

BALANCE SHEET (continued)
For Year Ending December 31

	2003	2002	2001
Accounts Payable	440,556	165,000	99,000
Line of Credit	570,638	353,000	267,435
Current Portion of Long-term Debt	325,346	162,000	41,461
Total Current Liabilities	1,336,540	680,000	407,895
Long-term Debt	3,256,460	1,620,000	414,605
Equity	1,510,000	1,500,000	1,527,500
Total Liabilities and Equity	6,100,000	3,800,000	2,350,000

Financial Situation

HPT has a \$600,000 line-of-credit with the Toronto Dominion Bank. The limit could be extended, but only if the bank has sufficient loanable funds and the company is in good financial condition. The company must maintain a current ratio of 1.5, a times interest earned ratio of 5.0, and can only borrow up to 50 per cent of the value of its accounts receivable and inventory. The company negotiates separate term loans and mortgages to finance its capital purchases. Under Jane Wallace's leadership, HPT had an excellent relationship with its bank, but William's poor management and interpersonal skills had put this relationship in jeopardy.

Retail sales were paid for in cash or by credit card so there were no accounts receivable. Sales to businesses made up about 40 per cent of sales and were on terms 2/10, net 30 with negligible bad debts. HPT bought its tires from the various manufacturers on terms 2/15, net 30, which was the norm in the industry. Interest was charged on overdue accounts at 12 per cent per annum and many retailers who got too far in arrears were put on a cash-and-carry basis.

A slowdown was forecasted in the local economy in 2004 due to the forest fires that took place in the summer of 2003 and the collapse of the Canadian beef industry caused by the discovery of mad cow disease in neighbouring Alberta.

The following industry average ratios (based on year-end figures) were available for companies that sold both tires and automotive maintenance services:

Current Ratio	1.90
Cash Ratio	.51
Inventory Turnover in Days	60 days
Accounts Receivable Turnover in Days	30 days
Accounts Payable Turnover in Days	15 days

Fixed Assets Turnover	3.19
Total Assets Turnover	2.00
Debt Ratio	30.00%
Times Interest Earned	14.63
Cost of Borrowing	6.50%
Gross Profit Margin	42.00%
Operating Profit Margin	12.00%
Net Profit Margin	6.71%
Return on Assets	13.42%
Return on Equity	19.17%

HPT's marginal tax rate was 40 per cent.

Turnaround

Jenny Chen had just returned to her downtown office at Dexter, Mathews & Jones from a meeting with Jane Wallace in February, 2004—Chen was feeling quite sad. Jane Wallace had worked very hard the last 35 years managing the family business as a legacy to her beloved parents who had passed away in a car accident prior to her taking control in the late 1960s. At 64, she was in need of a rest after a long career building HPT, but her son seemed to have mismanaged the business terribly during his short tenure and she now had to take back control before things got even worse.

Jane Wallace asked Chen to prepare a comprehensive review of HPT's operations with a focus on why things had deteriorated so much and what she might do to improve operations. Knowing, quite reasonably, that she could not continue running HPT indefinitely, Jane Wallace also asked Chen to make further recommendations on the future management of the company.



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LEADING THROUGH TROUBLE, THE HARVEST, AND BEYOND¹

Another time, we had a cart go up in flames, and we went out on another cart, which we wrecked by running it into the cart that was on fire.

Mike Weir, Golfer

It's better to burn out than it is to rust.

Neil Young, Musician

Upon completion of this chapter, you will be able to:

- | | | |
|------------------|---|------------------|
| RESULTS EXPECTED | <ol style="list-style-type: none"> 1. Identify specific signals and clues that can alert entrepreneurial leaders to impending crises, and describe both quantitative (ratio analysis) and qualitative symptoms of trouble. 2. Describe the principal diagnostic methods used to devise intervention and turnaround plans, and identify remedial actions used for dealing with lenders, creditors, and employees. 3. See the importance of first building a great company and thereby creating harvest options. | RESULTS EXPECTED |
| | <ol style="list-style-type: none"> 4. Explain why harvesting is an essential element of the entrepreneurial process and does not necessarily mean abandoning the company. 5. Identify the principal harvest options, including trade sale, going public, and cash flow ("capital cow"). 6. Discuss the importance of creating a longer-term legacy from personal and family wealth by pursuing philanthropic activities and contributing to community renewal. | |

This chapter tackles issues that generally arise in the latter stages of a venture's existence. The first part of this chapter deals with problems after time has elapsed and the venture has made it through growing pains. With experience comes both comfort and an array of problems associated with apathy. Alternatively the entrepreneur may come to the realization that what served the enterprise so well in the past may now be a source of sub-par performance. The second part of this chapter deals with the harvest—the end of one venture—an action that may lead to a foray into another endeavour.

Perhaps the analogy of the automobile serves to demonstrate the service period and final kilometres of a vehicle are similar to events for an enterprise. A new car may require a period of breaking in—any number of things might go wrong early on—but once those bugs are ironed out, it should run fine for quite a while. Later on—depending on how well it's maintained and how hard it's driven—the car comes to the end of its useful life with

its owner. The owner may upgrade to a bigger and better car. However, unlike a venture, vehicles seldom increase in value. Finally, tuning-up your vehicle or your venture ensures the highest price when you part ways.

WHEN THE BLOOM IS OFF THE ROSE

We now turn our attention to the entrepreneur and the troubled company. It traces the firm's route into and out of crisis and provides insight into how a troubled enterprise can be rescued by a turnaround specialist.

Many times in history, companies have experienced times of financial troubles. The most recent is the economic downturn in 2009 for instance. Both corporate and personal bankruptcies increased during this period, and entrepreneurs needed a new and special set of skills to lead through the shoals.

There is a saying among horseback riders that the person who has never been thrown from a horse probably has never ridden one! Jim Hindman, founder of Jiffy Lube, is fond of saying, "Ultimately it is not how many touchdowns you score but how fast and often you get up after being tackled." Mike Weir said "Playing hockey, there were a lot of guys bigger than me, so I knew I was going to get hit and have to deal with it. Gotta hit back." These insights capture the essence of the ups and downs that can occur during the growth and development of a new venture.

Getting into Trouble—The Causes

Trouble can be caused by external forces not under the control of management. Among the most frequently mentioned are recession, interest rate changes, changes in government policy, inflation, the entry of new competition, and industry/product obsolescence.

However, those who lead turnarounds find that while such circumstances define the environment to which a troubled company needs to adjust, they are rarely the sole reason for a company's failure. External shocks impact all companies in an industry, and only some of them fail. Others survive and prosper.

Most causes of failure can be found within company leadership. Although there are many causes of trouble, the most frequently cited fall into three broad areas: inattention to strategic issues, general management problems, and poor financial/accounting systems and practices. There is striking similarity between these causes of trouble and the causes of failure for start-ups given in Chapter 2. Exercise 10 "Flaws, Assumptions, and Downside Consequences—Risk Reconsidered" in the Venture Opportunity Screening Exercise that accompanies Chapter 3 and is found on the Online Learning Centre at www.mcgrawhill.ca/olc/timmons is a tool worth visiting.

Strategic Issues

- *Misunderstood market niche.* The first of these issues is a failure to understand the company's market niche and to focus on growth without considering profitability. Instead of developing a strategy, these firms take on low-margin business and add capacity in an effort to grow. They then run out of cash.
- *Mismanaged relationships with suppliers and customers.* Related to the issue of not understanding market niche is the failure to understand the economics of relationships with suppliers and customers. For example, some firms allow practices in the industry to dictate payment terms, when they may be in a position to dictate their own terms.
- *Diversification into an unrelated business area.* A common failing of cash-rich firms that suffer from the growth syndrome is diversification into unrelated business areas. These firms use the cash flow generated in one business to start another without good reason. As one turnaround consultant said, "I couldn't believe it. There was no synergy at all. They added to their overhead but not to their contribution. No common sense!"

- *Mousetrap myopia.* Related to the problem of starting a firm around an idea, rather than an opportunity, is the problem of firms that have "great products" and are looking for other markets where they can be sold. This is done without analyzing the firm's opportunities.
- *The big project.* The company gears up for a "big project" without looking at the cash flow implications. Cash is expended by adding capacity and hiring personnel. When sales do not materialize, or take longer than expected to materialize, there is trouble. Sometimes the "big project" is required by the nature of the business opportunity. An example of this would be the high-technology start-up that needs to capitalize on a first-mover advantage. The company needs to prove the product's "right to life" and grow quickly to the point where it can achieve a public market or become an attractive acquisition candidate for a larger company. This ensures that a larger company cannot use its advantages in scale and existing distribution channels, after copying the technology, to achieve dominance over the start-up.
- *Lack of contingency planning.* As has been stated over and over, the path to growth is not a smooth curve upward. Firms need to be geared to think about what happens if things go sour, sales fall, or collections slow. There need to be plans in place for layoffs and capacity reduction.

Leadership Issues

- *Lack of leadership skills, experience, and know-how.* As was mentioned in Chapter 5, while companies grow, entrepreneurs need to change their leadership mode from doing to leading to leading leaders.
- *Weak finance function.* Often, in a new and emerging company, the finance function is nothing more than a bookkeeper. One company was five years old, with \$20 million in sales, before the founders hired a financial professional.
- *Turnover in key management personnel.* Although turnover of key management personnel can be difficult in any firm, it is a critical concern in businesses that deal in specialized or proprietary knowledge. For example, one firm lost a bookkeeper—the only person who really understood what was happening in the business.
- *Big-company influence in accounting.* A mistake that some companies often make is to focus on accruals, rather than cash.

Poor Planning, Financial/Accounting Systems, Practices, and Controls

- *Poor pricing, overextension of credit, and excessive leverage.* These causes of trouble are not surprising and need not be elaborated. Some of the reasons for excess use of leverage are interesting. Use of excess leverage can result from growth outstripping the company's internal financing capabilities. The company then relies increasingly on short-term notes until a cash flow problem develops. Another reason a company becomes overleveraged is by using guaranteed loans in place of equity for either start-up or expansion financing. One entrepreneur remarked, "[The guaranteed loan] looked just like equity when we started, but when trouble came it looked more and more like debt."
- *Lack of cash budgets/projections.* This is a most frequently cited cause of trouble. In small companies, cash budgets/projections are often not done.
- *Poor management reporting.* While some firms have good financial reporting, they suffer from poor management reporting. As one turnaround consultant stated, "[The financial statement] just tells where the company has been. It doesn't help manage the business. If you look at the important management reports—inventory analysis, receivables aging, sales analysis—they're usually late or not produced at all. The same goes for billing procedures. Lots of emerging companies don't get their bills out on time."

