran a modestly successful business in Minnesota where he made buttercream candies overnight and his wife, Ethel, sold them from a trolley the next day. They had two main products, the Mar-O-Bar and Victoria Butter Creams, which became successful in 1923 when Woolworths started distributing them. Forrest Mars claimed that the idea for the family's first really successful product, the Milky Way, came to him while sitting drinking a chocolate malt drink in a café and he suggested to his father that he should put it into a chocolate bar. Sometime later, his father did just that, putting caramel on top and chocolate around it. Milky Way was a huge success with sales of $800,000 in its first year. The family moved to Chicago and Frank built a mansion in Wisconsin. However, relations between father and son deteriorated as Forrest wanted further growth and expansion but Frank wanted to settle for an easy life.

In 1932 Forrest Mars left to set up a one-room chocolate business in Slough, England. He quickly produced a similar product to Milky Way, calling it a Mars Bar, using creamier milk chocolate and a sweeter toffee filling. The Mars Bar is a very British product, unknown in the USA. The company returned to the USA in the late 1930s with the hugely successful M&Ms, the candy-coated chocolate 'that melts in your mouth, not in your hand'. Also in this period the company made the first moves into the European pet food industry by combining modern manufacturing techniques with nutritional science. In 1946 it applied modern manufacturing techniques to parboil rice and launched Uncle Ben's rice.

Forrest Mars (Snr) died in 1999, leaving the business to his three children: John (with three children), Jacqueline (with three children) and Forrest (Jnr), who died in 2016 leaving his shares to his four daughters, three of whom work in the business. Mars Inc. is committed to remaining under private ownership and a number of members of the family work in the business. It is now governed by a board of directors made up of Mars family members (who take turns acting as chair) and advisors, and run by a global management team led by president and CEO Grant F. Reid.

Forrest Mars (Snr) was a recluse and he and his family shunned public life. This secrecy continues to the present day with the

family very protective of its private life, rarely giving interviews or even allowing photographs to be taken in public. This secrecy spilled over into the company. When Forrest (Snr) died in 1999, the family did not even acknowledge the fact or that he had worked for the company. In 2020 it filed a lawsuit against another company for illegally downloading Mars internal documents, including detailed financial results and strategic planning documents.

Forrest (Snr) lived and work with a frugality that is in stark contrast to many modern firms. No one had a private office. There were no company perks such as cars, reserved parking or executive toilets. Employees did their own photocopying, made their own phone calls and travelled economy class on planes. Employees were known as 'associates' and were on first name terms. Forrest (Snr) had a management philosophy that involved five principles that are still followed by the company: Quality of work; Responsibility; Mutuality of benefit; Efficiency in use of resources; and Freedom to make financial decisions 'unrestricted by motivations of others'. The company now also has a 'compass' that comprises four quadrants that guide its long-term strategy: 'Top-tier' financial performance; Quality growth; Positive societal impact; and being a Trusted partner with its stakeholders. Successive chairs of the company, all family members, have reiterated that the company will remain private and in control of the Mars family.



Access the *Digital Links* booklet to visit the company website and watch a video telling the story of the Mars family.

Questions:

1. Why do you think the Mars family wish to retain ownership and control of the business?
2. What does the principle of 'mutuality of benefit' mean and why is this important?
3. What does the principle of 'freedom to make financial decisions unrestricted by motivations of others' mean and why is this important?
4. How important were these principles in growing the business?
5. What does the current 'compass' say about the company?

GENERATIONAL SUCCESSION

Another problem for a family business is the issue of generational transition – the mechanisms by which business leadership, ownership and knowledge are passed from one generation to another. Most owner-managers in Europe want to keep their business in the family – 57 per cent in Germany, 62 per cent in Italy and 74 per cent in Spain – although this figure dropped to 32 per cent in the UK where owner-managers preferred to sell the business, usually to a trade buyer, in order to make a capital gain (Burns and Whitehouse, 1996). Most owner-managers who had inherited their business wanted to pass it on to their children. Once the business is passed on to the next generation there seems to be a strong emotional commitment to keeping it (Family Business Institute, 2007).

However, there seems to be a mismatch between aspiration and reality. There is an old English adage repeated in many countries: 'from clogs to clogs in three generations'[1] – meaning you might find wealth but you can easily lose it all in three generations, and this is definitely true in relation to family firms. And despite the desire of many owner-managers to keep their business in the family, with the passing of each successive generation the chances of surviving the transition diminish. It has been estimated that both in the USA and UK less than a third of family businesses survive into the second generation, about 10 per cent survive into the third generation and less than 5 per cent into the fourth generation (Family Business Institute, 2014; Poutziouris and Chittenden, 1996). Of course, we noted in the previous chapter how large firms seem to have a natural life cycle, and family firms are not immune from these pressures. Nevertheless, succession is becoming an increasingly important issue in Asia because so many of the businesses there are relatively young and the issue is arising for the first time. Indeed, a large-scale study of 200 transfers of power in family-controlled companies listed on the Hong Kong, Singapore and Taiwan stock exchanges showed that these companies lost, on average, some 60 per cent of their market value during the transition from one generation to another (Bennedsen and Fan, 2014).

1 Around the world there are similar expressions to communicate this three-generation pattern of moving from poverty to business wealth, and back again to poverty: rags to rags, shirt sleeves to shirt sleeves, camel to camel, stable to stable, rice paddy to rice paddy.

It's an Asian way of working. We are all focused on what we are doing and we are working for succession. It's all in the family. We are not growing the business for an exit route.

Bharat Sha, founder of Sigma Pharmaceuticals, Kenyan Jewel: www.alusainc.wordpress.com

De Massis et al. (2008) suggested that there is a chain of causation that results in an abortive succession attempt. They undertook an extensive literature search and listed the factors in Table 21.1 as most likely to prevent succession. These issues are many and various, and not always restricted to what we might call a family business.

Table 21.1 Factors likely to cause unsuccessful succession in a family business

* Low ability of potential successor(s)	* Decrease in the scale of the business
* Dissatisfaction/lack of motivation of potential successor(s)	* Inability to find financial resources to liquidate the possible exit of heir(s)
* Unexpected loss of incumbent or potential successor(s)	* Inadequate financial resources to absorb the costs of hiring professional managers
* Personal sense of attachment of the incumbent with the business	* Loss of or decline in the relationship between the potential successor(s) and customers or suppliers
* Incumbent's unforeseen remarriage, divorce, or birth of new children	* Late or insufficiently exposing potential successor(s) to the business
* Conflicts/rivalries/competition among family members	* Not clearly defining the roles of the incumbent and the successor(s)
* Lack of trust in the potential successor(s) by family or non-family members	* Incorrectly evaluating the gaps between needs and potential successor's abilities
* Lack of commitment to the potential successor(s) by family or non-family members	* Not communicating and sharing the decisions related to the succession process with family members and other stakeholders
* Perils related to high 'consensus sensitiveness' of the family business	* Not giving the potential successor(s) sufficient feedback about the succession progress
* Conflicts between incumbent/potential successor(s) and non-family members	* Not formalising rational and objective criteria for selection
* Inability to sustain the tax burden related to succession	* Not defining the composition of the team in charge for the assessment of potential successor(s)
* Change in the business performance	

Family business succession is a complicated interplay of the life stages of family members and the multiple transitions of roles and responsibilities. Churchill and Hatten (1997) developed a four-stage model that shows generational succession over three generations (Figure 21.5). This provides a framework that shows the family dynamics during the process of succession and transfer of power from one generation to another. It suggests that changes in management, strategy and control can be planned and executed over the four stages, but are shaped by family relationships and driven by the inexorable human life cycle. In the model the life cycle of three generations is expressed as the level of influence a family member has on the strategic orientation and operations of the business, during the phases of family business development.

Stage 1: Owner-managed business

This is the early stage, beyond start-up, when the founder is in control but a son or daughter is introduced into the business on a permanent basis. Ward (2004) noted that the founders who were most successful in drawing competent heirs into the business were those who saw their role as stewards of the family business, a characteristic that made them less controlling, more objective and selfless.

Stage 2: Training and development of the new generation

This is the stage where decisions are made, although not always formally, about passing the business on to the son or daughter and a process of training and development should be taking place to groom

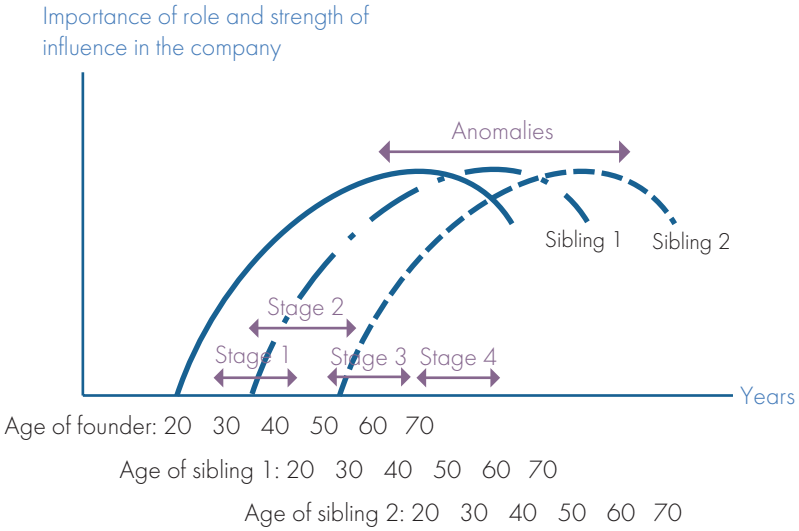


Figure 21.5 The family business life cycle

Source: Churchill and Hatten (1997).

them for their role. All of the leadership skills acquired by the founder in running the business need to be applied to leading succession within the family: having a vision (for a family dynasty); creating a strategy (to facilitate succession); communicating the vision and strategy; creating the family culture (to facilitate succession); and managing the process (Chapter 16). Open and frank communication is the key.

Stage 3: Partnership

This is the stage when the son or daughter shows sufficient business acumen and expertise that the founder starts to loosen the reins of control, delegate authority and share responsibility with them. At the same time the son or daughter needs to be able to work in partnership with the founder. They need to understand both the challenges facing the business and the issues facing the family.

Stage 4: Power transfer

This is the phase when strategic planning, management control and operational responsibility shifts from one generation to another. The succession process accelerates as the founder begins the retirement process and reduces their active participation in the business. At this stage they need to be able to let go and step back.

This four-stage model repeats, with increasing complexity as new generations join the firm. The problems arise as one generation hands over to another – the areas marked as 'anomalies' in Figure 21.5. These problems become more complex as ownership, and possibly management, is diluted among a wider and wider family group. It is here that there is conflict within the family and here that there is the greatest danger facing the business. Alderson (2011) reports that decision-making within the firm changes as each generation succeeds another. The founder made decisions themselves. The second generation probably tended to be more consultative. And by the third generation, decision-making has become more consensual, with other members of the family influencing the outcome. And through these multiple transitions there is always the increasing possibility that management and ownership of the family business becomes split.

Case insight 21.5 Morgan Motor Company (2)

Family conflict

Founded in 1909 by Henry Morgan, the Morgan Motor Company produces quintessentially British sports cars with 1930s looks but 2020s technology. They may have developed a lucrative market niche (see Case insight 7.2) but the family ownership seems to have become problematic after Peter Morgan, son of Henry, was replaced as chairman by Alan Garnet (a non-executive director) after his death in 2003. Garnet resigned in 2006 and was replaced by a four-man management team comprising Charles Morgan (son of Peter), Matthew Parkin, Tim Whitworth and Steve Morris. Parkin resigned in 2010 and Charles Morgan became managing director.

In 2013 Charles Morgan was 'removed' both as an employee and member of the board of directors with the company saying his plans to take the company's unique brand into new markets such as China and to start racing Morgan cars again 'did not fit with the philosophy of current management'. This meant that there were no members of the Morgan family involved with the company, although Jill Price, Peter Morgan's daughter, and members of the extended family continued to be members of the board of directors. Shortly after this the family appointed Andrew Duncan, a local solicitor, as chairman. In 2016, he resigned as chairman and company director and was replaced as chairman by a new director, Dominic Riley. In 2019 the company was sold to the Italian investment group InvestIndustrial (which owns a stake in a similar car maker, Aston Martin Lagonda). As part of the purchase agreement, management and staff were rewarded with shares in the company. The Morgan family retained a minority shareholding.

It is impossible to know what went on behind closed doors in the family and the company, but Jill Price, Peter Morgan's daughter and board member, said the family were delighted with the outcome.

Questions:

1. What do you think went on behind the closed doors of the family and the company?
2. Is this purchase, in your opinion, a sensible outcome:
   a. For the family? Explain.
   b. For the Morgan company? Explain.

RELATIONSHIPS WITH SIBLINGS

The succession from one generation to the next is the most likely point of conflict in the family business. And although daughters are being brought increasingly into the family business, the most common form of succession is still from father to son. Many father–son relationships can work extremely well, but psychologists tell us that this relationship has a unique potential for conflict. If you revisit the personal qualities likely to be present in the entrepreneurial founder, detailed in Chapter 3, you will realise that an entrepreneur is likely to have a very close emotional link with the business. A male entrepreneur is likely to see it as an extension of himself, a symbol of his achievement, even an extension of his masculinity. He may guard power jealously and have problems with delegation. He may want to facilitate his son's succession but he may also want to control it. Subconsciously he may feel the need to be stronger than, and in control of, his son, and succession may be seen as a 'threat' to his masculinity. This can result in rivalry between father and son, each trying to be the dominant character.

From the son's perspective things are different. We are told that rebellion is natural in youth but, although it is tolerated and sometimes encouraged at home, at work it is something that is normally repressed. Even in its mildest form, this natural tendency will show itself in an increasing drive for independence from father. But if father is also the boss, there is potential for conflict, particularly if father is himself having problems delegating control. So the scene is set with a rebellious son, pressing for more power within the firm, seemingly opposed by a father who, at the same time, is saying that he wants to pass the business on to the son. To the son, the father may appear to be hanging on to power and he may begin to doubt whether father really will retire. In fact, he may even begin to distrust his father, and that is the start of the end of the relationship. At the very least, the contradictory signals from the father are likely to lead to frustration in the son. What is more, for the son the option of leaving the business is problematic as it might be seen as disloyalty to the family.

Levinson (1983) described how fathers often try to avoid conflict. For example, they might cultivate an atmosphere of ambiguity in decision-making where rules and boundaries are unclear and they can

Case insight 21.6 Ferrero Group

Family succession

Ferrero Group is the third-largest confectioner in the world, with over 35,000 workers and a turnover in excess of €11 billion, selling into over 170 countries. Based in Luxembourg, the Group comprises some 104 companies worldwide, with manufacturing operations in 31 countries. The company was founded by Pietro Ferrero and his wife Piera in the Italian Alba region in Piedmont in the immediate post-war years. They produced a chocolate bar which included nougat and hazelnuts and called it *pasta gianduja*. With his brother Giovanni, Pietro Ferrero founded the company to produce and market the product. Giovani died in 1957 and the company bought out his shareholding. Pietro handed the business over to his son, Michele, who became chief executive. He renamed the product, Nutella, in 1964. The same basic recipe is used today for its famous Nutella chocolate spread, to which Michele added liqueur to make the famous Ferrero Rocher chocolate. Other brands owned by the company now include Kinder, Mon Chéri, Tic Tac and Thorntons.

Ferrero is a private company controlled by the Ferrero family. Up until Michele's death in 2015, aged 89, he had headed both the family and the company. He died Italy's richest man with a fortune estimated at $26 billion. Michele was a staunch Catholic and it is believed that he named the Ferrero Rocher chocolate after the craggy rock grotto, called the Rocher de Massabielle in Lourdes, France, the location of a reputed appearance of the Virgin Mary. He erected a statue of Mary in every production facility and every three years organised a pilgrimage to Lourdes for Ferrero workers. On 29 June each year, executives attended church in the Basilica of San Domenico, Bologna, to honour the day the company was founded. Michele has been described as a workaholic and an autocrat with a paternalistic management style. The firm was described as 'one of the world's most secretive firms' (*The Guardian*, 2 July 2010). It never held a press conference and did not allow media visits to its plants. Its products are made with machines designed by a secretive in-house engineering department. The company followed a number of 'core principles' outlined on its website, which include 'loyalty and trust', 'respect and responsibility' and 'integrity and sobriety'.

Michele's two sons, Pietro and Giovanni, had been involved with the company for a number of years, and in 1997 became co-chief executives (Michele remained chairman). However, Pietro died unexpectedly of a heart attack in 2011. When Michele died three years later things changed. He had owned the company and it was now divided among the family, leaving the majority of shares to Giovanni and the rest to Pietro's heirs in trust. Giovanni is reported to have felt 'overwhelmed' by being both CEO and chairman.