- **Lack of standard costing.** Poor management reporting extends to issues of costing, too. Many emerging businesses have no standard costs against which they can compare the actual costs of manufacturing products. The result is they have no variance reporting. The company cannot identify problems in process and take corrective action. The company will know only after the fact how profitable a product is.

Even when standard costs are used, it is not uncommon to find that engineering, manufacturing, and accounting each has its own version of the bill of material. The product is designed one way, manufactured a second way, and costed a third.

- **Poorly understood cost behaviour.** Companies often do not understand the relationship between fixed and variable costs. For example, one manufacturing company thought it was saving money by closing on Saturday. In this way, management felt it would save paying overtime. It had to be pointed out to the lead entrepreneur by a turnaround consultant that, "He had a lot of high-margin product in his manufacturing backlog that more than justified the overtime."

It is also important for entrepreneurs to understand the difference between theory and practice in this area. The turnaround consultant mentioned above said, "Accounting theory says that all costs are variable in the long run. In practice, almost all costs are fixed. The only truly variable cost is a sales commission."

Getting Out of Trouble

The major protection against and the biggest help in getting out of these troubled waters is to have a set of advisors and directors who have been through this in the past. They possess skills that aren't taught in school or in most corporate training programs. An outside "vision" is critical. The speed of action has to be different; control systems have to be different; and organization generally needs to be different.

Although uncontrollable external factors such as new government regulations do arise, an opportunity-driven firm's crisis is usually the result of management error. Yet in these management errors are found part of the solution to the troubled company's problems. It is pleasing to see that many enterprises—even enterprises that are insolvent or have negative net worth or both—can be rescued and restored to profitability.

Predicting Trouble

Since crises develop over time and typically result from an accumulation of fundamental errors, can a crisis be predicted? The obvious benefit of being able to predict crisis is that the entrepreneur, employees, and significant outsiders, such as investors, lenders, trade creditors—and even customers—could see trouble brewing in time to take corrective actions.

There have been several attempts to develop predictive models. Two are presented below and have been selected because each is easy to calculate and uses information available in common financial reports. Because management reporting in emerging companies is often inadequate, the predictive model needs to use information available in common financial reports.

Each of the two approaches below uses easily obtained financial data to predict the onset of crisis as much as two years in advance. For the smaller public company, these models can be used by all interested observers. With private companies, they are useful only to those privy to the information and are probably only of benefit to such non-management outsiders as lenders and boards of directors.

The most frequently used denominator in all these ratios is the figure for total assets. This figure often is distorted by "creative accounting," with expenses occasionally improperly capitalized and carried on the balance sheet or by substantial differences between tangible book value and book value (i.e., overvalued or undervalued assets).

Net-Liquid-Balance-to-Total-Assets Ratio

The model shown in Exhibit 15.1 was developed to predict loan defaults. This ratio has been shown to predict loan defaults with significant reliability as much as two years in advance. But the science of prediction is ever improving. Marissa Mayer, a Google vice president, points out that credit card companies are generating detailed psychometric profiles and accurately assessing behaviour; the credit card company knows that you will be getting divorced two years before you do.²

This approach is noteworthy because it explicitly recognizes the importance of cash. Among current accounts, it distinguishes between operating assets (such as inventory and accounts receivable) and financial assets (such as cash and marketable securities). The same distinction is made among liabilities, where notes payable and contractual obligations are financial liabilities and accounts payable are operating liabilities.

The model then subtracts financial liabilities from financial assets to obtain a figure known as the net liquid balance. Net liquid balance can be thought of as "uncommitted cash," cash the firm has available to meet contingencies. Because it is the short-term margin for error should sales change, collections slow, or interest rates change, it is a true measure of liquidity. The net liquid balance is then divided by total assets to form the predictive ratio.

Non-quantitative Signals

In Chapter 12 we discussed patterns and actions that could lead to trouble, indications of common trouble by growth stage, and critical variables that can be monitored.

Turnaround specialists also use some non-quantitative signals as indicators of the possibility of trouble. As with the signals discussed in Chapter 12, the presence of a single one of these does not necessarily imply an immediate crisis. However, once any of these surfaces and if the others follow, then trouble is likely to mount.

- Inability to produce financial statements on time.
- Changes in behaviour of the lead entrepreneur (such as avoiding phone calls or coming in later than usual).
- Change in management or advisors, such as directors, accountants, or other professional advisors.
- Accountant's opinion that is qualified and not certified.
- New competition.
- Launching of a "big project."
- Lower research and development expenditures.
- Special write-offs of assets and/or addition of "new" liabilities.
- Reduction of credit line.

EXHIBIT 15.1 Net-Liquid-Balance-to-Total-Assets Ratio

Net-Liquid-Balance-to-Total-Assets Ratio = NLB/Total Assets

Where

NLB = (Cash + Marketable securities) – (Notes Payable + Contractual obligations)

Source: Ismael G. Dambolena and Joel M. Shulman, "Primary Rule for Detecting Bankruptcy: Watch the Cash," *Financial Analysts Journal* 44, no. 5 (1988): 74–78.

THE GESTATION PERIOD OF CRISIS

Crisis rarely develops overnight. The time between the initial cause of trouble and the point of intervention can run from 18 months to five years. What happens to a company during the gestation period has implications for the later turnaround of the company. Thus, how the lead entrepreneur reacts to crisis and what happens to morale determine what will need to happen in the intervention. Usually, a demoralized and unproductive organization develops when its members think only of survival, not turnaround, and its entrepreneur has lost credibility. Further, the company has lost valuable time.

In looking backward, the plot of a company's key statistics shows trouble. One can see the sales growth rate (and the gross margin) have slowed considerably. This is followed by an increasing rise in expenses as the company assumes that growth will continue. When the growth doesn't continue, the company still allows the growth rate of expenses to remain high so it can "get back on track."

The Paradox of Optimism

In a typical scenario for a troubled company, the first signs of trouble (such as declining margins, customer returns, or falling liquidity) go unnoticed or are written off as teething problems of the new project or as the ordinary vicissitudes of business. For example, one entrepreneur saw increases in inventory and receivables as a good sign, since sales were up and the current ratio had improved. However, although sales were up, margins were down, and he did not realize he had a liquidity problem until cash shortages developed.

Although the lead entrepreneur may miss the first signs, outsiders usually do not. Banks, board members, suppliers, and customers see trouble brewing. They wonder why the venture team does not respond. Credibility begins to erode.

Soon the venture team has to admit that trouble exists, but valuable time has been lost. Furthermore, requisite actions to meet the situation are anathema. The lead entrepreneur is emotionally committed to people, to projects, or to business areas. Further, to cut back in any of these areas goes against instinct, because the company will need these resources when the good times return.

The company continues its downward fall, and the situation becomes stressful. Turnaround specialists mention that stress can cause avoidance on the part of an entrepreneur. Others have likened the entrepreneur in a troubled company to a deer caught in a car's headlights. The entrepreneur is frozen and can take no action. Avoidance has a basis in human psychology. One organizational behaviour consultant who has worked on turnarounds said, "When a person under stress does not understand the problem and does not have the sense to deal with it, the person will tend to replace the unpleasant reality with fantasy." The consultant went on to say, "The outward manifestation of this fantasy is avoidance." This consultant noted it is common for an entrepreneur to deal with pleasant and well-understood tasks, such as selling to customers, rather than dealing with the trouble. The result is that credibility is lost with bankers, creditors, and so forth. (These are the very people whose cooperation needs to be secured if the company is to be turned around.)

Often, the decisions the entrepreneur does make during this time are poor and accelerate the company on its downward course. The accountant or the controller may be fired, resulting in a company that is then flying blind. One entrepreneur, for example, running a company that manufactured a high-margin product, announced across-the-board cuts in expenditures, including advertising, without stopping to think that cutting advertising on such a product only added to the cash flow problem.

Finally, the entrepreneur may make statements that are untrue or may make promises that cannot be kept. This is the death knell of his or her credibility.

The Bloom Is Off the Rose—Now What?

Generally, when an organization is in trouble some telltale trends appear.

- Ignore outside advice.
- Worse is still yet to come.
- People (including and usually, most especially, the entrepreneur) have stopped making decisions and also have stopped answering the phone.
- Nobody in authority has talked to the employees.
- Rumours are flying.
- Inventory is out of balance. That is, it does not reflect historical trends.
- Accounts receivable aging is increasing.
- Customers are becoming afraid of new commitments.
- A general malaise has settled in while a still high-stressed environment exists (an unusual combination).

Decline in Organizational Morale

Among those who notice trouble developing are the employees. They deal with customer returns, calls from creditors, and the like, and they wonder why management does not respond. They begin to lose confidence in their leader(s).

Despite troubled times, the lead entrepreneur talks and behaves optimistically or hides in the office declining to communicate with employees, customers, or vendors. Employees hear of trouble from each other and from other outsiders. They lose confidence in the formal communications of the company. The grapevine, which is always exaggerated, takes on increased credibility. Company turnover starts to increase. Morale is eroding.

It is obvious there is a problem and that it is not being dealt with. Employees wonder what will happen, whether they will be laid off, and whether the firm will go into bankruptcy. With their security threatened, employees lapse into survival mode. As an organizational behaviour consultant explains:

The human organism can tolerate anything except *uncertainty*. It causes so much stress that people are no longer capable of thinking in a cognitive, creative manner. They focus on survival. That's why in turnarounds you see so much uncooperative, finger-pointing behaviour. The only issue people understand is directing the blame elsewhere [or in doing nothing].

Crisis can force intervention. The occasion is usually forced by the board of directors, lender, or a lawsuit. For example, the bank may call a loan, or the firm may be put on cash terms by its suppliers. Perhaps creditors try to put the firm into involuntary bankruptcy. Or something from the outside world fundamentally changes the business environment.

THE THREAT OF BANKRUPTCY

Unfortunately the heads of most troubled companies usually do not understand the benefits of bankruptcy law. To them, bankruptcy carries the stigma of failure; however, the law merely defines the priority of creditors' claims when the firm is liquidated.