In 2017 Giovanni appointed a company insider but non-family member, Lapo Civiletti, as CEO, 'focused on the achievements of the short and mid-term results'. Giovanni took the role of executive chairman, 'focusing on long-term strategies, new business directions and breakthrough innovation, while assuring continuity in the company's culture and values'. The CEO reports to the executive chairman. A raft of new managerial appointments was made at the same time – all publicly announced as 'enhanced new governance'. Giovanni even gave interviews to the press. He had studied marketing in the USA before joining Ferrero in the 1980s. His experience in the family firm displayed his commitment and focus.

In the past the company had focused mainly on organic growth. It saw itself as producing more up-market products. However, Giovanni also decided to completely change the company's strategy and focus on growth:

> *'I feel like we are duty-bound to grow ... We are in love with a growth algorithm of 7.33 periodic [7.33% per annum] because, organic or nonorganic, that would double the company in a ten-year time horizon.'* (Forbes, *26 June 2018)*

Giovanni started on an acquisitions spree – something his father had fiercely resisted. The company had purchased Oltan Group in 2014, the largest hazelnut producers in the world, in order to secure its nut supplies. However, after this Giovanni focused on buying market share and buying out competing confectioners: Thorntons (2015), biscuit brands Delacre and DeliChoc from United Biscuits (2017), Fannie May (2017), Ferrara Candy Company (2017), Nestlé's US sweet business (2018), a range of Kellogg's brands (2019) and Kelsen Group (2020). This is an expensive strategy but Giovanni believes in scale and that, in time, a few key players will come to dominate the confection market with Ferrero's existing product range not big enough to compete. However, this flies in the face of the views held by his late father and other industry experts, who believe consumers are shifting into more premium sweets and healthier foods. Only time will tell whether this complete turn-about in strategy will work.

Access the *Digital Links* booklet to visit the company website and watch a video about the Ferreo company and family.

Questions:

1. How much power does Giovanni now have in the company and in the family?
2. Why has the company been able to follow this expensive acquisition strategy?
3. Is it wise to fly in the face of dominant industry logic?

'meddle' – in this way avoiding any overt conflict. Alternatively, they may defer decisions until the last possible moment, continually putting off the time for conflict. The father seeks to avoid the business conflict because he does not want to harm his family relationship with his son. However, conflict is rarely best handled through avoidance, and putting off an important business decision is usually a very bad idea.

Leach (1996) claimed that father–daughter relationships are less problematic. Fathers seem more able to accept advice about the business and some criticism from daughters, and they often say that they would react to sons saying the same thing as if it were a personal attack. He observed that fathers do not feel threatened by daughters, and daughters are more accommodating, being brought up to be more nurturing, attuned to emotional needs and giving priority to family harmony. Perhaps that is changing.

> *You have to prove yourself more when it's a family business. You have to show that you are serious about your job and about your career. You only get respect by working alongside people and not being just the boss's daughter.*
>
> Zeenat Noon, daughter of the founder of Noon Products, *Family Business*, The Story Centre for Family Business, 8(1), 2000

Despite the growing importance of women in business, there is little research into mother–son relationships in the family firm, and even less mother–daughter relationships. We know next to nothing about the influences of an extended family (except in the context of ethnicity) or the development of new forms of families, such as those based upon gay relationships. Indeed, the assumed relationship in most of the literature is that of a patriarchal hierarchy. Perhaps the future will see a redefinition of the term 'family business'.

There can be yet another layer of complexity to the problems facing the family firm, this time caused by sibling rivalry. Sibling rivalry is normal, but some parents actively encourage it, particularly in the context of the family firm. If a number of sons and/or daughters work in the firm, there may be rivalry between them as they vie for favour in the eyes of the father or mother. The custom of favouring elder sons with respect to inheritance, although in decline, still shows itself when it comes to succession in the family firm. Elder sons may be favoured at the expense of daughters or younger sons who may be more able. This can lead to the best talent leaving the family business or the brothers or sisters trying to carve out niches for themselves in the business to establish their independence. Even if the business is split equally between the children, there is the danger of sibling rivalry becoming institutionalised in the firm.

RELATIONSHIPS ACROSS THE FAMILY

All businesses must adapt and change to meet the demands of a changing marketplace, but there is a danger that family firms will become moribund and unable or unwilling to respond with each succeeding generation. Many firms do, of course, adapt. However, some become increasingly introverted – becoming inward-looking, unresponsive to messages from the marketplace and unreceptive to new ideas. They might even become unwilling to recruit managers from outside the firm or, worse still, from outside the family. How does this come about?

It is not surprising that, as the size of the family increases with each succeeding generation, the tensions and the complexity of the problems that the family business faces can increase. At the same time ownership of the business might be diffused among an ever-growing family. Families can become distracted from the business for a number of reasons, not least the size of their shareholding and day-to-day involvement in its management. Disagreement between family members might paralyse decision-making within the firm. Avoidance behaviour in the extreme might lead to important business issues not being addressed. Damage done to the firm and relationships within it by the traumatic succession from one generation to another might leave it weak and, like the rabbit caught in the headlights of the car, traumatised. The past success of the firm which has led to increased prosperity for the family might itself cause problems. The family might start to regard the firm as their main store of wealth, demanding regular dividends when the firm can ill-afford them, imposing restrictions on commercial decisions that reflect their risk aversion or vetoing capital investment decisions because it would drain cash flow. The family might also start to view the firm as a Cash Cow, draining the cash away through expense accounts, pensions, cars and other perks or 'jobs for the family'. Borrowings might be vetoed because the family do not want their main store of wealth and source of income to be exposed to any form of risk or the possibility that they might lose control.

All of these things damage the business and can mean that it is not doing what it is supposed to do, that is, profitably generate goods and services.

The interests of the family are often seen as coming first in the family firm. However, what those interests might be can differ from one member of the family to another, and the larger the family, the greater the potential for different views. How these views might influence the business – both formally and informally – depends on the relationships within the family but, as we shall see in the next section, there are ways that these conflicts can be resolved in a more pragmatic and objective fashion than just relying on family politicking and in-fighting.

The problems facing the family firm can be compounded by a sense of alienation felt by non-family members as they see cash being squandered and no decisions or bad decisions being made. The continuous politicking and family in-fighting may make them feel uneasy and unsure about the future direction of the firm. They may feel forced to take sides when they do not wish to. They may feel that they are not part of the decision-making at all or that family considerations are always paramount. They may feel passed over for promotion in favour of less able family members. They might feel that there is no system for adequately rewarding them for the good work they do, for example by taking some equity in the firm, because the family would not countenance losing control. Indeed, the family might actively discourage or prohibit the employment of non-family managers.

Many of these issues come down to the business no longer having clear leadership. Second-generation firms might have a board comprising three brothers or sisters each with equal shareholdings and none with clear control. Perhaps none of them possess the entrepreneurial spirit of the founder. They may even all dislike each other and be unable to agree on anything. To compound the problem, shareholding might be diluted and distributed wider across an extended family. To avoid this catastrophe, family firms need ways of managing succession and resolving family conflict. The focus needs to shift from what the business can do for the family to what the family can do for the business, and two important questions need to be answered. Firstly, what special contribution can each member of the family make to the business? A family might have assets that can be leveraged to help the business. Apart from the personal qualities of family members, these might include strong family values or personal and business networks. Secondly, how can the business make best use of these contributions? By leveraging these family assets, the value of the business will be increased, as will the family store of wealth.

Bennedsen and Fan (2014) suggest that the importance of these family assets (personal qualities, values, networks etc.) and the barriers to using them (degree of family conflict, size of family legal constraints etc.) are key drivers of what *should* be the extent of family involvement in the business and its ownership structure. Figure 21.6 is based upon their work. It suggests that where the assets

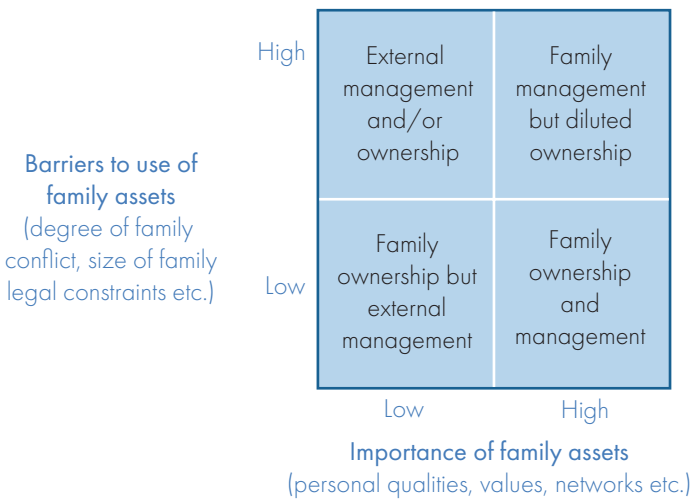


Figure 21.6 Influence of family assets on the structure of the family business

are important and the barriers low, then the firm can remain closely held with a strong involvement by the family in its day-to-day running. Even where the barriers are high, the family might still be involved in the management of the firm, even if it does not have control, for example because it has 'gone public' at some point. However, where the importance of the family asset is low and the barriers to ownership are high, then there is a strong incentive for the family to sell or dilute its ownership. Even where the barriers are low there will be an incentive to dilute ownership or, at the least, bring in external management.

In addition, how external management reacts to the complexity of the family firm is also a factor. Where the importance of the family asset is high, the role of external management may well be diminished and in any family firm the process of conflict resolution is likely to be political, with the external manager feeling that they are not part of the family decision-making. Non-family members can feel marginalised and undervalued. There is therefore the need to evaluate the performance of all staff objectively and reward and promote family employees strictly in line with their contribution to the firm. Being a member of the family should not be part of the criteria for promotion or appointment and delegation outside the family should be taking place regularly for sound commercial reasons. In other words, the culture of the family business needs to firmly emphasise business.

Case insight 21.7 Timpson Group

Family values

In 1865 William Timpson opened the first Timpson boot and shoe repair shop in Manchester. By 2020 Timpson had become the UK's leading retail services provider offering shoe repairs, key cutting, watch repairs, dry cleaning, engraving and assisted photo ID, with over 2,000 owned stores (including Johnsons Cleaners outlets) and some 110 Snappy Snaps franchises. All outlets are small units placed in high-footfall locations, many in concessions or pods in supermarkets. With a turnover of £330 million (profit £31 million) it employs over 5,000 staff (called 'colleagues').

The company's history is interesting. Having expanded into shoe-making it was listed on the stock market in 1929 and bought out by United Drapery Stores in 1973 only to be bought back in a management buy-out by John Timpson (who had continued to manage the business) from the then owners, Hanson Trust, in 1983. Funding came from selling the freehold of its stores and leasing them back using debt financing raised from venture capitalists. After four years of poor trading the company sold off its loss-making shoe retail business to repay its loans, leaving it focused on shoe repair and key cutting. The firm gradually diversified into the areas covered today and in 1993 John Timpson bought out the remaining non-family shareholders to form the Timpson we recognise today. The company is still owned and managed by the sixth generation of the Timpson family – John Timpson is chairman and his eldest son, James, is chief executive. And the family ethos and culture is very clear to see in everything the firm does.

The company believes in what it calls 'upside down management' which is essentially about delegating responsibility and trusting staff to do what they think is right and deal with customers in an honest and fair way. Staff can change shop prices, invent new displays and pay up to £500 to settle a complaint. They are selected on their personality and encouraged to use their initiative. There are only two rules: dress appropriately and put the money in the till. Dishonesty results in dismissal.

Timpson offers a long list of benefits to its colleagues. There is a weekly bonus scheme based on turnover and a free weekly £1,000 lottery; colleagues get the day off on their birthday and £100 bonus on their wedding plus a wedding limousine and an extra week off for their honeymoon; charitable giving is matched up to £250 and up to £250 is paid towards driving lessons. The company offers free use of its holiday homes, discounts to family and friends, free flu jabs and has a hardship fund and mental health counsellor. Last but not least, it still offers a final salary pension scheme. James Timpson summed up the company's approach:

> *'I believe being kind is the best way to make money. The more we care for our colleagues, the better the Timpson business seems to perform.'*

Timpson is also one of the largest employers of ex-offenders, with about 10% of its workforce made up of people with a criminal record and it boasts a 75% retention rate. Working through the Timpson Foundation, it has also set up several specialist training centres within prisons that mimic the activities in its high-street stores. These act as a bridge to employment by the company. On their day of release, colleagues will often meet them at the prison gates and introduce them to their new colleagues, providing them with uniform and lunch and settling

them in to their new home. In 2017 the company also established its own charity called the Alex Timpson Trust, named after John's deceased wife who had been a campaigner for children's rights. The trust aims to help schools better respond to the emotional needs of fostered and adopted children. It sponsors education and research programmes as well as offering free holidays for foster families. The family have two adopted children and had fostered some 90 others:

*'We are a family business and can take a long-term view. Don't be fooled – we are very much a commercial business too – but I believe being kind is the best way to make money. It's also a lot more fun.' (*The Sunday Times, *25 August, 2019)*

Access the *Digital Links* booklet to visit the website and to watch videos outlining the history of Timpson Group and explaining what the Alex Timpson Trust sets out to do.

Questions:

1. What conclusions do you draw from the history of the company?
2. How important are the 'family assets' to Timpson? Does the structure of the firm 'fit' with Figure 21.6? Explain.
3. Would Timpson have been better as a social enterprise rather than a private family business?

Explore further 21.1

Strengths and weaknesses of family business

Access the *Digital Links* booklet to watch a range of videos:

- Professor Rob Nason explaining the importance of family firms & some of the challenges they face.
- A TED talk by Vikram Bhalla looking at the strengths and weaknesses of family firms and their dynamism in emerging economies.
- A KPMG animated case history illustrating the potential problems facing a family business.
- A *Financial Times* video shot at the World Entrepreneur of the Year event featuring CEOs from leading family firms giving advice.

IDENTIFYING AND RESOLVING CONFLICT

Tensions between family expectations and business demands are bound to arise and will show themselves in the planning process and day-to-day decision-making. Questions like: What values and vision drive behaviour? How are decisions made? How are leadership and managerial roles decided on? How are resources invested? What form does investment take? How are profits used? How is the family protected? The more dispersed the business ownership among the family, the more likely there is to be disagreement.

One of the techniques used to highlight points of conflict and their causes is the genogram. This was first developed by McGoldrick and Gerson (1985). It is an organisational chart of a family that shows not only the hereditary links but also the relationships (close, conflicting etc.) as well as personal details of individuals (medical history, addictions etc.). It is used alongside the family tree to show hereditary relationships, patterns and psychological factors that might influence family social and emotional relationships and behaviours. These family dynamics can often highlight points of conflict. Genograms use their own set of symbols and specialist genealogy software is available (see Figure 21.7). The genogram is a useful tool and is often used by family therapists and consultants to help them understand relationship patterns within the family, particularly when trying to resolve dysfunctional or problematic behaviour.

While the genogram might identify where conflicts might arise and their underlying cause, it does not help resolve them. Arguably, the only real way to resolve conflict in the family firm is to resolve

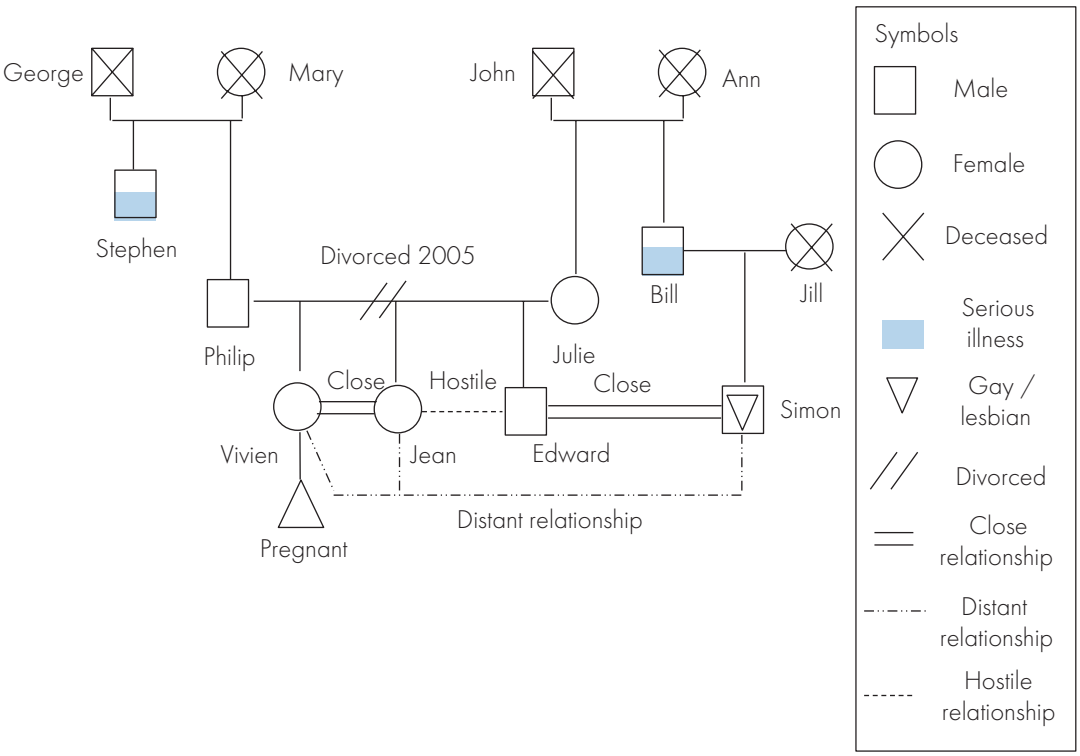


Figure 21.7 A genogram

conflict in the family itself – a very tall order indeed. However, restricting ourselves to business, the key to conflict resolution is open communication. But this in itself can lead to conflict if tried suddenly after years of avoidance – the British are known for avoiding sensitive personal and family issues and difficulties. Admitting and, most importantly, understanding the nature and cause of the problem is a good first step. Understanding that many of the problems come from our genetic make-up should help to defuse the situation and make it less personal. Understanding how individuals naturally react to conflict can help to explain why arguments happen. And here the Thomas–Kilmann Conflict Mode framework (page 362) can help explain why arguments happen between individuals and show the appropriate style to help resolve them ('collaboration' or 'compromise'). With a will, behaviours can be modified. With particularly difficult situations a third-party facilitator such as a friend or 'family therapist' or mediator, might help. Many consultancies offer specialist services to family firms.