Although bankruptcy can provide for the liquidation of the business, it also can provide for its reorganization. Bankruptcy is not an attractive prospect for creditors because they stand to lose at least some of their money, so they often are willing to negotiate. The prospect of bankruptcy also can be a foundation for bargaining in a turnaround. Of the late Ted Rogers, the *Globe and Mail* noted: "his greatest expectation-smashing act was escaping bankruptcy, as his flagship Rogers Communications Inc. survived a parade of near-death experiences, buried under the debt amassed by its risk-embracing owner."³

Voluntary Bankruptcy

When legal bankruptcy is granted to a business, the firm is given immediate protection from creditors. Payment of interest or principal is suspended, and creditors must wait for their money. Generally the current management (a debtor in possession) is allowed to run the company, but sometimes an outsider, a trustee, is named to operate the company, and creditor committees are formed to watch over the operations and to negotiate with the company.

The greatest benefit of bankruptcy is that it buys time for the firm. The firm has 30 to 90 days to come up with a reorganization plan and time to obtain acceptance of that plan by creditors. Under a reorganization plan, debt can be extended. Debt also can be restructured (composed). Interest rates can be increased, and convertible provisions can be introduced to compensate debt holders for any increase in their risk as a result of the restructuring. Occasionally, debt holders need to take part of their claim in the form of equity. Trade creditors can be asked to take equity as payment, and they occasionally need to accept partial payment. If liquidation is the result of the reorganization plan, partial payment is the rule, with the typical payment ranging from zero to 30 cents on the dollar, depending on the priority of the claim.

Bargaining Power

For creditors, having a firm go into bankruptcy is not particularly attractive. *Bankruptcy, therefore, is a tremendous source of bargaining power for the troubled company.* Bankruptcy is not attractive to creditors because once protection is granted to a firm, creditors must wait for their money. Further, they are no longer dealing with the troubled company but with the judicial system, as well as with other creditors. Even if creditors are willing to wait for their money, they may not get full payment and may have to accept payment in some unattractive form. Last, the legal and administrative costs of bankruptcy, which can be substantial, are paid before any payments are made to creditors.

Faced with these prospects, many creditors conclude that their interests are better served by negotiating with the firm. Because the law defines the priority of creditors' claims, an entrepreneur can use it to determine who might be willing to negotiate.

INTERVENTION

A company in trouble usually will want to use the services of an outside advisor who specializes in turnarounds.

The situation the outside advisor usually finds at intervention is not encouraging. The company is often technically insolvent or has negative net worth. It already may have been put on a cash basis by its suppliers. It may be in default on loans, or if not, it is probably in violation of loan covenants. Call provisions may be exercised. At this point, as the situation deteriorates more, creditors may be trying to force the company into bankruptcy, and the organization is demoralized.

The critical task is to quickly diagnose the situation, develop an understanding of the company's bargaining position with its many creditors, and produce a detailed cash flow business plan for the turnaround of the organization. To this end, a turnaround advisor usually quickly signals that change is coming. He or she will elevate the finance function, putting the "cash person" (often the consultant himself) in charge of the business. Some payments may be put on hold until problems can be diagnosed and remedial actions decided upon.

Diagnosis

Diagnosis can be complicated by the mixture of strategic and financial errors. For example, for a company with large receivables, questions need to be answered about whether receivables

are bloated because of poor credit policy or because the company is in a business where liberal credit terms are required to compete.

Diagnosis occurs in three areas: the appropriate strategic posture of the business, the analysis of the venture team, and "the numbers."

Strategic Analysis This analysis in a turnaround tries to identify the markets in which the company is capable of competing and decide on a competitive strategy. With small companies, turnaround experts state that most strategic errors relate to the involvement of firms in unprofitable product lines, customers, and geographic areas. It is outside the scope of this book to cover strategic analysis in detail.

Analysis of Management Analysis of management consists of interviewing members of the management team and coming to a subjective judgment of who belongs and who does not. Turnaround consultants can give no formula for how this is done except that it is the result of judgment that comes from experience.

The Numbers Involved in "the numbers" is a detailed cash flow analysis, which will reveal areas for remedial action. The task is to identify and quantify the profitable core of the business.

- **Determine available cash.** The first task is to determine how much cash the firm has available in the near term. This is accomplished by looking at bank balances, receivables (those not being used as security), and the confirmed order backlog.
- **Determine where money is going.** This is a more complex task than it appears to be. A common technique is called subaccount analysis, where every account that posts to cash is found and accounts are arranged in descending order of cash outlays. Accounts then are scrutinized for patterns. These patterns can indicate the functional areas where problems exist. For example, one company had its corporate address on its bills, rather than the lockbox address at which cheques were processed, adding two days to its dollar days outstanding.
- **Calculate percent-of-sales ratios for different areas of a business and then analyze trends in costs.** Typically, several of the trends will show flex points, where relative costs have changed. For example, for one company that had undertaken a big project, an increase in cost of sales, which coincided with an increase in capacity and in the advertising budget, was noticed. Further analysis revealed this project was not producing enough in dollar contribution to justify its existence. Once the project was eliminated, excess capacity could be reduced to lower the firm's break-even point.
- **Reconstruct the business.** After determining where the cash is coming from and where it is going, the next step is to compare the business as it should be to the business as it is. This involves reconstructing the business from the ground up. For example, a cash budgeting exercise can be undertaken and collections, payments, and so forth determined for a given sales volume. Or the problem can be approached by determining labour, materials, and other direct costs and the overhead required to drive a given sales volume. What is essentially a cash flow business plan is created.
- **Determine differences.** Finally, the cash flow business plan is tied into pro forma balance sheets and income statements. The ideal cash flow plan and financial statements are compared to the business's current financial statements. For example, the pro forma income statements can be compared to existing statements to see where expenses can be reduced. The differences between the projected and actual financial statements form the basis of the turnaround plan and remedial actions.

The most commonly found areas for potential cuts/improvements are these: (1) working capital management, from order processing and billing to receivables, inventory control, and, of course, cash management; (2) payroll; and (3) overcapacity and underutilized assets. More than 80 percent of potential reduction in expenses can usually be found in workforce reduction.

The Turnaround Plan

The turnaround plan not only defines remedial actions but, because it is a detailed set of projections, also provides a means to monitor and control turnaround activity. Further, if the assumptions about unit sales volume, prices, collections, and negotiating success are varied, it can provide a means by which worst-case scenarios—complete with contingency plans—can be constructed.

Because short-term measures may not solve the cash crunch, a turnaround plan gives a firm enough credibility to buy time to put other remedial actions in place. For example, one firm's consultant could approach its bank to buy time with the following: By reducing payroll and discounting receivables, it can improve cash flow to the point where the firm can be current in five months. If it is successful in negotiating extended terms with trade creditors, then the firm can be current in three months. If the firm can sell some underutilized assets at 50 percent off, it can become current immediately.

The turnaround plan helps address organizational issues. The plan replaces uncertainty with a clearly defined set of actions and responsibilities. Since it signals to the organization that action is being taken, it helps get employees out of their survival mode. An effective plan breaks tasks into the smallest achievable unit, so successful completion of these simple tasks soon follows and the organization begins to experience success. Soon the downward spiral of organizational morale is broken.

Finally, the turnaround plan is an **important source of bargaining power.** By identifying problems and providing for remedial actions, the turnaround plan enables the firm's advisors to approach creditors and tell them in very detailed fashion how and when they will be paid. If the turnaround plan proves that creditors are better off working with the company as a going concern, rather than liquidating it, they will most likely be willing to negotiate their claims and terms of payment. Payment schedules can then be worked out that can keep the company afloat until the crisis is over.

Quick Cash Ideally, the turnaround plan establishes enough creditor confidence to buy the turnaround consultant time to raise additional capital and turn underutilized assets into cash. **It is imperative, however, to raise cash quickly.** The result of the actions described below should be an improvement in cash flow. The solution is far from complete, however, because suppliers need to be satisfied.

For the purpose of quick cash, the working capital accounts hold the most promise.

Accounts receivable is the most liquid non-cash asset. Receivables can be factored, but negotiating such arrangements takes time. The best route to cash is discounting receivables. How much receivables can be discounted depends on whether they are securing a loan. For example, a typical bank will lend up to 80 percent of the value of receivables that are under 90 days. As receivables age past the 90 days, the bank needs to be paid. New funds are advanced as new receivables are established as long as the 80 percent and under-90-day criteria are met. Receivables under 90 days can be discounted no more than 20 percent, if the bank obligation is to be met. Receivables over 90 days can be discounted as much as is needed to collect them, since they are not securing bank financing. One needs to use judgment in deciding exactly how large a discount to offer. A common method is to offer a generous discount with a time limit on it, after which the discount is no longer valid. This provides an incentive for the customer to pay immediately.

Consultants agree **it is better to offer too large a discount than too small a one.** If the discount is too small and needs to be followed by further discounts, customers may hold off paying in the hope that another round of discounts will follow. Generally it is the slow payers that cause the problems and discounting may not help. By getting on the squeaky-wheel list of the particular slow-pay customer, you might get attention. A possible solution is to put on a note with the objective of having the customer start paying you on a regular basis; also, adding a small additional amount to every new order helps to work down the balance.

Inventory is not as liquid as receivables but still can be liquidated to generate quick cash. An inventory "fire sale" gets mixed reviews from turnaround experts. The most common objection is that excess inventory is often obsolete. The second objection is that because much inventory is work in process, it is not in saleable form and requires money to put in

saleable form. The third is that discounting finished-goods inventory may generate cash but is liable to create customer resistance to restored margins after the company is turned around. The sale of raw materials inventory to competitors is generally considered the best route. Another option is to try to sell inventory at discounted prices to new channels of distribution. In these channels, the discounted prices might not affect the next sale.

One interesting option for the company with a lot of work-in-process inventory is to ease credit terms. It often is possible to borrow more against receivables than against inventory. By easing credit terms, the company can increase its borrowing capacity to perhaps enough to get cash to finish work in process. This option may be difficult to implement because, by the time of intervention, the firm's lenders are likely following the company very closely and may veto the arrangements.

Also relevant to generating quick cash is the policy regarding current sales activity. Guiding criteria for this needs to include increasing the total dollar value of margin, generating cash quickly, and keeping working capital in its most liquid form. Prices and cash discounts need to be increased and credit terms eased. Easing credit terms, however, can conflict with the receivables policy described above. Obviously, care needs to be taken to maintain consistency of policy. Easing credit is really an "excess inventory" policy. The overall idea is to leverage policy in favour of cash first, receivables second, and inventory third.

Putting all accounts payable on hold is the next option. Clearly, this eases the cash flow burden in the near term. Although some arrangement to pay suppliers needs to be made, the most important uses of cash at this stage are meeting payroll and paying lenders. Lenders are important, but if you do not get suppliers to ship goods you are out of business. Getting suppliers to ship is critical. A company with negative cash flow simply needs to "prioritize" its use of cash. Suppliers are the least likely to force the company into bankruptcy because, under the law, they have a low priority claim.

Dealing with Lenders The next step in the turnaround is to negotiate with lenders. To continue to do business with the company, lenders need to be satisfied that there is a workable long-term solution.

However, at the point of intervention, the company is most likely in default on its payments. Or, if payments are current, the financial situation has probably deteriorated to the point where the company is in violation of loan covenants. It also is likely that many of the firm's assets have been pledged as collateral. To make matters worse, it is likely that the troubled entrepreneur has been avoiding his or her lenders during the gestation period and has demonstrated that he or she is not in control of the situation. Credibility has been lost.

It is important for a firm to know that it is not the first ever to default on a loan, that the lender is usually willing to work things out, and that it is still in a position to bargain.

Strategically, there are two sources of bargaining power. The first is that bankruptcy is an unattractive result to a lender, despite its senior claims. A low margin business cannot absorb large losses easily. (Recall that banks typically earn 0.5 percent to 1.0 percent total return on assets.)

The second is credibility. The firm that, through its turnaround specialist, has diagnosed the problem and produced a detailed turnaround plan with best-case/worst-case scenarios, the aim of which is to prove to the lender that the company is capable of paying, is in a better bargaining position. The plan details specific actions (e.g., layoffs, assets plays, changes in credit policy, etc.) that will be undertaken, and this plan must be met to regain credibility.

There are also two tactical sources of bargaining power. First, there is the strength of the lender's collateral. The second is the bank's inferior knowledge of aftermarkets and the entrepreneur's superior ability to sell.

The following example illustrates that, when the lender's collateral is poor, it has little choice but to look to the entrepreneur for a way out without incurring a loss. It also shows that the entrepreneur's superior knowledge of his business and ability to sell can get himself and the lender out of trouble. One company in turnaround in the leather business overbought inventory one year, and, at the same time, a competitor announced a new product that made his inventory almost obsolete. Since the entrepreneur went to the lender with the problem, the lender was willing to work with him. The entrepreneur had plans to sell the inventory at reduced prices and also to enter a new market that looked

attractive. The only trouble was he needed more money to do it, and he was already over his credit limit. The lender was faced with the certainty of losing 80 percent of its money and putting its customer out of business or the possibility of losing money by throwing good money after bad. The lender decided to work with the entrepreneur. It got a higher interest rate and put the entrepreneur on a "full following mechanism," which meant that all payments were sent to a lockbox. The lender processed the cheques and reduced its exposure before it put money in his account.

Another example illustrates the existence of bargaining power with a lender who is under-collateralized and stands to take a large loss. A company was importing look-alike Cabbage Patch dolls from Europe. This was financed with a letter of credit. However, when the dolls arrived in this country, the company could not sell the dolls because the Cabbage Patch doll craze was over. The dolls, and the bank's collateral, were worthless. The company found that the doll heads could be replaced, and with the new heads, the dolls did not look like Cabbage Patch dolls. It found also that one doll buyer would buy the entire inventory. The company needed \$30,000 to buy the new heads and have them put on, so it went back to the bank. The bank said, if the company wanted the money, key members of management had to give liens on their houses. When this was refused, the banker was astounded.

Lenders are often willing to advance money for a company to meet its payroll. This is largely a public relations consideration. Also, if a company does not meet its payroll, a crisis may be precipitated before the lender can consider its options.

When the situation starts to improve, a lender may call the loan. Such a move will solve the lender's problem but may put the company under. While many bankers will deny this ever happens, some will concede that such an occurrence depends on the loan officer.

Dealing with Trade Creditors In dealing with trade creditors, the first step is to understand the strength of the company's bargaining position. Trade creditors have the lowest priority claims should a company file for bankruptcy and, therefore, are often the most willing to deal. In bankruptcy, trade creditors often receive just a few cents on the dollar.

Another bargaining power boost with trade creditors is the existence of a turnaround plan. As long as a company demonstrates that it can offer a trade creditor a better result as a going concern than it can in bankruptcy proceedings, the trade creditor should be willing to negotiate. It is generally good to make sure that trade creditors are getting a little money on a frequent basis. Remember trade creditors have a higher gross margin than a bank, so their getting paid pays down their "risk" money faster. This is especially true if the creditor can ship new goods and get paid for that, and also get some money toward the old receivables.

Also, trade creditors have to deal with the customer-relations issue. Trade creditors will work with a troubled company if they see it as a way to preserve a market.

The relative weakness in the position of trade creditors has allowed some turnaround consultants to negotiate impressive deals. For example, one company got trade creditors to agree to a 24-month payment schedule for all outstanding accounts. In return, the firm pledged to keep all new payables current. The entrepreneur was able to keep the company from dealing on a cash basis with many of its creditors and to convert short-term payables into what amounted to long-term debt. The effect on current cash flow was very favourable.

The second step is to prioritize trade creditors according to their importance to the turnaround. The company then needs to take care of those creditors that are most important. For example, one entrepreneur told his controller never to make a commitment he could not keep. The controller was told that, if the company was going to miss a commitment, he was to get on the phone and call. The most important suppliers were told that if something happened and they needed payment sooner than had been agreed, they were to let the company know and it would do its best to come up with the cash.

The third step in dealing with trade creditors is to switch vendors if necessary. The lower priority suppliers will put the company on cash terms or refuse to do business. The troubled company needs to be able to switch suppliers, and its relationship with its priority suppliers will help it to do this, because they can give credit references. One firm said, "We asked our best suppliers to be as liberal with credit references as possible. I don't know if we could have established new relationships without them."

The fourth step in dealing with trade creditors is to communicate effectively. "Dealing with the trade is as simple as telling the truth," one consultant said. If a company is honest, at least a creditor can plan.

Workforce Reductions With workforce reduction representing 80 percent of the potential expense reduction, layoffs are inevitable in a turnaround situation.

A number of turnaround specialists recommend that layoffs be announced to an organization as a onetime reduction in the workforce and be done all at once. They recommend further that layoffs be accomplished as soon as possible, since employees will never regain their productivity until they feel some measure of security. Finally, they suggest that a firm cut deeper than seems necessary to compensate for other remedial actions that may be difficult to implement. For example, it is one thing to set out to reduce capacity by half and quite another thing to sell or sublet half a plant.

Longer-Term Remedial Actions

If the turnaround plan has created enough credibility and has bought the firm time, longer-term remedial actions can be implemented.

These actions will usually fall into three categories:

- **Systems and procedures.** Systems and procedures that contributed to the problem can be improved, or others can be implemented.
- **Asset plays.** Assets that could not be liquidated in a shorter time frame can be liquidated. For example, real estate could be sold. Many smaller companies, particularly older ones, carry real estate on their balance sheet at far below market value. This could be sold and leased back or could be borrowed against to generate cash.
- **Creative solutions.** Creative solutions need to be found. For example, one firm had a large amount of inventory that was useless in its current business. However, it found that if the inventory could be assembled into parts, there would be a market for it. The company shipped the inventory to Jamaica, where labour rates were low, for assembly, and it was able to sell very profitably the entire inventory.

As was stated at the beginning of the chapter, many companies—even companies that are insolvent or have negative net worth or both—can be rescued and restored to profitability.

Although we opened this chapter with the assertion that purchasing an automobile seldom provides a positive financial return—we do know that those who restore cars find great joy in the activity. Rescuing a wreck from the scrapyard or taking a jalopy from a barn and returning it to working condition is rewarding for those who have a passion for it. While diagnosing and overcoming troubles for a venture need not result in harvest, and harvest can be undertaken regardless of the venture's condition, often the two are related. While driving a car into the ground may be prudent with a fully depreciated vehicle, this certainly is not the ideal *modus operandi* for a viable business. We now turn our attention to exit strategy and execution.

A JOURNEY, NOT A DESTINATION

A common sentiment among successful entrepreneurs is that it is the challenge and exhilaration of the journey that gives them the greatest kick. Actor Jim Carrey captures the spirit: "Desperation is a necessary ingredient to learning anything, or creating anything. Period. If you ain't desperate at some point, you ain't interesting." It is the thrill of the chase that counts. And of course, many entrepreneurial individuals can't sit still—they're always restless. In Jim Carrey's case: "My report card always said, 'Jim finishes first and then disrupts the other students'."⁴

Entrepreneurs also talk of the venture's incredibly insatiable appetite for not only cash but also time, attention, and energy. Some say it is an addiction. Most say it is far more demanding and difficult than they ever imagined. Most, however, plan not to retire and

would do it again, usually sooner rather than later. They also say it is more fun and satisfying than any other career they have had.

For the vast majority of entrepreneurs, it takes 10, 15, even 20 years or more to build a significant net worth. According to the popular press and government statistics, there are more millionaires than ever in Canada. One report estimated 315,000 Canadian millionaires in 2001 and predicts 900,000 in 2010.⁵ According to Statistics Canada “surging real estate values and a strong economy helped drive up the number of millionaire families in Canada to 1.1 million in 2005.”⁶ Sadly, a million dollars is not really all that much money today as a result of inflation, and while lottery winners become instant millionaires, entrepreneurs do not. The number of years it usually takes to accumulate such a net worth is a far cry from the instant millionaire, the get-rich-quick impression associated with lottery winners or in either fantasy or “reality” TV shows.

THE JOURNEY CAN BE ADDICTIVE

The total immersion required, the huge workload, the many sacrifices for a family, and the burnout often experienced by an entrepreneur are real. Maintaining the energy, enthusiasm, and drive to get across the finish line, to achieve a harvest, may be exceptionally difficult. For instance, one entrepreneur in the computer software business, after working alone for several years, developed highly sophisticated software. Yet, he insisted he could not stand the computer business for another day. Imagine trying to position a company for sale effectively and to negotiate a deal for a premium price after such a long battle.

Some entrepreneurs wonder if the price of victory is too high. One very successful entrepreneur put it this way:

What difference does it make if you win, have \$20 million in the bank—I know several who do—and you are a basket case, your family has been washed out, and your kids are a wreck?