Bonus Case Everards Brewery

Visit the companion website at bloomsbury.pub/burns-esb-5e to access this bonus case.

THE FAMILY CONSTITUTION

Many writers advocate a more formal approach to conflict resolution – one that attempts to identify issues in advance and put in place mechanisms for their resolution. The aim is to remove some of the personal aggression and arrive at more 'rational' solutions in a way that keeps the family and business intact. Kets de Vries et al. (2007) said that the family needs to create narratives or family stories that explain their emotional dimensions (SEW), identify the issues they face and develop strategies to deal with them. Leach (1996) called this a 'family strategic plan'. Carlock and Ward (2010) outlined a process for its development in parallel with the company's strategic plan, involving the process shown in Figure 21.8.

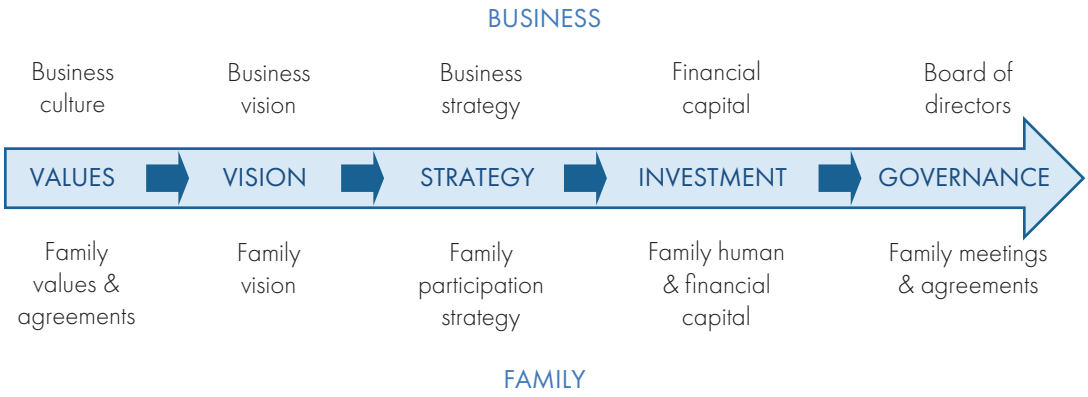


Figure 21.8 Family business parallel planning process

Part of the family participation strategy might involve training and development for family members joining the firm. Leach advocated giving sons or daughters managerial autonomy within parts of the business to help them grow and mature, separating out roles for other members of the family so as to minimise rivalry. Many writers advocate that some form of 'family council' be set up in parallel with the company board of directors to facilitate family communication and that they operate within the terms of reference of a 'family constitution'. Leach (1996) suggested that this is a four-stage process:

1. Address the critical issues relating to family involvement in the business – This involves looking at the business and the family and how they relate to each other. How are conflicts between family and business interests to be resolved?
2. Establish a family council – This provides a forum in which members can air their views and participate in policy-making. The council should develop its own ground rules as to how it operates.
3. Draw up a family constitution – This is a written statement of the family's values and beliefs and its policies and objectives in relation to the business. It is crucial to the working of this whole process and should cover these eight areas:
   a) Family values, beliefs and philosophy;
   b) Family objectives in relation to the business;
   c) Family involvement in the business – share ownership and disposal, voting and control of business;
   d) Criteria for family involvement in the business – board membership, voting;
   e) Criteria for family involvement in the business – selection of chair and managing director;
   f) Criteria for family involvement in the business – qualifications, status, jobs and remuneration;
   g) Family council meetings;
   h) Procedures for changing the family constitution.
4. Hold regular family council meeting – These meetings monitor business and family developments and maintain communication. If there is disagreement or conflict, the family constitution can be used to help resolve it.

Many writers advocate the use of non-executive directors on the boards of family companies (see Chapter 11). They can be the insurance against a company becoming too introverted. They can bring independence to boardroom discussions and should be relied on to put the firm, not the family, first.

SUCCESSION PLANNING

The usual approach to managing succession in a family business is to ignore the issue. It is almost as if owner-managers, particularly founders, are in denial about ever leaving the firm. It is a blind spot that they do not wish to discuss – a little like death. They are reluctant to relinquish power and control; they fear that doing so will somehow reflect on them, diminishing their status and identity (Aronoff and

Baskin, 2010). Founders often fear retirement – the lack of activity, purpose, independence – and often typical entrepreneurs are so single-minded that they do not have other outside interests. However, Ward (2004) believed that their overwhelming fear is loss of control of the family – the founder believes that as long as they control the business, they control the family. Love and trust were not enough. Succession planning can involve making unwelcome decisions that might change the business and upset the family, but it needs to be approached by all involved with honesty and openness.

The reality is that, if succession is not planned and managed, it can be an even more traumatic and stressful event which might threaten the very existence of the firm. Figure 21.6 provided a framework for considering the appropriate models for ownership and management of a family business. Actually keeping the business within the family is just one of the options open to the founder or family. If external management and ownership is appropriate, then the sale options outlined in Chapter 20 might be considered, although these can pose some problems:

» Floating the business on a stock market or selling existing shares – This can be problematic, particularly if there is no established leadership structure within the firm, and it requires careful planning to ensure that the company continues to operate successfully after the float. In addition there is the issue of how the family might protect its own interests and the values of the firm from those of institutional investors, particularly hedge funds. However, once a company has gone public, there will be a ready market for its shares and a divided family might be tempted to dilute its ownership even further.

» Trade sale – This may be attractive if cash is needed for retirement or other family reasons. It might also be the right time to get a good deal, for example because of consolidation in the industry or that the business has become less attractive than when it was set it up and there are better new opportunities for children.

» Management buy-out – If there is a strong management team in the firm they might be interested in bidding for the firm if they can arrange funding.

» Management buy-in – An external management team might be persuaded to bid for the firm, again as a going concern. There is little research on family firm buy-outs and buy-ins, but Wright and Kellermanns (2011) report that there is anecdotal evidence that these often fail because of the loss of family's tacit knowledge.

» Liquidate – In extremis, it may be impossible to find a buyer. Liquidation is usually the least attractive option as the price for the assets will not reflect any goodwill.

If external management is to be brought in but ownership retained in the family, there must be mechanisms in place to resolve family conflict and provide the professional manager with sufficient autonomy to manage the business effectively. If the founder or family wishes to pass on the firm but the son or daughter is too young or inexperienced, they are best advised to appoint a caretaker manager to see the firm through until the next generation is ready to take on the role.

If the business is to be maintained within the family, then succession will need careful planning. Who should be the successor? Do they possess the necessary skills and temperament? If not, can they be developed through training and experience within the available time frame? What is the role of the rest of the family? What are the financial, tax and pension consequences? The issues that need to be addressed may seem endless. To help approach the task systematically, Leach (1996) made eight recommendations:

1. Start planning early. This allows the next generation to grow into their new roles.
2. Encourage inter generational teamwork to develop the succession plan. This allows any issues surrounding the succession to be addressed and agreed by all the next generation, not just the chosen successor.
3. Develop a written succession plan with the family setting out what has to be done, by whom and when, including details of the founder's reducing involvement and the successor's expanding role and responsibilities.
4. Take advantage of outside help with advice from financial, tax and pension experts.
5. Establish a training and education plan to help the successor develop the necessary skills
6. Plan for retirement financially and emotionally.

7. Make retirement on time, as planned and make it unequivocal. Sonnenfield (1988) characterised a founder as typically having four exit styles, the last two having a more positive effect on the business:
   a) *Monarchs*: who do not leave the business until they are forced out through ill-health, death or a palace revolt;
   b) *Generals*: who leave the business, but plot a return and quickly do so 'to save the business';
   c) *Ambassadors*: who leave the business quickly and gracefully, frequently to serve as post-retirement mentors;
   d) *Governors*: who rule for a limited term and then turn to other activities to gain fulfilment.

The future might see a decline in the number of family businesses passing down from one generation to the next as family networks break down. Factors such as increasing demands for capital that families cannot supply and booming stock markets which make obtaining a stock market listing attractive mean that more and more companies are being sold on rather than passed on. However, even today the high proportion of owner-managers still wishing to pass on their business to the next generation contrasts strongly with the proportion actually succeeding in doing so.

Explore further 21.2

Family business membership organisations

Access the *Digital Links* booklet to explore the following resources:

- The UK-based Institute for Family Business provides support, information and business tools to members on its website. It is a not-for-profit membership organisation founded in 2001 by a group of family businesses.
- The UK-based Family Business Network was established in 2014 and provides news, research and networking opportunities for family firms via its website.
- The USA-based Family Business Institute offers consultancy services.
- The Family Business Matters website provides guidance on corporate governance in family business.
- Download *The Wates Corporate Governance Principles for Large Private Companies* (published by the UK Financial Reporting Council).

Case insight 21.8 Wates Group

Developing a family constitution

Wates Group (WG), based in Leatherhead, Surrey, is a fourth-generation family construction and land-trading business that was established in 1897 by Edward and Arthur Wates. In 2019 it employed some 4,000 people and had a turnover of almost £1.63 billion, producing net profits of £36.2 million. The award-winning company can boast of both commercial success and longevity as a family business. This longevity is based upon a well-thought-out and well-structured approach to family governance. There are separate family as well as business strategies operated through two distinct and separate legal structures – the WG and Wates Family Holdings (WFH). WG is now owned by WFH, having bought back 40% of the shares in WG from two branches of the family. The WG board of directors has 12 members including five Wates family members (Andrew, Charles, Jonathan, Timothy and James Wates, who is chairman), David Allen (CEO) and two non-executive members. The WFH board comprises the five family members of the WF board, two non-executive members and the director of the Wates Family Office.

To achieve these structures, the family went through a strategy development process, spread over six months, involving all



Source: Silvia Brazzoduro on Unsplash

family members and professionally facilitated. The results started with a vision: 'Wates will be a world-class, family-owned and professionally managed enterprise, generating long-term stakeholder value.' To achieve this vision, the family focused on four things – the interface with WG, finance, co-investment and the family 'modus operandi'. At the heart of this was the need to diversify the wealth and income of the family away from WG and at the same time insulate WG from the worst influences of the family. The family tackled the issue of effective family governance structures by setting up a family council that meets regularly, a shareholder management committee that operates through WFH, and a family charter that forms the basis of the relationship between the voting shareholders and regular meetings of a family council. The younger generation are encouraged to participate in the family council. Timothy Wates explained some of the difficulties this poses:

> *'Sitting in a council meeting alongside the very experienced older generation can be daunting if you're only 20 or 21, so we're exploring ways to introduce them to it gradually, and build their confidence. The council is really important to us as governance mechanism, so getting this right is key.'**

Succession planning is based upon encouraging the best of the next generation to succeed within WG. Progression is based on psychometrics, team building, personal development and coaching, supported by outside advisors. Timothy Wates explained:

> *'We're looking 15 or 20 years ahead, at the sort of business we want to hand over to our children. We need an outlook and a corporate structure that's flexible enough to adapt to new trends, and could allow us to change direction if that's what we decide to do. We're also looking at how to manage the family wealth, but also to support our children, whether that's into a career in Wates, or not. We don't expect any of the next generation to come into Wates and be Wates their whole life, without exploring what else might be out there. We wish to create opportunities for the whole of the next generation, so they can determine their own path, and become entrepreneurs, if that's where their talents lie.'*

As a non-family member, then chief financial officer of WG Huw Davies explained that the Wates governance model means that the company behaves more like a plc, with independent non-executive directors, and established audit, remuneration, nominations and risk committees.

Looking back at this, ten years later Timothy Wates commented:

> *'Over the years we've had to reinvent ourselves more than once. What's always held us together is the "family factor" ... We have values that we consider are the values of family ownership, which relate to but aren't the same as, the corporate values of the group.'*

This process has brought wider recognition for James Wates. In 2017 he was invited by the UK government to lead the development of a code of corporate governance for large private companies, which was published the following year (see Explore further 21.2). It provides a framework to help private companies meet legal requirements while promoting long-term success, encouraging them to adopt a set of key behaviours to secure trust and confidence among stakeholders and benefit the economy and society in general.

Access the *Digital Links* booklet to visit the company website and watch a short video showcasing the activities of Wates Group and an interview with James Wates.

Questions:

1. Why has the family separated ownership and management of WG by setting up WFH?
2. What areas of dispute within the family might you anticipate?
3. Will WG always be effectively insulated from these disputes? If not, how might they be handled?

Source: All quotes in this section are taken from PWC, UK Family Business Survey, 2016.

SUMMARY

- Family business is the oldest and most common form of any business organisation in the world. Although there are a number of legal definitions, they might be defined simply as an organisation in which decision-making is influenced by multiple generations of a family. Many of today's best-known public companies started life as family firms and still have relationships with the founding family. Familial brands build consumer loyalty over long periods which can be a very valuable asset to the family and the firm.
- Starting up as a family business can be attractive because of the emotional support and helping hands that may not expect to be paid. As they grow, family firms can foster loyalty, responsibility, long-term commitment – not least to ethical standards, and a pride in 'the family tradition'. These virtues are often welded into a desire to transfer the business from one generation to the next and to preserve it in difficult financial times. The 2019/2020 GEM study found that four of the five countries in the study with the highest score for 'continuing a family tradition' as a strong motivator to start a business were from Europe (Bosma et. al., 2020).
- At the heart of the family firm is the family culture – its values and beliefs. These can be based upon strong ethical or religious beliefs, but they can also be quite quirky. The family culture influences the culture of the business and can affect how it is managed.
- There is the potential for conflict here because family culture is essentially based on emotion – loyalty, caring and sharing – whereas business culture is unemotional – task-orientated and based on self-interest. The emotion-based family culture operates subconsciously and can get in the way of business.
- Family conflict and politics can result in the firm being neglected or business decisions being made for other than commercial reasons – the introvert firm which tries to ignore commercial reality. It can also mean that the firm is used as a Cash Cow for the family and loses its commercial edge.
- Succession in the family firm is often problematic and can itself lead to conflict. Founders tend to ignore succession until the last minute. Many of the problems stem from the entrepreneurial characteristics of the founder that include a reluctance to relinquish control of the business. Added to this there may be father–son rivalry as the son rebels or strives for independence within the firm. If there are more sons or daughters, then sibling rivalry can intensify the problem.
- Resolving conflict in a family business is often difficult. It requires accommodation or compromise. A genogram can help to understand the nature and underlying causes of the conflict. Ultimately, the best approach is to develop a family constitution and a family council to monitor it.
- Succession can be managed. Planning needs to start early and needs to be inter generational, building in consultation with the firm's accountants and lawyers. A written succession plan should be developed which shows how the founder will exit and how the new generation will take over. It will detail any training and development needed and help the founder plan for retirement. Finally, when it is time to go, go!

GROUP DISCUSSION TOPICS

1. What are the advantages and disadvantages of starting up a business with your partner or spouse?
2. What are the advantages and disadvantages of being part of a family firm?
3. How can the family contribute to making a start-up successful?
4. Familial brands build consumer trust over long periods and can be very valuable assets. Discuss.
5. Family firms are more common in most continental European countries than in Britain. Why do you think this might be?
6. How does national culture affect the desire to pass on a business as a going concern?
7. In the future, family firms will decline in importance. Discuss.
8. Does it matter how you define a family firm?
9. How might family and business cultures clash?
10. Why are there so many examples of successful family firms which are based on strong religious or ethical beliefs?
11. What are the problems you might face in being a non-family member running a family business?
12. What are the problems you might face in being a non-family employee in a family business?
13. What are the problems you might face in being the son or daughter of the founder employed in the family business?
14. How would you get on if you were working for your mother or father?
15. What are some of the underlying causes of conflict in a family and how might these show themselves in a family firm?

16. The family business sector is an endless soap opera of patriarchs and matriarchs, black sheep and prodigal sons, hubris and nemesis. Discuss.
17. What is an introvert firm? How might a business avoid becoming one?
18. How can succession be managed?
19. What do you think would be a good training programme for a son or daughter intending to take over the running of the family business?
20. From what you have read in this book about the gender of entrepreneurs, how might issues around gender affect succession?
21. In what circumstances might it be wise not to pass on the firm to a member of the family?
22. What should go into a family constitution? What are the advantages of having one?

STUDENT ACTIVITIES

1. List the questions you would ask members of the family working in a family firm in order to highlight the advantages and problems of working there. Based upon these questions, interview members of the family and write an essay highlighting the advantages and problems of working in a family firm.
2. List the questions you would ask the manager of a second- or third-generation family firm in order to highlight the problems they encountered in taking over the firm. Based upon these questions, interview the manager and write an essay highlighting the problems they encountered.
3. Write a specimen family constitution.
4. Investigate the tax problems associated with succession in the family firm and how they might be mitigated.

22

CORPORATE ENTREPRENEURSHIP AND INTRAPRENEURS

Contents

- Entrepreneurial intensity
- Defining corporate entrepreneurship
- Entrepreneurial orientation
- Entrepreneurial architecture
- The pillars of entrepreneurial architecture
- Knowledge and learning
- Matching architecture with environment
- Intrapreneurs
- Venture teams
- Facilitating intrapreneurship
- Innovation departments and divisions
- Corporate accelerators and incubators
- Structuring venture outcomes
- Successful corporate venturing
- Summary
- Group discussion topics
- Student activities



Source: Getty Images/Jacobs Stock Photography

Learning outcomes

When you have read this chapter and undertaken the related activities you will be able to:

- Explain what is meant by the term 'corporate entrepreneurship' and critically analyse the terminology used around it;
- Explain what is meant by the term 'organisational architecture' and how it might be shaped through leadership, culture, structure and strategies so as to make an organisation more entrepreneurial;
- Understand how context and environment should determine the appropriate architecture for an organisation;
- Understand how intrapreneurship (and venture teams) can be encouraged and the contribution made by other forms of corporate venturing;
- Explain how entrepreneurial architecture creates sustainable competitive advantage.

Case insights

22.1 3M and the Post-it Note®

22.2 Alphabet and X Development

22.3 Haier Group

Explore further links

22.1 Entrepreneurial architecture

22.2 Learning organisation

22.3 Intrapreneurship

22.4 Corporate Entrepreneurship Audit

ENTREPRENEURIAL INTENSITY

'Corporate entrepreneurship' is the loose term used to describe entrepreneurial behaviour in an established, larger organisation. The objective is to encourage greater entrepreneurial intensity within the organisation by increasing both the degree, or scale, and the frequency of entrepreneurial activity at all levels within it – at corporate, division, business unit, functional and/or project team levels. As shown in Figure 22.1, the degree or scale of the entrepreneurial activity can range from low/incremental to high/radical. Its frequency can also range from low/infrequent to high/frequent. Entrepreneurial activity might be evidenced by innovations in products, processes and marketing. Entrepreneurial firms are constantly trying to extend this envelope of entrepreneurial intensity. Corporate entrepreneurship is the overarching term used to describe the mechanisms and processes they use to achieve this and the behavioural characteristics that underpin them.

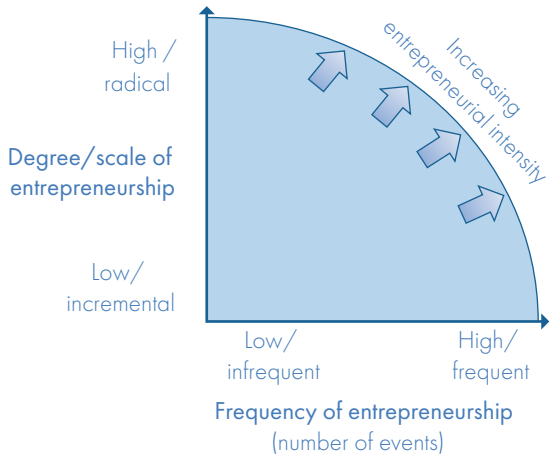


Figure 22.1 Entrepreneurial intensity

> *Today's businesses, especially the large ones, simply will not survive in this period of rapid change and innovation unless they acquire entrepreneurial competence.*
>
> Peter Drucker (1985) *Innovation antd Entrepreneurship: Practice and Principles*, London: Heinemann

Big companies ought to be good at innovation. After all they have more financial and human resources, more knowledge and experience, established brands and route to market – more of everything to throw at the challenge. But the reality is that it is often newer, smaller businesses that come up with innovations, particularly radical ones. And, as the pace of change accelerates, they seem more able to cope. The result is that lack of entrepreneurship is a threat to their survival. Chapter 11 observed that the core of the problem is that traditional management focuses on efficiency and effectiveness – control rather than empowerment. Indeed, up to the middle of the last century large companies were thought of as the way mass economic needs would finally be met – and efficiency and effectiveness were the key to their success. How things change. Now the focus is on creativity and innovation – finding niche markets as well as mass markets. And the challenge has become finding ways to transform these large companies so that they can bring their resources to bear on the challenges of the twenty-first century.

By increasing their entrepreneurial intensity, it is believed that organisations will be better able to cope with change, better able to innovate and therefore better able to cope with threats. The key is the ability to initiate and manage rapid change within these organisations, their markets and industries – in other words to innovate on a continuous basis. Corporate entrepreneurship is now seen as a vital part of the strategies needed to rejuvenate these larger companies, maintaining their ability to innovate quickly through entrepreneurial activities (Antoncic, 2006; Burns, 2005; Brizek, 2014; Kuratko and Audretsch, 2013). And central to this is how to organise to encourage this.

DEFINING CORPORATE ENTREPRENEURSHIP

Although there is a large literature on corporate entrepreneurship stretching back over 30 years, even as late as the 1980s some academics still believed it was difficult, if not impossible, for entrepreneurial activity to take place in larger organisations (Morse, 1986). Indeed, there was no real consensus on what the term 'corporate entrepreneurship' meant, which resulted in the topic being studied under a number of different headings. Figure 22.2 shows a hierarchy of the often-confusing terminology used in corporate entrepreneurship, each of which we shall explain. 'Entrepreneurial transformation', 'strategic renewal' and 'strategic entrepreneurship' are all terms used to describe entrepreneurial activities within larger organisations. They are evidenced by and result from an entrepreneurial orientation within the organisation – a behavioural characteristic. This is achieved through an entrepreneurial architecture – a strategic alignment of corporate resources so as to encourage entrepreneurship and innovation on a sustainable basis. Both internal and external corporate venturing mechanisms are simply tools or techniques that are used within this architecture.

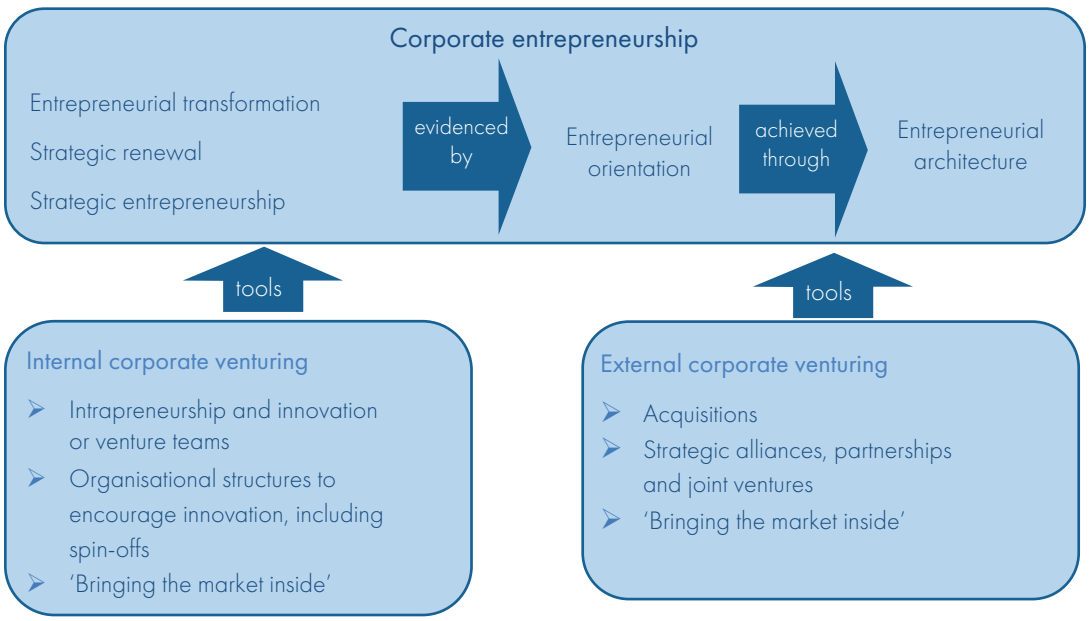


Figure 22.2 Hierarchy of terminology used in corporate entrepreneurship

Source: Burns (2020).

Much of the early literature is associated with corporate strategy rather than entrepreneurship. Sharma and Chrisman (1999) identified a number of terms used to describe entrepreneurial efforts within organisations, mainly under the headings of 'strategic renewal' and 'corporate venturing'. As Zahra (1996) said: 'Corporate entrepreneurship is seen as the sum of a company's innovation, strategic renewal and venturing efforts'.

Strategic renewal is about changing the strategic direction of the organisation, usually implying that it becomes more customer- and market-focused, more entrepreneurial (Sharma and Chrisman, 1999). Often linked to companies attempting to turn around continuing decline, it has also been called 'entrepreneurial transformation' (Birkinshaw, 2003), while the processes and strategies adopted have more recently been called 'strategic entrepreneurship' (Kuratko and Audretsch, 2009; Morris et al., 2008).

> *There is a real need for corporate entrepreneurs at the moment ... entrepreneurs recognise that action and change are crucial for maximising potential and taking advantage of opportunities.*
>
> Diane Thompson, Chief Executive of Camelot, *The Sunday Times*, 17 March 2002

Corporate venturing (internal and external) can be viewed simply as a series of tools or techniques that encourage entrepreneurship and innovation. They are indicators of corporate entrepreneurship (or any of these other terms). Some of these approaches relate to how the organisation structures itself internally while others relate to how it structures itself externally. Internal corporate venturing is concerned with the organisational structures needed to encourage new businesses to develop internally while aligning them with the company's existing activities (Burgelman, 1983; Drucker, 1985; Galbraith, 1982). It is particularly concerned with how companies can manage radical entrepreneurship and/or disruptive innovation (Christensen, 1997). A significant strand of the literature in its own right is concerned with intrapreneurs and innovation or venture teams – individuals and teams that develop new products or businesses.

External corporate venturing is concerned with how the organisation structures itself externally. This may be through partnerships, strategic alliances and joint ventures. It may also be through investments and acquisitions in strategically important smaller firms and the corporate venturing units needed to undertake this role (Chesbrough, 2002). Another strand of the literature in both internal and external corporate venturing might be called 'bringing the market inside' (Birkinshaw, 2003). This focuses mainly on the structural changes needed to encourage entrepreneurial behaviour within an organisation, in particular creating internal markets for resource allocation with structures such as spin-offs and venture funds (Foster and Kaplan, 2001; Hamel, 1999).



Source: Getty Images/iStockphoto/MGPhotostudio

Organisations involved in these processes have been said to exhibit a sustained pattern of entrepreneurial behaviour over time. This has been called an 'entrepreneurial orientation' and has attracted much attention in the literature on corporate entrepreneurship. However, its meaning is not always clear, particularly with regard to identifying how its dimensions are measured and therefore how entrepreneurship might be facilitated.

The term 'organisational architecture' first appeared in a book by Nadler et al. (1992) as a metaphor to describe the infrastructure an organisation needs in order to build business processes that deliver its vision. Organisational architecture comprises the four pillars shown in Figure 22.3: leadership (and management), culture, structure (including systems) and strategies. 'Entrepreneurial architecture' is a term used to show how the organisational architecture might be structured so as to encourage entrepreneurship and innovation on a sustainable basis by embodying within it the DNA of the entrepreneur and how they manage (Burns, 2020).

A firm with an entrepreneurial architecture is more likely to show greater innovation intensity – scale and frequency of innovation. This approach is said to provide a structured approach to the search for how to encourage entrepreneurship and provides a framework for understanding how the elements or dimensions of an entrepreneurial orientation might arise.

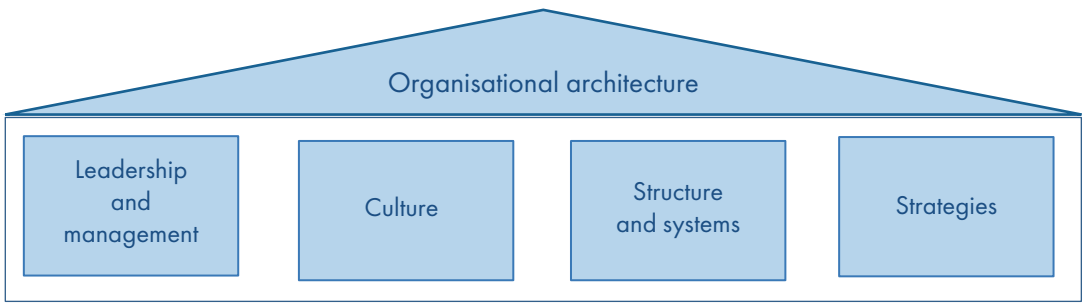


Figure 22.3 Four pillars of organisational architecture

ENTREPRENEURIAL ORIENTATION

'Entrepreneurial orientation' is probably the most widely used term to describe the entrepreneurial climate and strategy development process in larger firms and is probably the most widely used construct of corporate entrepreneurship (Covin et al., 2006; Wales et al., 2013). It has been linked not only to new venture creation but also improved financial performance (Miller, 2011). In a meta-analysis of 134 studies by Rauch et al. (2009) it was shown to be a strong predictor of firm performance. However, there is some debate about how patterns of entrepreneurial orientation behaviour might be defined (Covin and Wales, 2012) and it is often less than clear how they were derived. Notwithstanding this, most conceptualisations include three broad dimensions of 'organisational climate' (e.g. Lumpkin and Dess, 1996; Miller and Friesen, 1977; Rauch et al., 2009; Wales et al., 2013):

» Innovativeness – This relates to the firm's encouragement of innovation through its systems, structures and strategies. This is generally considered to be the most important and statistically influential element (Lumpkin and Dess, 1996) and yet researchers have repeatedly confused input measures of organisational climate with output measures such as the number of innovations generated (e.g. Covin and Slevin, 1989; Forsman, 2011).

» Risk-taking – This relates to willingness of the firm to engage in what might be seen as risky strategies in pursuit of growth.

» Pro activeness – This relates to the firm's pro active and speedy pursuit of new opportunities for growth through research, information search etc.

A further two dimensions that broadened the scope of entrepreneurial orientation have also been shown to have validity (Lumpkin and Dess, 1996; Covin and Wales, 2012):

» Competitive aggressiveness – This relates to how a firm engages with competitors in an aggressive way through its marketing strategies.

» Internal autonomy – This relates to the ability of individuals or teams to bring forward new ideas.

However, while entrepreneurial orientation might focus on a number of specific dimensions of behaviour, entrepreneurial architecture looks at the whole organisational framework and how they inter relate. Not all firms are the same, producing different types of products/services in different industries, for different markets – so the importance of different elements or dimensions might vary. Entrepreneurial architecture can be adapted to different environments where different components become more or less important (Arshi and Burns, 2019). What is more, it emphasises the inter dependency of the elements or dimensions and the importance of consistency between all the elements.

ENTREPRENEURIAL ARCHITECTURE

An entrepreneurial architecture is one that replicates entrepreneurial behaviour throughout an organisation. It is built upon four pillars: leadership (and management), culture, structure (including systems) and strategies. Together these influence the 'climate' within the organisation and the decisions that it makes. Burns (2020) based the characteristics on the entrepreneurial mindset outlined in Chapter 3:

» Their character traits: autonomy, need for achievement, internal locus of control, drive and determination, creativity and innovation and willingness to take measured risks.