Entrepreneur Brett Wilson recalls:

It was hard not to enjoy the success we were having, doing a deal a day. It was enthralling to be at the office. I got as caught up in my career as any investment banker could be. I had always told myself that I worked so hard because of my family. Suddenly, I was facing the possibility of no family at all.⁷

The message is clear: Unless an entrepreneur enjoys the journey and thinks it is worthy, he or she may end up on the wrong train to the wrong destination.

FIRST BUILD A GREAT COMPANY

One of the simplest but most difficult principles for non-entrepreneurs to grasp is that wealth and liquidity are results—not causes—of building a great company. They fail to recognize the difference between making money and spending money. Most successful entrepreneurs possess a clear understanding of this distinction; they get their kicks from growing the company. They know the payoff will take care of itself if they concentrate on proving and building a sustainable venture.

Hard Work and Bad Luck

Sam Tilden bought a Hertz Rent-a-Car franchise for Montréal in 1925. Hertz took the franchise back in 1929 thinking it could make more money, Sam went into the miniature golf business for a few years, and in 1932 Sam reclaimed his old franchise! He expanded to Ottawa and Hamilton, Ontario. In 1953, Sam Tilden and several Hertz franchises walked—and founded Tilden Rent-a-Car. (Hertz had a cancellation policy that allowed them to revoke a franchise without cause on 60-days' notice.) By 1954, they had 100 Tilden locations across Canada.

Sam formed partnerships (50-50 joint ventures) with U.S.-based National Car Rental for Europe and Japanese Nippon Rent-a-Car for Asia. In 1973, at the age of 76 Sam died of a heart attack. His sons Walter and Ted took over and moved headquarters from Montréal to Toronto. In 1991, Ted died of a heart attack. Two months later a Tilden car was involved in a gruesome accident in New York City involving a gasoline tanker truck. Nearly a dozen stores were burned as 200 firefighters fought the blaze. The trucking company did not have insurance and over 20 lawsuits were aimed at Tilden's deeper pockets. For estate planning reasons, Walter looked to sell the company. His niece, Patricia Tilden took over as president and CEO of the family company. Tilden sought protection from potential liability and sought protection under the Companies' Creditor Arrangement (bankruptcy protection) a month before the lawsuits were expected to go to trial. Walter's son, Bruce, witnessed the claims being tossed out of court and within a week National Car Rental paid \$115 million for Tilden's fleet with Tilden retaining about \$4 million in real estate assets. Walter died in 2008 at age 80.⁸

Source: Anthony J. Patterson, “Canada's Tildens: Waving the Flag That Works for Them,” *Financial Times*, March 24, 1975; “Car Rental Industry's Ted Tilden Dies at 60,” *Calgary Herald*, March 7, 1991; “Court Clears Way for Tilden Sale,” *Financial Post*, June 8, 1996; Sandra Martin, “He Helped Build Tilden Rent-a-Car Into a Thriving, All-Canadian Concern,” *Globe and Mail*, July 30, 2008.

CREATE HARVEST OPTIONS

Here is yet another great paradox in the entrepreneurial process: Build a great company but do not forget to harvest. This apparent contradiction is difficult to reconcile, especially among entrepreneurs with several generations in a family-owned enterprise. Perhaps a better way to frame this apparent contradiction is to keep harvest options open and to think of harvesting as a vehicle for reducing risk and for creating future entrepreneurial choices and options, not simply selling the business and heading for the golf course or the beach, although these options may appeal to a few entrepreneurs.

It is not difficult to think of a number of alternative outcomes for those wanting to exit the venture. By stubbornly and steadfastly refusing to explore harvest options and exiting as a natural part of the entrepreneurial process, owners may actually increase their overall risk and deprive themselves of future options. Innumerable examples exist whereby entrepreneurs sold or merged their companies and then went on to acquire or to start another company and pursued new dreams:

- At the age of six Ted Rogers' father died. At the urging of family, his mother sold off industrial assets, including radio station CFRB, which Ted promised his mother he would one day buy back.
- Edgar Bronfman expanded the family fortune as Seagram expanded and then divested ownership in favour of other financial and personal pursuits. The decision to divest the family stake in DuPont Chemical was controversial and received much criticism.
- E.D. Smith & Sons of Winona, Ontario, had been a family business making jams, spreads, marmalades, etc. since 1882. In 2002, Llewellyn S. Smith, chairman of E.D. Smith & Sons Ltd. sold the company to Imperial Capital Corporation. E.D. Smith went on to acquire other food processors. In late 2007, E.D. Smith & Sons was sold to Treehouse Foods Inc.
- While in his early 20s, Stephen Spinelli was recruited by his former college football coach, Jim Hindman, to help start and build Jiffy Lube International. As a captain of the team, Spinelli had exhibited the qualities of leadership, tenacity, and competitive will to win that Hindman knew was needed to create a new company. Spinelli later built the largest franchise in America, and after selling his 49 stores to Pennzoil in 1993, he returned to his MBA alma mater to teach. So invigorated by this new challenge, he even went back to earn his doctorate.

- Dominion Loose Leaf Company was started in 1918, the Nicholds family purchased the company in 1956 creating an exit for the previous owners. The printing services company was renamed Dollco Printing and in 2001 ownership passed to the third generation, cousins Krista Nicholds and Kevin Nicholds co-presidents of an organization that today has 300 employees and operations in Ottawa, Toronto, Québec, Halifax, and the northeastern United States.

These are a tiny representation of the tens of thousands of entrepreneurs that build on their platforms of entrepreneurial success to pursue highly meaningful lives in philanthropy, public service, and community leadership. By realizing a harvest, such options become possible, yet the vast majority of entrepreneurs make these contributions to society while continuing to build their companies (see Jim Pattison). This is one of the best-kept secrets in our culture: The public has very little awareness and appreciation of just how common this pattern of generosity is of their time, their leadership, and their money. One could fill a book with numerous other examples. The entrepreneurial process is endless.

Jim Pattison

Born in Saskatoon, Saskatchewan, Jim Pattison has amassed an amazing empire. At age 81, he is still going strong and making acquisitions one after the other. Forbes lists him as the 6th wealthiest Canadian and like many other high net-worth individuals devotes much time, effort, and money to causes he finds worthy. When CBC Television announced that during the NHL playoffs they could not afford to rent high-definition broadcast trucks during away games, Pattison announced that his Save-On Foods, a western Canadian grocery chain, would cover the costs—\$100,000.⁹

Despite his age, Jim Pattison shows no signs of cashing out. As the sole owner of the third-largest privately held Canadian company, he is not required to reveal any “harvest” plans.

Source: www.jimpattison.com.

A HARVEST GOAL

Having a harvest goal and crafting a strategy to achieve it are what separate successful entrepreneurs from the rest of the pack. Many entrepreneurs seek only to create a job and a living for themselves. It is quite different to grow a business that creates a living for many others, including employees and investors, by creating value—value that can result in a capital gain.

Setting a harvest goal achieves many purposes, not the least of which is helping an entrepreneur get after-tax cash out of an enterprise and enhancing substantially his or her net worth. Such a goal also can create high standards and a serious commitment to excellence over the course of developing the business. It can provide, in addition, a motivating force and a strategic focus that does not sacrifice customers, employees, and value-added products and services just to maximize quarterly earnings.

There are other good reasons to set a harvest goal as well. The workload demanded by a harvest-oriented venture versus one in a venture that cannot achieve a harvest may actually be less and is probably no greater. Such a business may be less stressful than managing a business that is not oriented to harvest.

There is a very significant societal reason as well for seeking and building a venture worthy of a harvest. These are the ventures that provide enormous impact and value added in a variety of ways. These are the companies that contribute most disproportionately to technological and other innovations, to new jobs, to returns for investors, and to economic vibrancy.

Also, within the harvest process, the seeds of renewal and reinvestment are sown. Such a recycling of entrepreneurial talent and capital is at the very heart of our system of private responsibility for economic renewal and individual initiative. Entrepreneurial companies organize and manage for the long haul in ways to perpetuate the opportunity creation and recognition process and thereby to ensure economic regeneration, innovation, and renewal.

Thus, a harvest goal is not just a goal of selling and leaving the company. Rather, it is a long-term goal to create real value added in a business. (It is true, however, that if real value added is not created, the business simply will not be worth much in the marketplace.)

CRAFTING A HARVEST STRATEGY: TIMING IS VITAL

Consistently, entrepreneurs avoid thinking about harvest issues. In a survey of the computer software industry, 80 of the 100 companies had only an informal plan for harvesting. The rest of the sample confirmed the avoidance of harvest plans by entrepreneurs—only 15 of the companies had a formal written strategy for harvest in their business plans and the remaining five had a formal harvest plan written after the business plan.¹⁰ When a company is launched, then struggles for survival, and finally begins its ascent, the farthest thing from its founder's mind usually is selling out. Selling is often viewed by the entrepreneur as the equivalent to complete abandonment of his or her very own “baby.” But a harvest “makes perfect sense” when the entrepreneur “finds it is the appropriate timing for capturing the value that has been created through the venture.”¹¹

Thus, time and again, a founder does not consider selling until terror, in the form of the possibility of losing the whole company, is experienced. Usually, this possibility comes unexpectedly: New technology threatens to leapfrog over the current product line, a large competitor suddenly appears in a small market, or a major account is lost. A sense of panic then grips the founders and shareholders of the closely held firm, and the company is suddenly for sale—for sale at the wrong time, for the wrong reasons, and thus for the wrong price. Selling at the right time, willingly, involves hitting a strategic window, one of the many strategic windows that entrepreneurs face.

Entrepreneurs find that harvesting is a non-issue until something begins to sprout, and again there is a vast distance between creating an existing revenue stream of an ongoing business and ground zero. Most entrepreneurs agree that securing customers and generating continuing sales revenue are much harder and take much longer than they could have imagined. Further, the ease with which those revenue estimates can be cast and manipulated on a spreadsheet belies the time and effort necessary to turn those projections into cash.

At some point, with a higher potential venture, it becomes possible to realize the harvest. It is wiser to be selling as the strategic window is opening than as it is closing. Business financier and stock market speculator Bernard Baruch's wisdom is as good as it gets on this matter. He has said, “I made all my money by selling too early.” For example, a private candy company with \$150 million in sales was not considering selling. After contemplating advice to sell early, the founders recognized a unique opportunity to harvest and sold the firm for 19 times earnings, an extremely high valuation. Another example is that of a cellular phone company that was launched and built from scratch. Only 18 months after purchasing the original rights to build and operate the system, the founders decided to sell the company, even though the future looked extremely bright. They sold because the sellers' market they faced at the time had resulted in a premium valuation—30 percent higher on a per capita basis (the industry valuation norm) than that for any previous cellular transaction to date. The harvest returned over 25 times the original capital in a year and a half. (The founders had not invested a dime of their own money.)

If the window is missed, disaster can strike. Shaping a harvest strategy is an enormously complicated and difficult task. Thus, crafting such a strategy cannot begin too early. Companies declared bankruptcy in the wake of the dot-com bubble burst and stock market crashes. The toll includes large corporations and dozens of lesser-known small and mid-size companies. This is one history lesson that seems to repeat itself. While building a company is the ultimate goal, failure to preserve the harvest option, and utilize it when it is available, can be most disheartening.

In shaping a harvest strategy, some guidelines and cautions can help:

- **Patience.** As has been shown, several years are required to launch and build most successful companies; therefore, patience can be invaluable. A harvest strategy is more sensible if it allows for a time frame of at least three to five years and as long as seven to 10 years. The other side of the patience coin is not to panic as a result of precipitate events. Selling under duress is usually the worst of all worlds.
- **Realistic valuation.** If impatience is the enemy of an attractive harvest, then greed is its executioner. For example, an excellent, small firm, which was nearly 80 years old and run by the third generation of a line of successful family leaders, had attracted a number of prospective buyers and had obtained a bona fide offer for more than \$25 million. The owners, however, had become convinced that this “great little company” was worth considerably more, and they held out. Before long, there were no buyers, and market circumstances changed unfavourably. In addition, interest rates skyrocketed. Soon thereafter, the company collapsed financially, ending up in bankruptcy.
- **Outside advice.** It is difficult but worthwhile to find an advisor who can help craft a harvest strategy while the business is growing and, at the same time, maintain objectivity about its value and have the patience and skill to maximize it. A major problem seems to be that people who sell businesses, such as investment bankers or business brokers, are performing the same economic role and function as real estate brokers; in essence, their incentive is their commissions during a quite short time frame, usually a matter of months. However, an advisor who works with a lead entrepreneur for as much as five years or more can help shape and implement a strategy for the whole business so that it is positioned to spot and respond to harvest opportunities when they appear.

HARVEST OPTIONS

There are seven principal avenues by which a company can realize a harvest from the value it has created. Described on the next pages, these most commonly seem to occur in the order in which they are listed. No attempt is made here to do more than briefly describe each avenue, since there are entire books written on each of these, including their legal, tax, and accounting intricacies. As you read through these harvest options consider Roots. Established in 1973, Roots is “Canada’s leading lifestyle” brand known worldwide, particularly after outfitting Olympic athletes.¹² But Roots has had ups and downs. Roots is owned by its co-founders Michael Budmand and Don Green who met one summer at camp in Algonquin Park, Ontario. When would you “harvest” Roots and how? What signals would tell you? Exercise 7 “Capital and Harvest—How Will You Realize Dollars from the Venture?” in the Venture Opportunity Screening Exercise that accompanies Chapter 3 and is found on the Online Learning Centre at www.mcgrawhill.ca/olc/timmons is worth visiting.

Capital Cow

A “capital cow” is to the entrepreneur what a “cash cow” is to a large corporation. In essence, the high-margin profitable venture (the cow) throws off more cash for personal use (the milk) than most entrepreneurs have the time and uses or inclinations for spending. The result is a capital-rich and cash-rich company with enormous capacity for debt and reinvestment. Take, for instance, a health care–related venture that realized early success and went public. Several years later, the founders decided to buy the company back from the public shareholders and to return it to its closely held status. Today the company has sales in excess of \$100 million and generates extra capital of several million dollars each year. This capital cow has enabled its entrepreneurs to form entities to invest in several other higher potential ventures, which included participation in the leveraged buyout of a \$150-million sales division of a larger firm and in some venture capital deals. Sometimes the creation of a capital cow results in substantial real estate holdings by the entrepreneur, off the books of the original firm. This allows for greater flexibility in the distribution of cash flow and the later allocation of the wealth.

Employee Stock Ownership Plan

Employee stock ownership plans have become very popular among closely held companies as a valuation mechanism for stock for which there is no formal market. They are also vehicles through which founders can realize some liquidity from their stock by sales to the plan and other employees. And since an ESOP usually creates widespread ownership of stock among employees, it is viewed as a positive motivational device as well. In General Motors’ 2009 restructuring, Magna sought to acquire GM’s European product group Opel. The deal called for 10 percent of the shares to be turned over to Opel employees.

Management Buyout

Another avenue, called a management buyout (MBO), is one in which a founder can realize a gain from a business by selling it to existing partners or to other key managers in the business. If the business has both assets and a healthy cash flow, the financing can be arranged via banks, insurance companies, and financial institutions that do leveraged buyouts (LBOs) and MBOs. Even if assets are thin, a healthy cash flow that can service the debt to fund the purchase price can convince lenders to do the MBO.

Usually, the problem is that the managers who want to buy out the owners and remain to run the company do not have the capital. Unless the buyer has the cash up front—and this is rarely the case—such a sale can be very fragile, and full realization of a gain is questionable. MBOs typically require the seller to take a limited amount of cash up front and a note for the balance of the purchase price over several years. If the purchase price is linked to the future profitability of the business, the seller is totally dependent on the ability and integrity of the buyer. Further, management, under such an arrangement, can lower the price by growing the business as fast as possible, spending on new products and people, and showing very little profit along the way. In these cases, it is often seen that after the marginally profitable business is sold at a bargain price, it is well positioned with excellent earnings in the next two or three years. As can be seen, the seller will end up on the short end of this type of deal.

Merger, Acquisition, and Strategic Alliance

Merging with a firm is still another way for a founder to realize a gain. For example, two founders who had developed high-quality training programs consummated a merger with another company. These entrepreneurs had backgrounds in computers, rather than in marketing or general management, and the results of the company’s first five years reflected this gap. Sales were under \$500,000, based on custom programs and no marketing, and they had been unable to attract venture capital. The firm with which they merged was a \$15-million company that had an excellent reputation for its management training programs, had a large customer base, had repeat sales of 70 percent, and had requests from the field sales force for programs to train managers in the use of personal computers. The buyer obtained 80 percent of the shares of the smaller firm, to consolidate the revenues and earnings from the merged company into its own financial statements, and the two founders of the smaller firm retained a 20-percent ownership in their firm. The two founders also obtained employment contracts, and the buyer provided nearly \$1.5 million of capital advances during the first year of the new business. Under a put arrangement, the founders will be able to realize a gain on their 20 percent of the company, depending upon performance of the venture over the next few years.¹³ The two founders now are reporting to the president of the parent firm, and one founder of the parent firm has taken a key executive position with the smaller company, an approach common for mergers between closely held firms.

In a strategic alliance, founders can attract badly needed capital, in substantial amounts, from a large company interested in their technologies. Such arrangements often can lead to complete buyouts of the founders downstream.

Outright Sale

Most advisors view outright sale as the ideal route to go because up-front cash is preferred over most stock, even though the latter can result in a tax-free exchange.¹⁴ In a stock-for-stock exchange, the problem is the volatility and unpredictability of the stock price of the purchasing company. Many entrepreneurs have been left with a fraction of the original purchase price when the stock price of the buyer's company declined steadily. Often the acquiring company wants to lock key management into employment contracts for up to several years. Whether this makes sense depends on the goals and circumstances of the individual entrepreneur. Recall from Chapter 2 that John W. Sleeman sold his namesake in 2004 and agreed to stay on to serve as CEO under the new owner Sapporo Breweries of Japan.

Public Offering

Probably the most sacred business school cow of them all—other than the capital cow—is the notion of taking a company public.¹⁵ The vision or fantasy of having one's venture listed on one of the stock exchanges arouses passions of greed, glory, and greatness. For many would-be entrepreneurs, this aspiration is unquestioned and enormously appealing. Yet, for all but a chosen few, taking a company public, and then living with it, may be far more time and trouble—and expense—than it is worth. Richard L'Abbé of Med-Eng (end-of-chapter case in Chapter 5) was strongly opposed to taking his company public.

After the stock market crash of October 1987, the market for new issues of stock shrank to a fraction of the robust IPO market of 1986 and earlier years. The number of new issues and the volume of IPOs did not rebound; instead, they declined between 1988 and 1992. Beginning in 1993 the IPO window opened again. During this IPO frenzy, small companies with total assets under \$500,000 issued most of the IPOs. Previously, small companies had not been as active in the IPO market. Now most of the firms that go public in Canada have small capitalizations.

This cyclical pattern repeats itself regularly. As the dot.com, telecommunications, and networking explosion accelerated from 1995 to 2000, the IPO markets exploded as well. In 1996, for instance, despite twice the number of IPOs as in 2005, the total dollar value in 2006 was lower than in 2005. In 2008, there were months when not a single IPO occurred on the Toronto Stock Exchange! Few signs of recovery were evident in 2009. The lesson is clear: Depending upon the IPO market for a harvest is a highly cyclical strategy, which can cause both great joy and disappointment. Such is the reality of the stock markets. Exhibits 15.2(A) and 15.2(B) show this pattern vividly.

There are several advantages to going public, many of which relate to the ability of the company to fund its rapid growth. Public equity markets provide access to long-term capital, while also meeting subsequent capital needs. Companies may use the proceeds of an IPO to expand the business in the existing market or to move into a related market. The founders and initial investors might be seeking liquidity, but restrictions limiting the timing and the amount of stock that the officers, directors, and insiders can dispose of in the public market are increasingly severe. As a result, it can take several years after an IPO before a liquid gain is possible. A public offering not only increases public awareness of the company but also contributes to the marketability of the products, including franchises. Tim Hortons went public in 2006 on the New York Stock Exchange and the Toronto Stock Exchange.

However, there are also some disadvantages to being a public company. For example, 50 percent of the computer software companies surveyed in one study agreed that the focus on short-term profits and performance results was a negative attribute of being a public company.¹⁶ Also, because of the disclosure requirements, public companies lose some of their operating confidentiality, not to mention having to support the ongoing costs of public disclosure, audits, and tax filings. With public shareholders, the management of the company has to be careful about the flow of information because of the risk of insider trading. Thus, it is easy to see why companies need to think about the positive and negative attributes of being a public company. When considering this decision, you may find it useful to identify the key components of the IPO process and to assess which investment bankers, accountants, lawyers, and advisors might be useful in making this decision.