» Their informal relationship-based approaches to management.

» Their apparently intuitive and incremental approach to strategy and decision-making.

» Their approach to risk-taking – making decisions incrementally using information gained from personal, relationship-based networks.

The architecture he constructed was also underpinned by the principles of complexity theory that explain how large systems are able to react to multiple independent and unexpected changes – changes we see every day in today's interconnected global market. It is the capacity of these systems to self-

organise, to react to change and create new structures and systems by making appropriate independent decisions rapidly that can give direction to the changes and, for a business, create competitive advantage – characteristics we recognise in the actions of the entrepreneur.

Complexity theory shows that there are three requirements to create effective self-organisation:

» A common identity and purpose – There must be a clear understanding of and belief in the 'common good' (head and heart) that permits a common sense-making process within the organisation;

» A free flow of knowledge and information – The organisation as a whole must work on the same information in order to provide the possibility of synchronised behaviour;

» Strong personal relationships – These relationships are the pathways through which information is transmitted and then transformed into intelligent, coordinated action.

This approach acknowledges that all the elements of organisational architecture can contribute to an entrepreneurial orientation, that they are interdependent and that they can assume different importance in different environments at different times. It also underlines that an entrepreneurial organisational orientation may not be appropriate in all circumstances. This approach goes some way to explaining the variations in the results of empirical research into the importance of the different dimensions of entrepreneurial orientation. Burns (2020) provides a useful checklist of these characteristics in his Corporate Entrepreneurship Audit tool.

Entrepreneurial architecture is based upon strong relationships between stakeholders – an important characteristic of entrepreneurial management. The strongest relationships are built on 'relational contracts' – tacit, informal contracts which are only partly specified and only really enforced by the need of the parties to work together (Kay, 1995). These create a community, a sense of belonging with an almost familial bond – a sense of corporate identity. Like all relationships, they are based upon mutual trust, underpinned by mutual self-interest and demonstrated by reciprocity (Dubini and Aldrich, 1991; Larson, 1992). Individuals understand that in exchange for their effort and commitment to the organisation they will be paid a fair wage and the organisation will look after their interests and develop their potential. They participate in these relationships voluntarily due to a strong personal feeling that it is in their interests because they are participating in a 'repeated game' in which they share the rewards of collective achievement. These relationships solve problems of cooperation, co ordination and commitment. They set expectations and the 'rules of the game' and, despite the rules being unwritten, if you cheat you would find it difficult to play the game again with the same players. This is the incentive they need to do the 'right thing' for the organisation and, if they have sufficient autonomy in decision-making, to make independent decisions for the good of the whole organisation.

Just as entrepreneurs use networks of relationships to help them operate in a way that allows them to seize opportunities quickly, architecture allows the entrepreneurial firm to respond quickly and effectively to change and opportunity. Developing organisational architecture is a systematic exploitation of one of the main distinctive capabilities of entrepreneurs. It builds on dynamic capabilities that are difficult to copy. It does so by creating within the organisation the knowledge and routines that enable this to happen smoothly and unhindered. Entrepreneurial architecture therefore creates an entrepreneurial organisation. Staff are somehow motivated or empowered to make this happen, knowing it is good for the organisation. These relationships become institutionalised and can then create competitive advantage and barriers to market entry.

THE PILLARS OF ENTREPRENEURIAL ARCHITECTURE

The four pillars of organisational architecture shape it. The objective is to make it entrepreneurial – opportunity seeking, innovative, fast to respond to the changing environment. Figure 22.4 shows how these elements are interrelated, each affecting the other, hence the direction of arrows. The leader's role is crucial. They have prime responsibility for shaping an organisation's architecture by building its structures and systems, culture and strategies. Having said that, how this is transmitted through the organisation by its management and how managerial tasks are undertaken are also very important – the

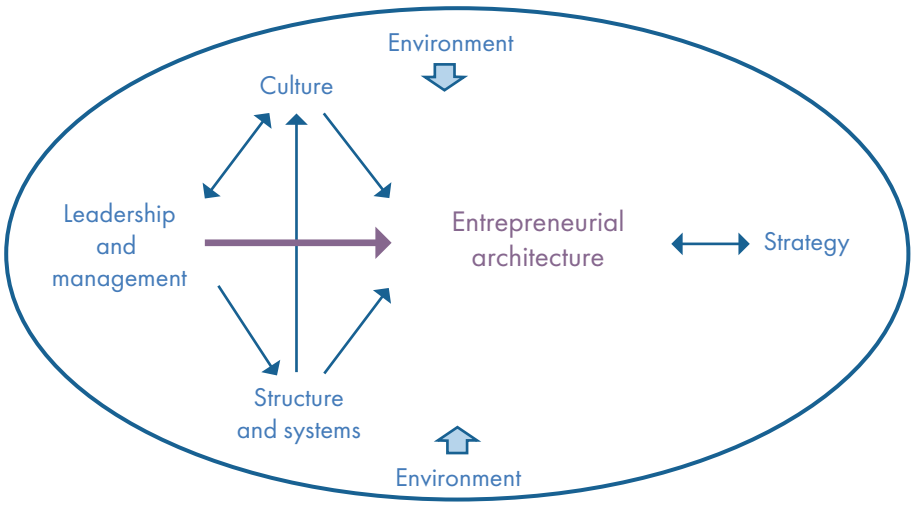


Figure 22.4 Influences on entrepreneurial architecture

Source: Burns (2020).

two are linked. Indeed, leadership and management styles, organisational cultures and structures are all linked. They should all be consistent and one should reinforce the other. If one is not consistent with the other two then the organisation will not function as it should.

Leadership and management

Chapter 16 outlined the skills needed for leadership but emphasised that, according to contingency theory, context dictates the most appropriate leadership style. The entrepreneurial context is one characterised by uncertainty, rapid change and risk-taking. What is more, the defining characteristics of entrepreneurial leadership are the embracing of change and commitment to innovation. It outlined a number of leadership paradigms. Entrepreneurial leadership needs to be both visionary and transformational but, importantly, it also sets out to build and embed leadership into the organisation – and this is more than just dispersed leadership. Instead of concentrating only on acquiring the individual attributes of leadership, they take an architectural approach – building these leadership attributes into the organisation itself and spreading them throughout it so that the organisation can continue being entrepreneurial without them.

> *Entrepreneurship in large firms is, unequivocally, a precursor to innovation. In other words, the more entrepreneurial a large company is, the more innovative it will be in aligning its product or service offering with the demands of its intended market.*
>
> Mischa Kaplan, CEO of Cardinal Research Group, *Ottawa Business Journal*, 9 October 2018

Culture

Chapter 16 looked at how organisational cultures might be viewed and measured. Establishing an appropriate culture is vital in developing an entrepreneurial organisation not least because of the informal organisation structure and loose management control. Based on values, norms and beliefs, it influences individual and social behavioural norms. The culture should see change as the norm, certainly not something to be feared. Above all it should value strong relationships, creativity and innovation, empowerment, measured risk-taking through experimentation and continual learning. It should value relationships sufficiently to generate a strong sense of group identity (Hofstede's 'in-group'). This can be built around the vision for the organisation as well as its recognisable values, norms and beliefs. This should generate confidence in its future. It should be egalitarian but slightly anti-authoritarian – always daring to be different. It should tolerate mistakes and encourage learning from them. Individuals should feel empowered and motivated to make decisions for the good of the organisation, with decision-making delegated down, as far as possible, and information shared rather than hoarded. There will be a 'can-do' attitude around, that values achievement.

Figure 22.5 shows what the cultural web of an entrepreneurial organisation might look like. At the core of the web, highlighted in blue, is the organisational focus on creativity and innovation. Also



Figure 22.5 The cultural web of an entrepreneurial organisation

highlighted in blue are the important cultural characteristics of: strong relationships at all levels inside and outside the organisation; the sharing and using of information and knowledge; continual learning; measured risk-taking; the feeling of empowered decision-making that staff should have.

Structure and systems

There is no single 'best' structure. However, because they typically face a high degree of turbulence and uncertainty, entrepreneurial structures need be flexible to fit these changing circumstances – with structures within structures that encourage smaller, often informal, organic structures to develop, each with considerable autonomy. As the levels of formal hierarchy are reduced, the managerial span of control will widen, with an emphasis on getting things done. The processes underlying how the different levels of hierarchy interact and communicate are just as important as the structure itself. They should encourage rapid, open, effective communication across and throughout the organisation, so that decision-making can be delegated as much as possible giving staff greater autonomy and looser control, albeit with greater accountability. Structures, behaviours, even controls are likely to be more informal than formal, based on strong personal relationships. It certainly will not be bureaucratic in any way. There should be an emphasis on flexible team working and open communication, with team-based, project-based and process-based structures.

> *One of the first things I learned though was that there was a relationship between screwing up and learning: the more mistakes I made, the faster I learned.*
>
> Michael Dell, founder of Dell Corporation, (1999), *Direct from Dell: Strategies that Revolutionized an Industry*, New York: Harper Business

Strategy

While the creation of an entrepreneurial architecture is central to the organisation's corporate strategy, other competitive strategies may originate from within the organisation, determined by the interplay of factors in Figure 22.4. In these circumstances strategy development becomes part of entrepreneurial architecture creating an organisation that is better able to respond to unpredictable change and opportunity in the way the entrepreneur does, making it better suited to survive in the age of uncertainty. And strategy development, like all aspects of entrepreneurial architecture, is difficult to copy because it is constantly evolving and adapting to the changing marketplace. Entrepreneurial architecture is a very real and valuable asset in its own right as it creates competitive advantage and is sustainable.

Explore further 22.1

Entrepreneurial architecture

Access the *Digital Links* booklet to watch the following:

- A talk by Professor Paul Burns explaining the terms and exploring the concepts.
- An animation explaining what a complex system is.
- An animation explaining how to design and construct a strong and unique organisational architecture.

KNOWLEDGE AND LEARNING

Strong organisational architecture is difficult to copy because it is informal in nature, not based on legal contracts and not written down anywhere. Instead it relies on the complex network of long-term personal relationships throughout the organisation. Any one individual only knows or understands a small part of the overall structure. And just as entrepreneurs use their network of relationships to gain information and knowledge so as to mitigate risk, so too a strong architecture can facilitate the free exchange of knowledge and create a valuable organisational asset that allows it to respond flexibly to changing situations:

> If there is a single central lesson … it is that the stability of relationships and the capacity to respond to change are mutually supportive, not mutually exclusive, requirements … Each is capable of creating an asset for the firm – organisational knowledge which is more than the sum of individual knowledge, flexibility, and responsiveness which extends to the institution as well as to its members. (Kay, 1995)

With this description we again glimpse reflections of the start-up entrepreneur in the middle of the spider's web of informal, personal relationships, recognising opportunity everywhere, trying to innovate and trying to replicate success, using networks, relying on personal relationships with customers, staff and suppliers. Entrepreneurs prefer influence and informal relationships to formal contracts. They use these to secure repeat sales at the expense of competitors and to secure resources or competitive advantage that they might not otherwise have. Close partnerships with suppliers where information and knowledge are shared can lead to significant advantages in lowering costs, lead times and inventories. All these relationships are based on trust – 'my word is my bond' – and most involve a degree of self-interest. The challenge in a larger organisation is to replicate these relationships across the whole organisation and develop an entrepreneurial architecture.

Strong architecture creates valuable organisational information and knowledge but how does this translate into organisational learning? Real knowledge is about more than just information sharing. It is about learning from each other and from outside the organisation. It is about getting a better understanding of inter relationships, complexities and causalities – the causes rather than just the symptoms of a problem – and then translating this into future decision-making. Constant learning by organisations requires the acquisition of new information, knowledge and skills and the willingness to apply them to decision-making (Miller, 1996). Importantly it includes the unlearning of old routines (Markoczy, 1994) so that the range of potential behaviour is altered (Wilpert, 1995). This willingness to question accepted ways of doing things – the 'dominant logic' of an organisation or an industry – is at the heart of true innovation. Dominant logic is the mindset with which an organisation or industry collectively sees itself and the world it inhabits – its position with customers, competitors and other stakeholders. Dominant logic filters the information, subconsciously interpreting environmental data in a certain way. It influences behaviour.

This challenging of dominant logic happens in what is often called 'double-loop learning'. Building on Kolb's (1984) experiential learning cycle, Kim (1993) suggested that effective learning can be

considered to be a revolving wheel – the wheel of learning (Figure 22.6): forming concepts, testing concepts, learning from this experience and then reflecting how the concept might be inappropriate, changed or improved. During half the cycle, concepts are formed and then tested, observing what happens through experience – learning 'know-how'. Chapter 3 explained how entrepreneurs learn predominantly by doing and experiential learning is probably the most powerful form of learning. We learn most things in life – eating, crawling, walking and communicating – through trial and error; action, consequence, reflection and then remedial action. In the second half of the cycle, reflection on these observations takes place and new concepts are formed – learning 'know-why'. This is 'double-loop learning' (Argyris and Schön, 1978) and it is when the root causes of the problem are diagnosed and systematic solutions put in place. This is when the questions 'why?' and 'why not?' are asked and dominant logic is questioned. This is when an individual starts to reframe their thinking and become more creative and innovative, able to spot opportunities for new products or markets that others have failed to see. Real learning is about application, continuous problem-solving, and understanding the root cause of problems rather than being distracted by the symptoms.

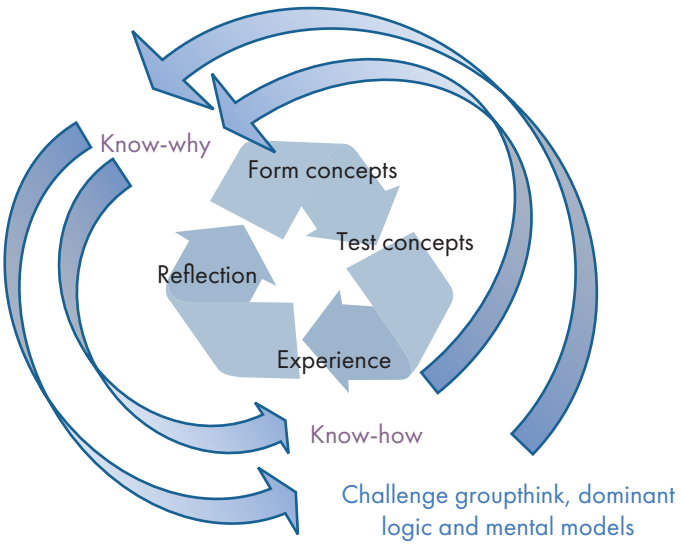


Figure 22.6 The wheel of learning

Since dominant logic is a social construct it can be influenced and changed by the organisational architecture, albeit over time. By embedding double-loop learning within the organisation, the dominant logic of managers can be changed and they can be encouraged to reframe the way they approach business to become more creative. It is the constant turning of the wheel of learning, sharing knowledge of know-how and know-why, that embeds double-loop learning within an organisation. Dominant logic is constantly challenged. Over the years this generates organisational learning, and becomes part of the collective 'memory' of the organisation. Although this accumulated knowledge is tacit (i.e. embedded in minds and activities, rather than written down) as well as being shadowy and fragile, it is unique to the organisation and difficult to copy. It is therefore a valuable part of the architecture that underpins the organisation's competitive advantage.

Explore further 22.2

Learning organisation

Access the *Digital Links* booklet and watch an animation that explains the concept of the learning organisation and how one might be developed.

MATCHING ARCHITECTURE WITH ENVIRONMENT

Developing strong entrepreneurial architecture creates competitive advantage in certain types of environment. It is designed to facilitate change and encourage creativity and innovation. However, this may not be appropriate for all organisations. Entrepreneurial architecture is probably not appropriate for a benign, unchanging environment in which simple tasks are undertaken with a view to achieving maximum efficiency, for example for companies adopting a low-cost/low-price business model. Constructing an entrepreneurial architecture may involve extra costs compared with a more conventional architecture. It may also encourage behaviours that are considered 'inappropriate' in these circumstances. However, such companies need to beware of changes in the environment, for example when disruptive shifts in the market take place, meaning that their business model is no longer attractive to customers.

If an organisation's architecture does not 'fit' with its commercial environment the organisation will not prosper. Entrepreneurial firms thrive in environments of change, chaos, complexity, competition, uncertainty and even contradiction, where innovation is essential. These are highly competitive and rapidly changing markets facing pressures for greater corporate social responsibility and problems in attracting suitable staff. The exact form an organisation's architecture should take also depends on the economic, technological and societal environment in which it operates. This is an imprecise art, not a science. These are some of the commercial environments that an entrepreneurial architecture is designed to cope with:

- Markets where new technologies are important – Where new technological developments are highly valued by customers there is considerable 'first-mover advantage', reinforcing the importance of a rapid response to developments.
- Markets that value creativity – Many markets value creativity, for example the video-gaming industry which combines creativity with technological development. The creative industries generally should thrive within an entrepreneurial architecture.
- New or changing markets – This could be any market that is changing rapidly for any reason. New markets could be emerging and the whole structure of the market might be changing, with many mergers or take overs. In these circumstances customers might be seen as promiscuous as their 'needs' change rapidly and, as a result, the industry spends increasing amounts on advertising in order to get their attention.
- Interconnected markets – The interconnectedness of markets and economies tends to amplify small initial changes – in customer needs or market trends – and this makes for instability and unpredictability and it means that traditional forms of strategic planning no longer work. Speed of response is vital.
- Markets where information and knowledge are important – In markets providing up-to-date or real-time information and knowledge rapid changes in both the information and market needs are important. This includes changes in technology that might impact on the ability to deliver this service.
- Price-sensitive markets – Markets might be highly price sensitive, with low barriers to entry and high economies of scale. New competitors might be emerging all the time and these new competitors might be very price competitive and/or good at innovating.
- Markets coming to an end of their life cycle – The ending of a product life cycle may threaten the existence of a business or may just unbalance its product portfolio. Either way it will need to innovate.

The appropriate entrepreneurial architecture can even vary with the nature of the entrepreneurial intensity (scale and frequency) required within the organisational unit. The important point is that different organisational architecture may be required for different subsidiaries, divisions, departments or other operating units within an organisation. This implies the need to break down organisations into units that reflect their commercial purpose and external environment – possibly with structures within structures, sub cultures within cultures and different approaches to leadership within an overall approach. Not all parts of a multi-product/market business may exhibit the same characteristics because

of differences in their operational needs (e.g. the stage in the life cycle of products) and/or their market situations (e.g. they do not operate in an entrepreneurial environment). For example, the Virgin Group is a conglomerate that operates across different sectors and requires different architecture in each of its divisions or subsidiaries. However, the overarching architecture of the holding company can still be entrepreneurial, allowing it to be responsive to change. Entrepreneurial architecture is not a one-size-fits-all blueprint. It needs to be applied selectively, with thought and judgement.

INTRAPRENEURS

Entrepreneurial firms encourage innovation and new product/service development, often spinning out new business in the process. Individuals who do this are called 'intrapreneurs', although more often this is undertaken by a team, often called a 'venture team'. The term intrapreneur is generally used to describe the individual charged with pushing through innovations within a larger organisation, in an entrepreneurial fashion – a salaried 'entrepreneur' in a big company that they do not own. The key is that they work in an entrepreneurial way, with an entrepreneurial mindset. At the same time they must be sufficiently adept (and patient) at manoeuvring their way through the bureaucracy of a large organisation. Pinchot (1985) defined them as 'dreamers who do; those who take hands-on responsibility for creating innovation of any kind within an organisation; they may be the creators or inventors but are always the dreamers who figure out how to turn an idea into a profitable reality.' Actually they are rarely the inventor of the product, but rather they usually work with teams to cut through the bureaucracy of the organisation to develop it for the marketplace as quickly as possible. Like entrepreneurs they turn the dream into reality. The practice of intrapreneurship can be undertaken at many different levels – corporate, divisional or project level. While not dependent upon the size of the organisation (Antoncic and Hisrich, 2003), intrapreneurship appears to become more difficult to sustain as the firm grows (Ross, 1987).

Innovative behaviour can occur in a random, unsystematic way. Gillis Lundgren was a driver trying to deliver a table in 1953 when he discovered that it wouldn't fit into the back of his small car. His solution was to remove the legs. He worked for a small mail-order furniture company in Sweden called IKEA, and this idea was taken up by the company and led to it developing the flat-pack, self-assembly furniture it is known for today. Lundgren was only IKEA's fourth employee at the time, and he certainly did not regard himself as an intrapreneur. He just had a problem to solve and he told his boss how he solved it. He later became IKEA's head of design and played a major role in the company's success. The difference between this random behaviour and intrapreneurial behaviour is that giving the behaviour a name recognises and legitimises it so that it can be encouraged and facilitated in a systematic way.

> *While it is true that every company needs an entrepreneur to get it under way, healthy growth requires a smattering of intrapreneurs who drive new projects and explore new and unexpected directions for business development.*
>
> Richard Branson, founder of Virgin Group, www.entrepreneur.com/article/218011, January 2011

Successful intrapreneurs share many of the character traits of entrepreneurs – a need for achievement, a need for autonomy, drive and determination, a high internal locus of control, creativity and innovativeness and an ability to live with risk and uncertainty. Although they have a desire for autonomy and a willingness to live with risk and uncertainty (Hornsby et al., 1993), this does not translate into a desire to be completely independent and set up their own business – they are probably too risk-averse. Autonomy, and in particular 'psychological ownership' of their intrapreneurial project, can be seen as a strong personal motivator encouraging a feeling of efficacy. Their project also gives them a sense of purpose and mastery that also are important motivators. It demonstrates their willingness to take limited risks and cope with uncertainty within the framework of a regular job. However, they probably have sufficient belief in their abilities that, were they to lose their job, they would quickly find another. Nevertheless, they remain less willing to take personal risks than entrepreneurs.

Nevertheless, intrapreneurs are comfortable with change and able to cope with uncertainty (Kanter, 2004). They are able to perceive an opportunity and have a vision for what it might become (Kanter, 2004; Pinchot, 1987). They are motivated to pro actively take the initiative and run with it – they are action-orientated: 'Vision and imagination make up half of "the dreamers that do". Action is the other half' (Pinchot, 1987). They are results-orientated (Pinchot, 1985; Ross and Unwalla, 1986). Pinchot (1985) characterised them as being like entrepreneurs, self-confident and optimistic, but probably cynical about the bureaucratic systems within which they operate, although they believe they can circumvent or manipulate the 'system' to achieve their goals; like entrepreneurs, strongly intuitive

(right-brain thinkers), but because of their corporate background less willing to rely solely on intuition and more willing to undertake research into a new business idea (left-brain thinking).

According to Ross and Unwalla (1986) the best intrapreneurs are ambitious, rational, competitive and questioning. They dislike bureaucracy and are challenged by innovation but have an understanding of their organisation and a belief in their colleagues. Unlike many entrepreneurs, they need to be adept at politics and good at resolving conflict as they navigate their way through the blocks and blockers in other operational units in their organisation (Govindaranjan and Trimble, 2010). Pinchot (1985) observed that they are adept communicators with strong interpersonal skills that make them good at persuading others to do what they want. They are also sensitive to the need to disguise risks within the organisation so as to minimise the political cost of failure. This process of influencing without authority, based upon some form of reciprocity, is at the heart of the skill of intrapreneurs (Cohen and Bradford, 1991). Intrapreneurs need to identify potential allies and understand the 'language' they use and their values and motivations. By doing this they are able to develop a personal relationship and are better able to influence an ally through exchanges of value – a process of give and take. According to Kanter (2004) intrapreneurs prefer to use a participative management style and have an understanding that they need to work with others to achieve their goals.

VENTURE TEAMS

These days most intrapreneurial activity involves teamwork. This may be an ad hoc team formed for a specific project from staff with different skills from different departments. Some companies have permanent departments dedicated to innovation. Some projects might be so close to the company's core competencies and relate directly to its core operations or be of such strategic importance that they are eventually assimilated into mainstream operation. Some projects may be sufficiently different that they need to be set up with some degree of separation from the mainstream activity – the degree of separation is important. Other projects might be so distant from the core activities of the organisation that they are spun off or sold off completely.

Partnership and teamworking are important in innovation, bringing together a diversity of knowledge, skills and perspectives. Krippendorff (2019) looked at the 30 innovations that experts thought have most transformed the world in the last three decades – big innovations like the portable computer, internet, mobile phone and magnetic resonance imaging (MRI). He claimed that most were the result of a more collaborative effort: 22 of the 30 had been conceived by employees and 23 of them had been developed when a larger community (including the public sector) formed around the idea. What is more, 28 of these transformative innovations were scaled and 16 were commercialised by competitors rather than the original innovators:

> We owe much of the modern world to the efforts and passions of internal innovators. To tell the true story of innovation, we would have to say that employees conceive of innovations, communities composed of corporations and institutions build them, and then the competition takes over to scale them. (Krippendorff, 2019)

Team working is commonplace now across most businesses and is particularly valuable in pushing through innovations. A single intrapreneur on their own rarely has all the skills required to see a project through to completion. They often need a team to work with them – called a venture team. The most innovative companies use cross-functional teams and agile ways of developing innovations (BCG, 2017). Venture teams are ad hoc, forming and re forming to tackle different projects. They need to have all the freedom and support that would be given to an intrapreneur. To be successful the team needs to have:

» The skills, knowledge and competencies to undertake the project, probably from a wide range of different disciplines such as computer programming, engineering, marketing or finance. Phadke and Vyakarnam (2017) noted that experience of 'different market spaces' is particularly important for teams to develop 'creative synthesis' – an understanding of how technology-based products might be commercialised. The problem with cross-functional teams is that they need to be managed (e.g.

to resolve conflict) and this can be difficult if the team leader does not have direct authority over the team members. This duality of loyalty can also affect motivation. Conflict of interest can be difficult to resolve if the team leader (or who they report to) does not have sufficient authority and power within the organisation.

» Underpinning this, the team needs to have an intrapreneurial culture, defined by Hisrich (1990) as one that develops visions, goals and action plans; takes action and rewards action; encourages suggesting, trying and experimenting; encourages creating and developing regardless of the area; and one that encourages the taking of responsibility and ownership. This strong sense of purpose or 'shared cognition' improves collective understanding within a group, and helps individuals with different functional backgrounds to reach consensus. This can improve decision-making quality and the general performance (Smith et al., 2005; West, 2007). It should also create a strong sense of identity and cohesion, characterised in Chapter 3 as Hofstede's 'in-group'.

» Complementary personal characteristics so that their team roles complement each other's (see Belbin team roles, Chapter 14). The team needs to build trust and this can be helped if the team has prior experience of working together.

The ability to work effectively as a team is important. At Google, all staff are involved in product development work in some form. They work in small teams of three or four people. Larger teams get broken down into smaller sub-teams, each working on specific aspects of the bigger project. Each team has a leader who rotates depending on the changing project requirements and most staff work in more than one team. As we have noted, research suggests that how the team functions and their commitment to achieving overall goals (shared cognition) are the most important factors in team effectiveness, and the personal chemistry between members of the team is important.

FACILITATING INTRAPRENEURSHIP

Intrapreneurs and venture teams should thrive within an organisation with an entrepreneurial architecture – an architecture created and nurtured by the leader of the organisation. However, for an intrapreneurial project to succeed it needs a number of other facilitating elements:

» High-level sponsor – Since it may not be appropriate for the architecture around the core activity of an organisation to be entrepreneurial, the intrapreneur and their team may need to be shielded in some way and made to feel that they are different and protected. Every project needs a high-level sponsor with sufficient authority to protect them when times are difficult or vested interests are upset and to help them unblock the blockages to change as they occur. The sponsor will help secure resources, provide advice and contacts and help give them the organisational freedom they need. They will need to nurture and encourage the intrapreneur and their team, particularly early on in the life of the project or when things go wrong. They will need to handle the internal politics, endorsing the project and creating visibility for it at the appropriate time. Underpinning this must be a trusting relationship between the sponsor and the intrapreneurial team and a clear vision for the future of the project either inside or outside the organisation.

» Resources – Resources of all kinds are needed for any project – particularly free time or slack from day-to-day responsibilities. Other resources may include money, materials and access to information, knowledge and skills that other managers may be jealously guarding. The high-level sponsor may need to facilitate cross-departmental transfers of staff to provide the team with the necessary skills to undertake the project and press departments to provide information to the project team.

» Tolerance of uncertainty and risk-taking – The team need to believe that they can take risks in pushing through the project without fear of being penalised. These risks may relate not only to the success or failure of the project but to potential damage to interpersonal relationships if the team is perceived as circumventing the authority of certain managers. The internal politics of an organisation may need to be managed by the high-level sponsor.

» Reward – We have seen how monetary reward is not necessarily a motivation for those undertaking cognitive tasks, although regular pay and security of employment are important for intrapreneurs. Gardner (2017) argued that companies should measure the inputs of individuals, not just their outputs, to reinforce the behaviour they want to encourage. They should prioritise intrinsic motivators, such as recognition, promotion, expanded job responsibility and personal development, over extrinsic motivators such as money. Rather than offering bonuses to individuals, companies should have a single profit pool and use frameworks and guidance, not formulas, to determine pay. She cautioned against rewards that discouraged collaboration. However, simple competitions can send clear signals to the organisation about what behaviour is valued. For example, the Chinese firm Tencent offers cash prizes for ideas that translate into innovations. Haier, the Chinese consumer electronics and appliance company, has competitions where teams of employees 'pitch' their ideas for projects against other teams to obtain prestigious recognition as well as resources. Haier now considers itself to have some 3,000 micro-businesses (Case insight 22.3).

Intrapreneurs and venture teams need to be aligned around one important goal – a specific, measurable achievement within a specific time frame. However, they need to have strategic intent to allow them to 'regroup' if they are pushed off course. Not only do they need to feel that they have autonomy, they need

> *Intrapreneurship focuses on building an environment where employees feel free to develop their ideas and provides mechanisms to support them.*
>
> Kevin Desouza, (2017), *Intrapreneurship: Managing Ideas Within Your Organisation*, Toronto: University of Toronto Press

Case insight 22.1 3M and the Post-it Note®

Intrapreneurs and 'bootlegging'

3M has been known for decades as an entrepreneurial company that pursues growth through innovation. In the late 1920s it developed a policy of allowing researchers to spend up to 15% of their time working on their own projects. To this day, it tries to make innovation part of the corporate culture by encouraging staff to spend some of their time working on pet ideas that may one day become new products for the company. Staff are encouraged to 'bootleg' (borrow) resources early in a product's development, but once an idea is accepted they can be allocated a budget to buy equipment and hire extra help. To get an idea accepted, they must first get the personal backing of a member of the main board. Then an inter-disciplinary team is set up to take the idea further. Membership of these teams is encouraged and often voluntary. Failure is not punished, but success is well rewarded.

Perhaps the best-known contemporary example of the success of this policy is the development of the Post-it Note® by Art Frye in the 1980s. He has become one of the best-known examples of how intrapreneurs work. He was looking for a way to mark places in a hymn book – a paper marker that would stick, but not permanently. At the same time the company had developed a new glue for the aerospace industry which, unfortunately as it seemed at the time, would not dry – a glue that would not stick firmly but left no residue. Art spotted a use for the product but what was different was the way he went about persuading his



Source: AbsolutVision on Unsplash

bosses to back the project. He produced the product, complete with its distinctive yellow colour, and distributed it to secretaries who started using it throughout 3M. Art then cut their supplies, insisting that there would be no more unless the company officially backed the product. The rest is history.

Access the *Digital Links* booklet to watch a video that tells the story of the Post-it Note®.

Questions:

1. Why is 'bootlegging' important for intrapreneurship?
2. What other lessons might you learn from how Art Frye went about getting the company to back his product?

to actually have that autonomy. However, since they will inevitably end up 'breaking the rules', they also need to be shielded from the politics of the organisation. At the same time, they need to be held accountable for their results and that implies a certain amount of control is needed.

Explore further 22.3

Intrapreneurship

Access the *Digital Links* booklet and watch the following videos:

- A TED talk by intrapreneur Joshua Mitro Lavra making the case for intrapreneurship.
- A Harvard Business Review interview with authors Linda Hill and Kent Lineback about networks and office politics.

INNOVATION DEPARTMENTS AND DIVISIONS

An innovation department is a permanent organisational structure set up for the purpose of originating and/or developing innovations. These innovative ideas might originate from within the department or from other sources, including intrapreneurs. The department then needs the resources to develop the idea. Innovation may also simply be a function within a department, for example an innovation function might be located within the marketing department of a company. The distinction between function and department is important in signalling to others in the organisation the authority and autonomy its management has and the importance of innovation within the organisation. Being part of an existing organisation, these functions or departments can be subsidised from other activities.

Being part of an existing organisation, these structures allow existing skills and competencies to be leveraged at the same time as maintaining the potential to learn and/or hire-in new ones. They allow revenues from existing, successful products and services to finance innovations which might take some time to become profitable. However, by separating out the development of innovation the hope is that the division or department will be able to establish its own organisational architecture that encourages and facilitates innovation as a continuous process. Mainstream activities can then continue as 'business as usual' in the rest of the organisation.