EXHIBIT 15.2(A) Number of Canadian IPOs

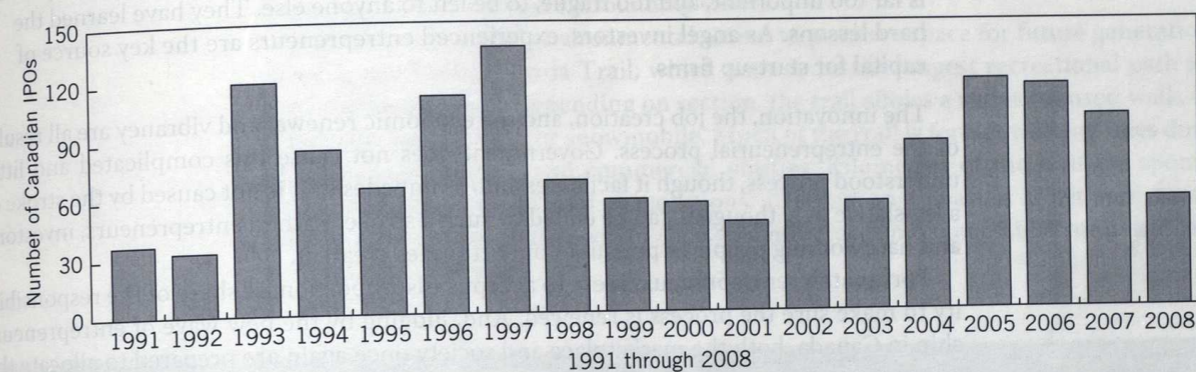
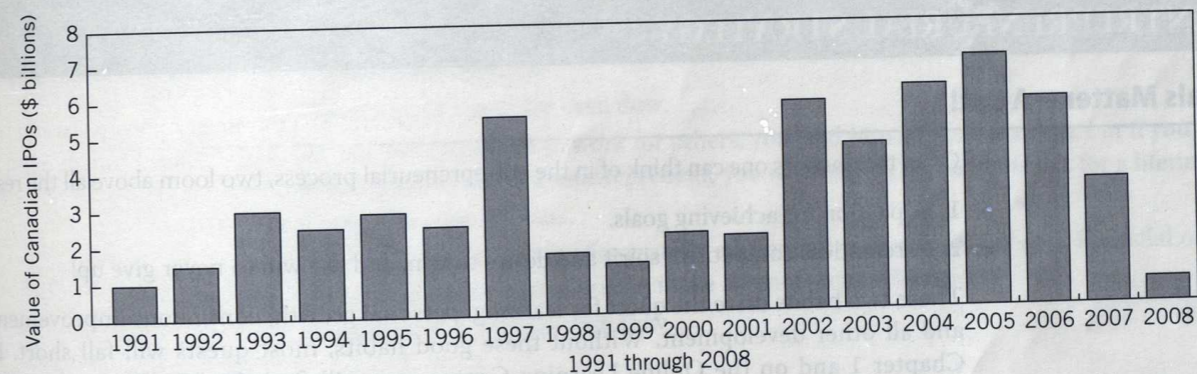


EXHIBIT 15.2(B) Value of Canadian IPOs (\$billions)



Source: "Survey of IPOs in Canada," PricewaterhouseCoopers (2004, 2006, 2008).

BEYOND THE HARVEST

A majority of highly successful entrepreneurs seem to accept a responsibility to renew and perpetuate the system that has treated them so well. They are keenly aware that our system of opportunity and mobility depends in large part upon a self-renewal process.

There are many ways in which this happens. Some of the following data often surprise people:

- **University endowments.** Entrepreneurs are the most generous regarding larger gifts and the most frequent contributors to school endowments, scholarship funds, and the like. One study showed that eight times as many entrepreneurs, compared to all other graduates, made large gifts to the schools that they attended.¹⁷ On college and university campuses across Canada, a huge number of dorms, classroom buildings, arts centres, and athletic facilities are named for the contributor. In virtually every instance, these contributors are entrepreneurs whose highly successful companies enabled them to make major gifts of stock to their alma mater.
- **Community activities.** Entrepreneurs who have harvested their ventures very often reinvest their leadership skills and money in such community activities as symphony orchestras, museums, and local colleges and universities. These entrepreneurs lead fund-raising campaigns, serve on boards of directors, and devote many hours to other volunteer work.

- *Investing in new companies.* Post-harvest entrepreneurs also reinvest their efforts and resources in the next generation of entrepreneurs and their opportunities. Successful entrepreneurs behave this way since they seem to know that perpetuating the system is far too important, and too fragile, to be left to anyone else. They have learned the hard lessons. As angel investors, experienced entrepreneurs are the key source of capital for start-up firms.

The innovation, the job creation, and the economic renewal and vibrancy are all results of the entrepreneurial process. Government does not cause this complicated and little understood process, though it facilitates and/or impedes it. It is not caused by the stroke of a legislative pen, though it can be ended by such a stroke. Rather, entrepreneurs, investors, and hardworking people in pursuit of opportunities create it.

Fortunately, entrepreneurs seem to accept a disproportionate share of the responsibility to make sure the process is renewed. And, judging by the new wave of entrepreneurship in Canada, both the marketplace and society once again are prepared to allocate the rewards to entrepreneurs that are commensurate with their acceptance of responsibility and delivery of results.

THE ROAD AHEAD: DEVISE A PERSONAL ENTREPRENEURIAL STRATEGY

Goals Matter—A Lot!

Of all the anchors one can think of in the entrepreneurial process, two loom above all the rest:

1. A passion for achieving goals.
2. A relentless competitive spirit and desire to win, and the will to never give up!

These two habits drive the quest for learning, personal growth, continuous improvement, and all other development. Without these good habits, most quests will fall short. In Chapter 1 and on the Online Learning Centre, you will find the “Crafting a Personal Entrepreneurial Strategy” exercise. Visit www.mcgrawhill.ca/olc/timmons and the exercise is within the material associated with Chapter 1. Completing this lengthy exercise will help you develop these good habits.

Values and Principles Matter—A Lot!

We have demonstrated, in numerous places throughout the book, that values and principles matter a great deal. We encourage you to consider those of others as you develop your own anchors. This is a vital part of your leadership approach, and who and what you are:

- Treat others as you would want to be treated.
- Share the wealth with those high performers who help you create it.
- Give back to the community and society.

We would add a fourth principle in the Aboriginal spirit of considering every action with the seventh generational impact foremost in mind:

- Be a guardian and a steward of the air, land, water, and environment.

One major legacy of the coming generations of entrepreneurial leaders can be the sustainability of our economic activities. It is possible to combine a passion for entrepreneurship with love of the land and the environment. The work of such organizations as the Nature Conservancy, the World Wildlife Fund, and Direct Relief International, and dozens of others is financially made possible by the contributions of money, time, and leadership from highly successful entrepreneurs. It is also one of the most durable ways to give back. Practising what he preaches, Professor Timmons and his wife made a permanent gift of

nearly 500 acres of their New Hampshire farm to a conservation easement. Other neighbours joined in for a combined total of over 1,000 acres of land preserved forever, never to be developed. This has led to a regional movement as well, which involves landowners from a dozen surrounding towns.

Another purposeful environmental action to preserve space for future generations to enjoy is the Trans Canada Trail, which aims to be the longest recreational path in the world when finished. Depending on section, the trail allows a variety of uses: walk, cycle, ski, canoe, horse, ATV, or snowmobile. Much of the trail is former railroad lines donated by provincial, federal, and commercial entities. Kilometres of the trail are sponsored by individuals, families, and corporations. It began on Canada's 125th anniversary in 1992 and upon completion will be 21,500 kilometres connecting 1,000 communities and 33 million Canadians.

SEVEN SECRETS OF SUCCESS

The following seven secrets of success are included for your contemplation and amusement:

1. There are no secrets. Understanding and practising the fundamentals discussed here, along with hard work, will get results.
2. As soon as there is a secret, everyone else knows about it, too. Searching for secrets is a mindless exercise.
3. Happiness is a positive cash flow.
4. If you teach a person to work for others, you feed him or her for a year, but if you teach a person to be an entrepreneur, you feed him or her, and others, for a lifetime.
5. Do not run out of cash.
6. Entrepreneurship is fundamentally a human process, rather than a financial or technological process. You can make an enormous difference.
7. Happiness is a positive cash flow.

Chapter Summary

1. Numerous signals of impending trouble—strategic issues, poor planning and financial controls, and running out of cash—invariably point to a core cause: top management.
2. Crises don't develop overnight. Often it takes 18 months to five years before the company is sick enough to trigger a turnaround intervention. Both quantitative and qualitative signals can predict patterns and actions that could lead to trouble.
3. Bankruptcy, usually an entrepreneur's nightmare, can actually be a valuable tool and source of bargaining power to help a company survive and recover.
4. Turnaround specialists begin with a diagnosis of the numbers—cash, strategic market issues, and management—and develop a turnaround plan.
5. The turnaround plan defines remedial action to generate cash, deal with lenders and trade creditors, begin long-term renewal, and monitor progress.
6. Entrepreneurs thrive on the challenges and satisfactions of the game: It's a journey, not a destination.
7. First and foremost, successful entrepreneurs strive to build a great company; wealth follows that process.
8. Harvest options mean more than simply selling the company, and these options are an important part of the entrepreneur's know-how.
9. Entrepreneurs know that to perpetuate the system for future generations, they must give back to their communities and invest time and capital in the next entrepreneurial generation.

Study Questions

1. What do entrepreneurs need to know about how companies get into and out of trouble? Why?
2. Why do most turnaround specialists invariably discover that it is management that is the root cause of trouble?
3. Why is it difficult for existing management to detect and to act early on signals of trouble?
4. Why can bankruptcy be the entrepreneur's ally?
5. What are the main components of a turnaround plan and why are these so important?
6. Why is it essential to focus first on building a great company, rather than on just getting rich?
7. Why is a harvest goal so crucial for entrepreneurs and the economy?
8. Define the principal harvest options, the pros and cons of each, and why each is valuable?
9. Beyond the harvest, what do entrepreneurs do to give back, and why is this so important to their communities and the nation?