There are a number of issues with innovation departments or functions:

» They may find it difficult to 'think outside the box' in searching for innovative ideas because they share the same 'dominant logic' with the rest of the organisation but are likely to have narrower horizons. Indeed, rather than allowing skills and competencies across the organisation to be leveraged, they may cause them to be compartmentalised. If the innovation function is part of the production department, the innovations are likely to relate to production. If it is part of the marketing department, they are likely to relate to marketing.

» They may not have the skills and capabilities to take a promising idea forward, despite it being in some way strategically important to the future of the organisation. New ideas may need resources and investment beyond the normal budget of a department or function within a department. In these circumstances the intervention of top management may be required to provide the resources and degree of organisational separation and/or support needed by the department.

» They may be unduly susceptible to political infighting because of the seniority (or otherwise) of the managers and, even if the department has an entrepreneurial architecture itself, it may face a hostile architecture elsewhere in the organisation.

Because of these issues, an innovation department is most likely to come up with incremental innovations to products, processes or marketing that, because of their operational relatedness, will

probably be quickly adopted by the organisation. Typically, they have limited skills, knowledge and competencies compared to an ad hoc team drawn from across an organisation. To address this, one variant is to second individuals from that wider organisation on an ad hoc basis. What is really needed for large organisations that are seeking to encourage both incremental and radical innovation is an organisational capability that is more flexible and has more resources and greater perceived and real authority within the organisation. This may come by simply giving that department more resource, greater autonomy and more senior management – perhaps linking it to innovation across different divisions that straddle different product/market sectors.

However, many of the most innovative companies have set up separate, autonomous innovation units or divisions, often in a separate location, reporting directly to the CEO. Studies indicate that radical innovations are best placed in separate locations, led by a high-level manager with greater autonomy and free from the bureaucracy of the main organisation (e.g. Gwynne, 1997). The annual Boston Consulting Group survey of the most innovative companies found that 70 per cent of the 'strong' *digital* innovators had either a centralised organisation that controlled and drove innovation or one that drove research and development (R&D) and passed the results to business units (BCG, 2018). The distinction between department/function and division/unit is important – it indicates greater importance and autonomy – and depends to a large degree on volume and scale of activity, but might also reflect scope of activity and strategic importance of innovation within the organisation. For example, Alphabet has its own secretive early-stage ideation and development division called X Development whereas its major subsidiary, Google, has its own product development group and in-house incubator called Advanced Technology and Projects (ATAP).

CORPORATE ACCELERATORS AND INCUBATORS

While often intrapreneurial teams are left to work on their own within existing structures, albeit with a high-level sponsor, another approach is to move them into a corporate accelerator. These are development programmes, often linked to resources and facilities such as incubators, designed to facilitate rapid conceptualisation, prototyping and development of a business idea within a tight time frame. They might be open to company-only teams or mixed with outside projects teams – the aim being to encourage the cross-fertilisation of ideas and knowledge. Project selection is usually based upon recommendation but the team will also usually be required to make a 'pitch' to senior managers. If successful they might be extracted in whole or in part from their day-to-day jobs and allocated a budget and a time frame for completion of the project. The intrapreneur and their venture team might be moved to the incubator to develop the project until the organisation decides what to do with it – a topic we return to later. The project team might decide to join any spin-off from the project or move back into mainstream operations, where it is hoped that they will have developed that entrepreneurial mindset that can then be applied to another innovation project.

Corporate accelerators and incubators usually span all the divisions of an organisation. They therefore have a scale and scope that innovation departments do not have. They should have access to all the resources needed to develop the project prior to launch and expertise in facilitating a successful outcome. Maletz and Nohria (2001) found that placing innovative projects in this sort of organisational 'whitespace' outside the formal organisation – with its usual rules and procedures about planning, organising and controlling – accelerated natural experimentation and generally nurtured project development. The broader the boundaries of this 'whitespace', the more radical the innovations are likely to be.

Corporate accelerators and incubators are cost centres rather than short-term revenue generators but are strategically important for future developments in the organisation. Their success depends very much upon the resources they command, the autonomy they are granted and therefore the seniority of their management. Ultimately they will be judged by the success or otherwise of the projects they help to develop. The manager of the accelerator or incubator needs to have the seniority

Case insight 22.2 Alphabet and X Development

New product/service ideation and development divisions

Alphabet is the holding company for Google and other subsidiaries: Calico, Chronicle, Dandelion, DeepMind, GV, CapitalG, Google Fiber, Jigsaw, Sidewalk Labs, Verily, Waymo and X Development. Located on the edge of the Google campus in Mountain View California, X Development (formerly Google X) is where new ideas are identified and new products developed. It is focused on making actual objects that interact with the real world and have commercial value, and prides itself on being able to build the bridge between idea and proven concept. X is a secretive organisation. However, projects that have 'graduated' out of X to become subsidiaries of Alphabet include Google Glass, driverless cars (project Waymo), high-altitude Wi-Fi balloons (project Loon) and glucose-monitoring contact lenses (project Verily, which includes other life science projects).

X was originally set up in 2010 to build a driverless car. Its aim now is broader – to find and develop other major revenue streams to the highly successful Google search engine, which finances its current activities. Alphabet has unimaginable resources of money and talent, and it is bringing them to focus on the opportunities brought about by the coalescing of networks, computing power and artificial intelligence – areas where it has skills, competencies and market presence. Because of this, unlike many companies that fund only research with a short-term payback, most of X's projects are medium to long term. Most projects originate inside Google but it does 'buy in' some ideas, for example a current project called Makani that produces wind energy using kites was purchased in 2013.

X has over 250 employees from diverse backgrounds – former park rangers, sculptors, philosophers and machinists. One X scientist has won two Academy Awards for special effects. Another spent five years of his evenings and weekends building a helicopter in his garage. This diversity helps them bring different perspectives to problems and ideas. None are particularly 'experts' in any field. Astro Teller is CEO or 'Captain of Moonshots', and reports directly to Serge Brin (co-founder of the original Google and president of Alphabet). Teller himself has written a novel, worked in finance, and has a PhD in artificial intelligence. All projects are called 'moonshots' – defined as the intersection of a big problem, a radical solution, and breakthrough technology. Not surprisingly most of moonshots never see the light of day. Teller explained:

> *'If one of Google X's projects were a home run, became everything we wanted, I would be really happy. I would be overjoyed if it happened with two.'* (Fast Company, *May 2014)*



Source: AFP via Getty Images/Gerard Julien

X projects cover an extremely wide spectrum, across a wide variety of technological domains. They are not constrained by Google's core activity. There are three broad criteria to become an X project. Firstly, they must address a problem that affects millions of people (and therefore has the potential to generate $millions). Secondly, they must utilise a radical solution that has not been considered so far. Finally, they must use technologies that are now (or very nearly) obtainable. Despite the risks in this approach, X is not interested in incremental projects. Rich and DeVaul, head of the Rapid Evaluation Team, explained that this is as much because of practical as ideological reasons:

> *'It's so hard to do almost anything in this world. Getting out of bed in the morning can be hard for me. But attacking a problem that is twice as big or 10 times as big is not twice or 10 times as hard. If there's a completely crazy, lame idea, then it's probably come from me.'* (Fast Company, *May 2014)*

The generation of moonshots is encouraged, and staff are celebrated and rewarded for both project success and failure. Projects 'graduating' from X are celebrated with teams being awarded diplomas and wearing mortarboards at the ceremony. Finding good ideas is a numbers game – the more ideas you have, the more likely you are to find a good one – and X is as much about failure (or 'fail-fast') as success. At X failure is the norm. Teller has said that he sometimes hugs people who admit mistakes or defeat in group meetings. As DeVaul said: 'Why put off failing until tomorrow or next week if you can fail now?' (*Fast Company*, May 2014).

X monitors ideas from anywhere, inside and outside Alphabet, particularly academia. Ideas are brainstormed and often scenarios are built around how products might be used in the future. Each 'moonshot' comprises a small core team supplemented by in-house staff with expertise in particular, relevant fields such as design or mechanical engineering. To help build and develop prototypes X has its own 'Design Kitchen' next to the main building – a large-scale fabrication shop filled with 3-D printers, sophisticated lathes, table saws and other machinery. Obi Felton is 'Head of Getting Moonshots ready for Contact with the Real World' – which means she is in

charge of bringing an idea to market. She explained that not all the projects have to evolve into large revenue earners:

> *'The portfolio has to make money [but] not necessarily each product. Some of these will be better businesses than others, if you want to measure in terms of dollars. Others might make a huge impact on the world, but it's not a massive market.'* (Fast Company, *May 2014)*

The Rapid Evaluation Team test out the most promising moonshots by doing everything they can to get the idea to fail – theoretically, practically and commercially – a method that emphasises rejecting ideas more than affirming them. This is a three-stage process. Firstly, the team get a few weeks and a few thousand dollars to try to understand a moonshot's biggest risks. Overcoming those risks becomes the team's milestones and will unlock more budget or permission to grow the team. This kills many ideas quickly. In the second stage the team are given a few months and more money to build prototypes, focusing on the hardest and riskiest parts of the technology to better understand the problem they're trying to solve. At the same time, they must also build a techno-economic analysis that proves this idea could survive in the real world as a large business with a real market potential. Even fewer ideas survive this stage. Finally, under the direction of Obi Fenton, the project goes to the 'Foundry' to iron out any technology issues and decide whether or not the project can eventually be turned into a product and business in a reasonable time span. This can last about a year and even then the project might be returned to the Rapid Evaluation Team for 'reimagining'. X also uses 'kill signals'. These are metrics agreed with the team at the start of the project, such as viability within a certain time frame. If triggered, these metrics will kill the project immediately. Only about half of these projects 'graduate' from the Foundry stage. For example, the Loon Wi-Fi delivery system project went through the following process:

1. Problem identification – While the Rapid Evaluation Team were discussing issues and ideas related to communication generally and internet connection in particular, the project started life as an idea involving connections between mobile devices. But in 2011, DeVaul decided to shift focus towards increasing internet access for rural or poor areas – areas currently without any connection.
2. Idea development – The team discovered that Lockheed was working on a high-altitude communication airship that could stay in one place, but keeping such a craft stationary was proving extremely difficult. DeVaul had the insight of, rather than keeping one airship in place, replacing it quickly and cheaply with more airships – or rather balloons.
3. Solution testing – DeVaul bought a batch of high-flying weather balloons and assembled a radio transmitter in a cardboard box that he attached to one of them. He launched it over a reservoir, following in his car to see if it worked. An early milestone was to have balloons that could last for three months. Having achieved that, the next milestones became lowering the total cost of the balloons.
4. Prototype building – Loon was commissioned as an official project in 2011 and a team was recruited to build a small fleet of prototypes. X's 'Design Kitchen' began to work on a Loon antenna, building a small house in their workshop to see how the antenna might attach to customers' residences. They developed wireless routers that could be placed in these balloons that could fly high in the stratosphere.
5. Product introduction – Entrepreneur Mike Cassidy was brought in to manage the project's rollout as an actual business, first in 2013 as a pilot in New Zealand. In 2018 Loon graduated to become a subsidiary of Alphabet. Balloons are manoeuvred by adjusting their altitude in the stratosphere so that they float up to a wind layer that is blowing in the appropriate direction and speed. Users connect to the balloon network using their home antenna. The signal then travels from balloon to balloon, finally connecting to a ground station connected to an internet service provider. The aim is to enable everyone to access the internet even in remote areas.

Alphabet has a number of other research or innovation-focused subsidiaries. Google also has its own research division called Advanced Technology and Projects (ATAP), set up to continually review developments in Google's highly competitive technology-based environment, its product/market offering and to speed up its strategic research projects. One example of its work is on issues related to developing new unique user interfaces (UIs) for small smartwatches and other 'wearables' where, in a project called Jacquard, they have shown how to weave a multi-touch input panel like a mouse pad into regular cloth using existing textile industry processes.



Access the *Digital Links* booklet to visit the X Development website and to watch a video that explains what X Development does, highlighting some of its known projects. There is also a 42-minute interview with Astro Teller.

Questions:

1. How does Alphabet mitigate the risks associated with innovation?
2. What lessons are to be learned from X's approach to turning ideas into proven concepts? What is required to launch the proven concept onto a market?
3. How does the work of X differ from that of other research subsidiaries and in particular from ATAP? Why is the company organised in this way? Are there any disadvantages to this form of organisation?
4. Can any company imitate Alphabet's approach to organising innovation or is this model heavily based upon technological innovation?

that facilitates a close relationship not only with the leader of the organisation but also with each of the high-level sponsors of the projects that they house. Indeed, the manager of the accelerator or incubator may be the sole or joint high-level sponsor of the project, involved in project selection and monitoring.

Innovation departments or divisions and corporate incubators are not the same as traditional R&D departments. R&D departments are staffed by technical staff and dedicated to taking existing products further in their technical sophistication. In the R&D department the focus is entirely on technological advancement. The work is research-based and technology-driven. Many R&D departments are better at inventing than innovating. Innovation departments and corporate accelerators and incubators should be technology-enabled but market-focused and market-driven – where are the opportunities and how can we capitalise on them? Part of their work may be technology based but the emphasis is on how this will be delivered to a market and how it will best meet a real market need. This has been one of the real successes of both Apple and Alphabet, where the two functions are separated into different divisions.

STRUCTURING VENTURE OUTCOMES

Once the flow of innovative ideas has started the question will arise as to what to do with them, in particular, whether they are kept 'in-house' or 'spun out' in some way. Foster and Kaplan (2001) argued that companies should create and spin off new businesses continuously and sell off or close down those parts of the organisation where growth was slowing. They called these 'transformational strategies' of 'creative destruction'. This may be somewhat extreme. Generally there are two factors that influence this decision, both involve making judgements – there are no hard-and-fast rules to apply:

» Operational relatedness – This refers to how close the innovation is to the existing product/service portfolio and its market footprint, reflecting the core skills, competencies and capabilities of the organisation. This is not necessarily related simply to the industry a company is in. For example, Google's AdSense was not an internet search product, but rather leveraged Google's unique ability to gather data on what users were browsing so as to help better target advertising. Most incremental innovations will have high operational relatedness.

» Strategic importance – This refers to how important the innovation is to the future of the organisation. There could be many reasons for this but one factor is the current strategic orientation of the organisation and the business model it adopts in meeting the needs of customers. This might also provide some insights into the capabilities and competencies that underpin its business models (e.g. product quality, process efficiency or cost and customer focus).

Figure 22.7 shows how innovations are likely to be treated, based upon these judgements.

Box 1 Spin off

The less the innovation is related to existing operations, the more likely it is to be separated out in some way. If it has no strategic importance then it is likely to be spun off or sold, with the organisation retaining little or no ownership or control. For example, in 2003 McDonald's launched Redbox, a business that operates DVD-rental kiosks primarily outside grocery stores. Despite its success, between 2005 and 2008, it was sold off to a company called Coinstar because it was neither operationally related nor strategically important to McDonald's. The most important value in a spin-off is the skills, competencies and knowledge of the staff rather than the physical assets (Garvin, 1983). Spin-offs can create significant shareholder value, particularly for diversified firms (conglomerates). In 2016 there were 35 spin-offs in the USA, worth some $100 billion in initial market value. And spin-offs seem to perform particularly well once freed of the constraints of their parent. Cornell (2017) observes that between 2002 and 2016 spin-offs as a group outperformed the broader US stock market – the Bloomberg US Spun-Off Index returned 714 per cent, while the S&P 500 Index returned 155 per cent.

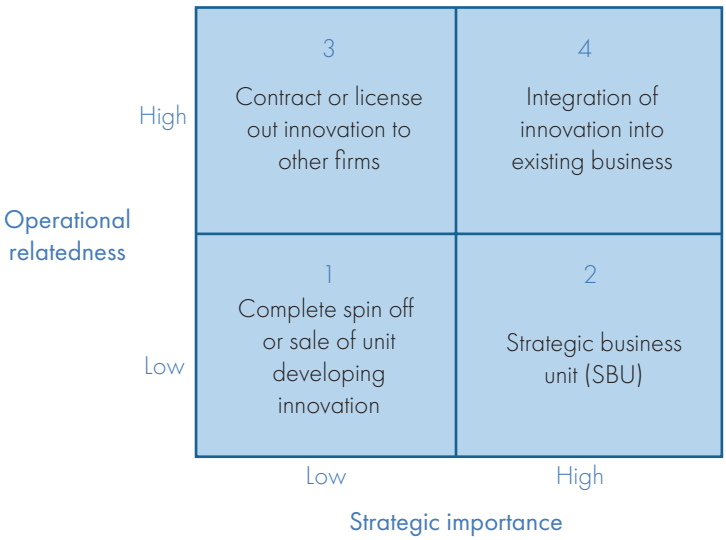


Figure 22.7 Structuring venture outcomes

Source: Burns (2020).

Box 2 Strategic business unit (SBU)

This is also called an 'independent or special business unit' or 'new venture unit'. If it is uncertain whether the innovation may have some strategic importance to the organisation, perhaps because it is based on new technology or emerging markets, then it could be placed within a separate 'unit' with a high degree of independence and autonomy until its fate is decided. Indeed, it may already have some degree of independence as a separate legal entity because of this importance or because legal separation allows any risks associated with it to be contained within the 'unit'. Sometimes these projects are grouped together in a separate division or legally separate company. The innovation might have originated from a corporate incubator or directly from an intrapreneurial team. It might be the result of a partnership or joint venture with another firm and therefore already enjoys a legal separation and independence from the organisation. It might already have new staff with different skills. Because the innovation may lead to new strategic directions for the organisation (i.e. diversification), full or partial ownership and control needs to be retained until decisions can be made about its future.

Box 3 Contract or license out

If the innovation is of little strategic importance but highly related to current operations, it might eventually be offered to other firms under contract or licence. This is appropriate where the intellectual property (IP) is embodied in a physical product or process that is owned by the company and that IP has commercial value but is not critical to the competitive advantage enjoyed by the mainstream operations. These innovations are also likely to be incremental and have originated from either ad hoc intrapreneurship teams or internal innovation departments.

Box 4 Integration

The more the innovation is related to existing operations, the more likely it is to be integrated into the existing business, particularly if it is also strategically important. These innovations are likely to be incremental and have originated from either ad hoc intrapreneurship teams or internal innovation departments. They will be absorbed into the mainstream activities of the organisation and are likely to have an immediate impact.

SUCCESSFUL CORPORATE VENTURING

Tidd and Bessant (2013) claimed that on average around half of all new ventures coming out of larger organisations survive to become operating divisions and they will typically achieve profitability within two to three years, with almost half becoming profitable within six years, and that internal corporate venturing is a less risky strategy of acquiring other companies. They said that four factors characterised firms that are consistently successful at internal corporate venturing:

- New venturing is seen as a learning process, learning from both success and failure;
- Distinction is made between bad decisions and bad luck in failed ventures;
- Metrics and milestones are agreed in advance and monitored regularly, learning from experience and redirecting or resetting strategies as necessary;
- There is a willingness to terminate the venture if necessary, rather than making further investments.

They claimed that the main reason for the failure of these ventures is not simply their poor commercial prospects, but rather 'strategic reversal':

- When the timescales for the new venture conflict with those of the existing business, for example it does not generate profit or cash flow quickly enough;
- When internal politicking undermines the venture and it faces difficulties of some sort, called the 'emergency trap'.

Internal corporate venturing is just one of the tools used in corporate entrepreneurship. Others include developing partnerships, alliances and joint ventures (Chapter 11) and external corporate venturing through acquisition of other companies (Chapter 18). Such acquisitions are likely to involve the purchase of IP and/or market share. For example, it has been estimated that it can take 15 years to research and develop a new medicine and cost up to $1.7 billion to get it into production. This has led many large pharmaceutical companies to look to other smaller organisations to undertake the 'research' and then buy it in through patents or company acquisition, reducing the risks they face and leaving the 'development' and the marketing of the product to them, where they consider their real skill and capability to lie.

The degree of relatedness of new products or markets will often determine how far an organisation is able to move into new products and markets on its own through internal corporate venturing.

Case insight 22.3 Haier Group

Entrepreneurial architecture

Although little known in the West, Haier Group is one of the largest non-state-owned enterprises in China. With over 10% of the global market, it is the largest manufacturer of 'white goods' in the world. It is also the world's fastest-growing appliance manufacturer. Haier was hailed by *Strategy + Business* as a 'high-performing and truly entrepreneurial global business' (Issue *77*, Winter 2014). Its CEO, Zhang Ruimin, was invited to give the keynote address at the 2013 annual meeting of the Academy of Management and was lauded by the journal for 'organising the company around a conceptual framework that has guided its development for years – in Haier's case, practically since its founding'. In this framework you will recognise all the characteristics of corporate entrepreneurship:

> *'As soon as a company grows large, its employees learn to work in accordance with the company's rules. As regulations multiply and companies control their employees more tightly, everyone becomes really good at following orders. Their sensitivity to the market decreases accordingly ... Lack of entrepreneurial spirit is a major reason for the decreasing competitiveness – and even the eventual collapse – of big enterprises. It is an extremely difficult problem for Chinese companies in particular ... An enterprise must evolve into a system that stands on its own, and does not depend on the whim and fancy of its current leader'.*

Haier started its life as a manufacturing firm that was partly owned by the city of Qingdao, one of China's first enterprise zones. It was not successful. Many of its products had to be repaired before they could be used. Zhang, who was then an assistant administrator in the city, was instructed to find a managing director who could turn the business around. He failed and so in 1984, at the age of 25 and with little or no

business experience, he took the job himself. It took time, but Zhang eventually succeeded.

Today Haier manufactures a wide range of appliances such as refrigerators, washing machines, dryers, entertainment electronics and air and water conditioners. It is an international company with manufacturing facilities in China, across Asia, the Middle East, Africa, South America and the USA (it bought GE Appliances in 2017). It has differentiated itself by targeting the needs of market niches. For example, it manufactures large washing machines for Pakistani robes, small ones for Chinese delicate fabrics and durable ones with large hoses for washing vegetables on Chinese farms. It has water purifiers that remove specific pollutants from each of 220,000 communities across China (it jointly holds some 20 water purification patents). In 2015 it launched the world's first 'pocket' washing machine, the size of an electric shaver and weighing just 200g, called the CODO.

Haier is also repositioning itself from being a manufacturer to being a 'provider of solutions to consumers' problems', selling both home appliances and services such as water safety information. Part of this repositioning involves dealing with customers more directly, online and through social media, involving them in product selection (for example by offering different configuration of products – colour and design), testing or reviews (sharing feedback) and even product development. The CODO idea came from an engineer in the company's washing machine R&D department and was developed by Haier's central R&D department in Japan. Once the project team had developed an early prototype the project leader placed the concept onto the internet to get consumers' views, which ranged from suggestions about the product, through to its name, colour and packaging:

> *'We have a culture of self-questioning. Everyone is always challenging their own ideas and continuously surpassing themselves ... Those inside Haier, especially managers, understand that it's crucial that we adapt to the evolving needs of users and the changing environment.'*

Haier's success hinges on four key capabilities:

- Customer responsive innovation – The ability to tailor products or services to local needs;
- Operational excellence – The ability to produce high quality products at very low prices through a commitment to continuous improvement, a zero-defect policy and internal competition;
- Management of local distribution networks – An ability developed in China's decentralised value chain and applied to emerging markets;
- On-demand production and delivery – Combining a customer-pull distribution chain and a zero-inventory logistics system to deliver high variety at very low cost.

Key to achieving this was the move towards a flat organisation structure with decentralised, participative management and autonomous but accountable work teams and platforms (see Chapter 14). Every part of the company is an autonomous, platform-based profit centre or micro-enterprise. They can make their own decisions about target customers, employees and who they partner with – including other parts of the company. R&D projects embrace open innovation and can involve collaborative working with outside designers, academics – even competitors – through its own ecosystem of partners called HOPE (Haier Open Partnership Ecosystem). For example, the Air Box is a smartphone-controlled intelligent controller for monitoring and managing the climate in a building – linking heating, air conditioning and air filtration. The concept was developed with significant customer input but the product was developed in partnership with Samsung and Apple so that it can control any climate control system, not just those manufactured by Haier. The company has so many innovations being developed that it now has its own in-house intellectual property team of some 40 specialists:

> *'We reorganised ourselves as an entrepreneurial platform. We flattened everything out, taking out all the middle management. We decentralised the structure to one with more than 2,800 counties. Each county organisation has seven people or fewer.' (Zhang Ruimin, CEO, Haier Group,* Strategy + Business, *Issue 77, Winter 2014)*

Haier is starting to expand its product/market offerings by developing a comprehensive series of 'smart solutions' for the home – the living room, kitchen, laundry room and bathroom. These network-enabled products use an open ecosystem-based platform called Haier U+ Smart Life Platform which allows a wide range of products to be controlled remotely.

Access the *Digital Links* booklet to visit the company website and watch a short video in Chinese all about Haier (with subtitles) and a 45-minute video that explains how Haier grew to become what it is today (in English).

Questions:

1. Is Haier an entrepreneurial organisation? If so, how does it achieve this? Is this part of an entrepreneurial architecture?
2. How would you go about the task of creating an entrepreneurial architecture? How difficult is it?

External corporate venturing may help an organisation extend this reach. What is more, both strategies can be carried out side by side. The appropriateness depends on how far the organisation is straying from its core competencies, and in particularly from its existing products and markets. The further it strays, the higher the risk. Partnerships, alliances and joint ventures can mitigate these risks. They are particularly valuable when two partners have complementary capabilities to each other, with strengths related to either the product or market development being undertaken. As we noted in Chapter 18, launching radically new products into completely new markets is a high-risk strategy and one where corporate acquisition can be attractive. Figure 22.8 shows how these tools might be used to mitigate risk. It should be viewed alongside Figure 18.8.

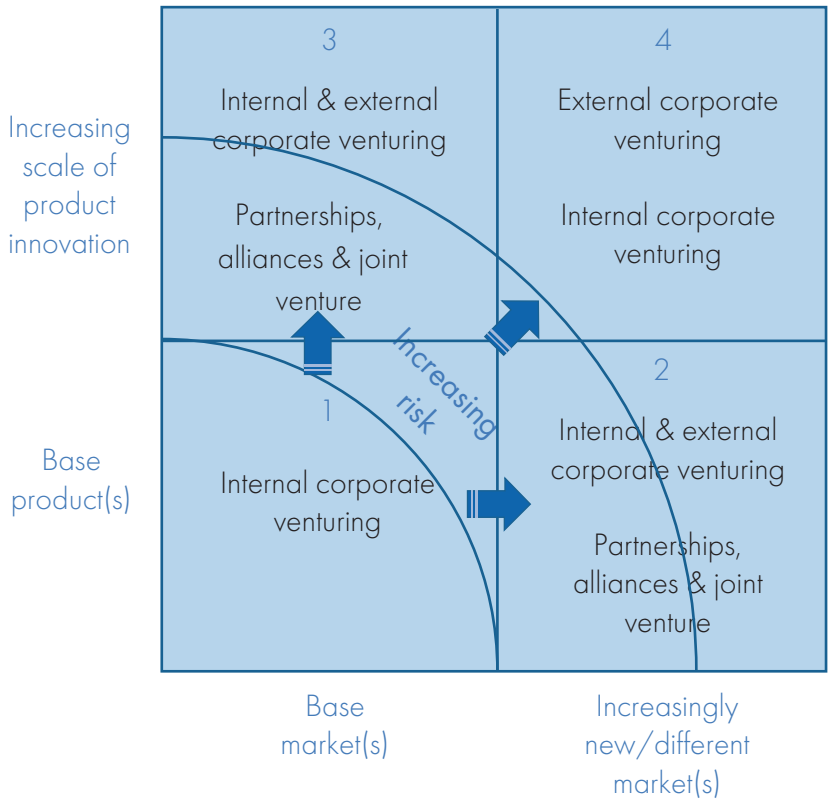


Figure 22.8 Corporate venturing and risk mitigation

Source: Burns (2020).

Explore further 22.4

Corporate Entrepreneurship Audit

Access the *Digital Links* booklet to explore the Corporate Entrepreneurship Audit (CEA) tool. This free interactive tool offers a structured approach to assessing the entrepreneurial orientation of organisational architecture. It comprises a 100-question audit based on structure, culture, leadership and strategies. A further 25 questions assess the environment within which it operates in order to assess comparability.

SUMMARY

- 'Corporate entrepreneurship' is the term used to describe entrepreneurial behaviour in an established, larger organisation. It includes terms such as 'entrepreneurial transformation', 'strategic renewal' and 'strategic entrepreneurship'. Organisations involved in these processes have been said to exhibit a sustained pattern of entrepreneurial behaviour over time, which in turn has been called an 'entrepreneurial orientation'. These patterns of behaviour are the result of an organisational architecture that encourages entrepreneurial behaviours.
- Corporate venturing (both internal and external) is a major tool for encouraging corporate entrepreneurship and part of an entrepreneurial architecture. This includes intrapreneurship (including venture teams), partnerships, alliances and joint ventures as well as strategic acquisitions.
- The four pillars of organisational architecture are leadership, culture, structure and strategy. These can be crafted to make an entrepreneurial architecture based on the character traits and approaches to management, decision-making and risk-taking of entrepreneurs.
- A strong architecture is based on a network of relational contracts within or around the organisation – with employees, suppliers, customers and other networks. This is not based on legal contracts and often only partly specified; therefore it is not easy to copy. It is based upon trust and mutual self-interest. Because it is complex and difficult to copy, architecture can be a major source of sustainable competitive advantage.
- Entrepreneurial architecture creates within the organisation the knowledge and routines that allow it to respond flexibly to changes and opportunities in the very way the entrepreneurs respond. Real knowledge means using the wheel of learning to understand the root cause of problems so as to put in place systematic solutions – 'knowing how', 'knowing why' and doing something about it. This double-loop learning also involves challenging 'dominant logic' and can be a way of encouraging managers to become more entrepreneurial. The knowledge generated is also tacit and therefore more difficult to copy by competitors.
- There can be no prescriptive blueprint for an entrepreneurial architecture. It depends on the environment. It can be sectorally and geographically dependent. It can also vary with the nature of the entrepreneurial activity. For the organisation to work effectively, the organisation architecture and the style of management need to be in sync.
- Intrapreneurs and venture teams push through innovations within larger organisations in an entrepreneurial fashion. The four most significant enablers of intrapreneurship are senior management support, organisational architecture, resources (including time) and tolerance of risk-taking. Without these, intrapreneurship will not flourish.
- Corporate venturing (both internal and external), including corporate acquisitions, allows companies to move into new products and new markets at lower risk, ultimately extending their core competencies. It is particularly valuable in emerging markets.
- What to do with a new development depends on how strategically important and how operationally related it is to the business. The more strategically important the development and the more operationally related it is to existing activities, the more likely it is to be kept in house. If there is little or no operational relatedness and the development has little or no strategic importance to the existing business, then it is likely to be spun off, with no ownership retained.

GROUP DISCUSSION TOPICS

1. Can large firms also be entrepreneurial? Is it in their interests to be so? What pressures are there for them not to be entrepreneurial?
2. What is corporate entrepreneurship?
3. What do you understand by the term 'entrepreneurial architecture' and how can it be shaped?
4. Why are relationships rather than legal contracts important within organisational architecture?
5. If learning and knowledge are tacit, how do you spread them within an organisation?
6. How does architecture produce sustainable competitive advantage?
7. Should an entrepreneur find building an entrepreneurial architecture easier than other people?
8. Can a traditional manager become an intrapreneur? What are the blocks or barriers and how can they be overcome?
9. Will an entrepreneurial architecture succeed in all economic and/or geographic environments? Explain.
10. In what circumstances might a bureaucratic organisation be more successful than an entrepreneurial organisation?
11. What is corporate venturing? How does it relate to corporate entrepreneurship?

12. Why are operational relatedness and strategic importance important determinants of what an organisation might do with new ventures' outcomes?
13. Is external corporate venturing any more than an excuse for buying up successful small firms?
14. Why might a large company want to spin out a new venture with good commercial opportunities?
15. The number of people leaving to set up their own business is a sign of a 'real' entrepreneurial organisation. Discuss.
16. Does there always have to be at least one intrapreneur in a venture team?
17. What are the pros and cons of innovation departments compared to innovation divisions?
18. How does an innovation or new venture division differ from an R&D department?
19. Why should new product/service ideas not simply be integrated into an existing business?
20. Can lean start-up methodologies be applied to projects in large firms? If so, how might they need to be adapted to deal with internal political considerations?

STUDENT ACTIVITIES

1. Assess the entrepreneurial orientation of a company using the Corporate Entrepreneurship Audit tool.
2. List the types of organisations and market sectors that face high degrees of turbulence. Select a particularly turbulent sector and research how the organisations within it are organised and the success, or otherwise, they have in dealing with it. Write a brief report outlining the main organisational characteristics you observe.
3. Select two organisations, one that you would describe as entrepreneurial, and the other that you would describe as bureaucratic. Using the OCAI as your framework (see Chapter 16), write a brief report contrasting their cultures.
4. Select an industry where a hierarchical, bureaucratic structure should be the best way to organise. Select a company in this industry and investigate its organisational structure. Write a brief report outlining its structures and explain why it conforms or otherwise to your expectations, taking into account the success of the business.
5. Select a large company spin-out. Research and write a brief report outlining its history and describe its success or failure. Explain the lessons to be learned from this.
6. Find an example of a corporate acquisition that has proved either successful or unsuccessful and analyse why. Write a brief report outlining the lessons to be learned from this.

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