Mind Stretchers *Have you considered?*

1. General Motors was forced to "harvest" a few of its divisions. Oldsmobile was eliminated in 2004. Saab, founded in 1937 in Sweden, came under GM's full control in 2000. GM placed Saab on the auction block during the economic turmoil of 2009, but is that the best time to sell? And with GM under bankruptcy protection plans were to shrink Pontiac, and Saturn, a fresh new venture within GM created in 1985 was to be folded or sold off—Penske eventually bid on it. After only a decade under GM's control Hummer was sold to a machinery company in China. Meanwhile Magna International was poised to purchase GM's European lines: Opel and Vauxhall. The deal included a Russian bank and Opel employees taking a 10-percent stake. Please discuss harvest timing.
2. CanWest Global Communications is in financial distress. Is it another brontosaurus heading for a fall? What are the signals and what is the remedy?
3. With so much positive spin on restructuring, has the stigma of bankruptcy (personal and corporate) completely been eliminated?
4. Would you go to work for a troubled company? Why and under what conditions?

CASE

CAVENDISH COVE COTTAGES

Preparation Questions:

1. What are the strengths and weaknesses of CCC's current strategy?
2. Should Sherry Noonan make an offer? What is the value of the business?
3. What is the business's financial position now and for the future?
4. What valuation methods can be used to construct an estimate?

"I just don't know if the asking price is fair," Sherry Noonan explained to Martin Heaney, one of her business professors at the University of Prince Edward Island (UPEI). It was December 10, 2008 and Sherry had just finished writing her final exam for the semester. She was now finished with the first half of her fourth and final year of the business program at UPEI. Sherry was considering making an offer on a cottage rental business located in the heart of Cavendish, the very popular tourist destination on Prince Edward Island (PEI). While Sherry would have some financial support from her

family if she bought the cottage business, she knew that a key to ensure the future success of the business was to pay a fair price for it, and to be able to exploit marketing opportunities.

As Sherry left Martin Heaney's office, she reflected on the conversation with her professor. At this point in her university career, Sherry had completed courses in all of the functional areas of business (marketing, operations management, corporate finance, organizational behaviour, and accounting) and she felt that she should be able to analyze the information she had available regarding the cottage property. The work

required to make an offer on the business, would have to be completed over the next few days. That would allow Heaney and her parents the time to review her work. It would also give Sherry the time to negotiate with the business's owners, Fran and Ted Baker. It was important to get all of this work done before the activities of Christmas began, and before she would begin her final semester of classes. It would also ensure that she would have plenty of time to prepare for the opening of the cottages in May 2009, if her bid was successful.

The price for the cottages was \$800,000, and Martin Heaney had asked Sherry whether she thought that was a fair price for the business. Heaney had focused on some of the key questions that had to be answered: How should the value of the cottage business be estimated? Could a new marketing strategy increase the value of the business to Sherry? If so, how would the new marketing strategy differ from the one employed by the current owners? What is the business worth? If a deal was negotiated, how should the purchase be financed? Now all Sherry had to do was answer these questions using the concepts she had learned over the last three-and-a-half years of her business education.

PEI and the Cavendish Area

Prince Edward Island is Canada's smallest province, with a population of just 140,000 and 5,684 square kilometres of land. The Island, as it was known to locals, was often called "the million acre farm," though PEI actually consisted of 1.4 million acres. About 55 percent of the population lived in rural areas. PEI, in the Gulf of St. Lawrence, was separated from its sister provinces of Nova Scotia and New Brunswick by the Northumberland Strait. In 1997, the Confederation Bridge was opened providing PEI with a permanent link to New Brunswick. A ferry service also ran between PEI and Nova Scotia for about eight months of the year. At the turn of the 21st century, PEI continued to rely heavily on three industries that had seen it through the last century: agriculture, tourism, and fishing.

From May 1 to October 31, 2008, 1,105,264 visitors in 393,681 tourist parties spent a total of \$345.6 million while vacationing on PEI. Compared to 2007, this was a decrease of 3.8 percent in numbers and 2.1 percent in expenditures. In 2008, 93.9 percent of the visitors and 90.6 percent of the tourist parties visited PEI for pleasure (rather than business), and accounted for 90.6 percent of the expenditures. The average party size was 2.91 people, and they spent an average of 4.5 nights on PEI.

Tourism on PEI was seasonal with mid-July to late-August being the peak of the tourism season. The early season (pre-July) is quite slow in many areas of PEI, and winter tourism is almost non-existent, except when special events are held. These are normally on weekends. The fall season was starting to become popular after many years of marketing by the Provincial Government Tourism Department and individual operators. The primary visitors during the fall were older and retired couples who liked the cooler temperatures and smaller crowds. While some came on bus tours, many were independent travellers who valued quality products and services.

The largest share of visitors (27.8 percent) came from Ontario followed by the United States with 19.4 percent and Nova Scotia was a close third. New Brunswick and Québec accounted for 18 percent of visitors. About 56 percent of the

pleasure visitors were repeat customers, while 47 percent were in the 40–59 age bracket. Over 74 percent reported household incomes greater than \$50,000. The primary activities of pleasure visitors in 2008 were: sightseeing (84 percent), soft outdoor adventure (77 percent), beach visits (71 percent), and craft shopping (69 percent). Golf was enjoyed by 15 percent of visitors.

Cavendish was located on the north shore of PEI, on the Gulf of St. Lawrence, in the centre of the province. It was about a 30-minute, very scenic, drive from Charlottetown, the capital city. Cavendish was a favourite destination for many visitors since the area has much to offer in terms of tourist attractions. In the area there were national parks, beaches, amusement parks, and many other types of tourist attractions, eight golf courses within a 15-minute drive and eight more within 30 minutes, numerous restaurants, shopping, a nightclub for night life, miniature golf, as well as beautiful scenery.

In addition, there were all types of accommodations from campgrounds to self-catering cottages, to hotels and resorts, to four-star B&Bs and country inns. A major draw was the famous Cavendish Beach, within the PEI National Park, with its rolling dunes and beautiful sandstone rock facings. The beach attracted many visitors to PEI either to swim in its warm waters, or walk the long stretches of red sandy shoreline. Young and old could always find something to do in the area.

Market research statistics for the 2008 tourism season, as collected by the government agency Tourism PEI, indicated that Cavendish was the main overnight destination for 263,600 pleasure visitors, or 25.4 percent of all pleasure visitors to PEI. Cavendish was the second most popular destination for visitors with Charlottetown being the first (32.9 percent of visitors). Other statistics for the pleasure visitors whose main overnight destination was Cavendish indicated that:

- 95 percent stayed in paid accommodations. Of these, 34 percent rented cottages or cabins.
- 55 percent were repeat customers.
- 46 percent made their decision to come to PEI more than 12 weeks prior to their departure.
- 49 percent of visitors were adult couples, while families with children less than 18 years old accounted for 38 percent.
- They spent an average of 4.1 nights on PEI.
- Expenditures averaged \$919 per tourist party, similar to the level in 2007.
- Accommodations, restaurant meals, and souvenirs accounted for 66 percent of total expenditures.
- Total expenditures were \$65.5 million in 2008.
- The top activities enjoyed by visitors to Cavendish in 2008 were: sightseeing (85 percent), beach visits (81 percent), souvenir shopping (73 percent), visiting the National Park (63 percent), visiting "Anne attractions" (51 percent), driving tours (50 percent), and lobster suppers (48 percent).¹

"Anne attractions" referred to the book *Anne of Green Gables* written by the well-known Island author Lucy Maud Montgomery. Montgomery was born and raised in the Cavendish area where she lived until she was 36. *Anne of Green Gables*, published in 1908, was based in Cavendish. It has been translated into 15 different languages, put on film, and was the title of a musical stage production that had been staged at

This case was written by Dr. Sean M. Hennessey, University of Prince Edward Island, for purposes of classroom discussion.

¹ Data were taken from "Economic impact: Tourism 2008" published by the Province of PEI.

the Confederation Centre of the Arts in Charlottetown since 1965. The production also toured around the world. The story imparted an image of PEI that each year drew thousands of visitors to Cavendish from around the world. As a result, *Anne* was a major focus of the tourism industry in Cavendish with many attractions and names of businesses based on characters and locations in the book.

Cavendish Cove Cottages

Cavendish Cove Cottages (CCC) was located in the heart of the community of Cavendish on Route 6, Cavendish Road, a few hundred metres inland from the shoreline. Route 6 was the main road running along the north coastline of central PEI and was easily reached from all parts of PEI. All of the main tourist attractions in Cavendish and the neighbouring communities were on this main road. Cavendish beach, a significant attraction in its own right, was a four-minute drive away from the main entrance to CCC. Those with more time could easily walk to the beach in less than 15 minutes.

Also within 200 metres of the business, were grocery stores, restaurants, a laundromat, shopping, and numerous family-oriented attractions. These included amusement parks such as Rainbow Valley (water and ride park), Sandspit (roller coasters, racing cars, and other park rides), and Avonlea Village (a re-creation of a village from 1908 that allows visitors to interact with characters from the *Anne of Green Gables* novel). Also close by was the Green Gables heritage site that includes the famous Green Gables House. The house and farm site were once owned by relatives of Lucy Maud Montgomery and were the inspiration for her book. Also on the site were numerous other family-oriented attractions.

Finally, within 10 minutes of the cottages were four championship golf courses, with two of these within walking distance. One was the brand new, five-star, 27-hole, championship Eagles Glenn Golf Course that bordered the cottage complex. The other was the scenic, ocean-side Green Gables golf course, designed and built in 1939 by world-renowned architect Stanley Thompson. The cottage business had been in operation in the same location, under the same name, for over 50 years. The complex was zoned as "resort commercial" and, for property tax purposes, was assessed a value of \$417,250 with property taxes of \$5,340. On the income statement, this expense was included within licences.

The business was owned and operated by an older couple, Fran and Ted Baker. They started the business in the 1950s when land and building costs were quite low. Fran and Ted each owned half of the common shares of the business. The property consisted of 19 rental units and one owner's unit on 2.4 acres of land. Of the rental units, seven were 1-bedroom, four were 2-bedroom, and eight were 3-bedroom. The units were further divided into standard, deluxe, and executive categories. The rental units ranged in size from 226 to 784 square feet. There were five smaller (226 to 270 square feet) units with the remainder generally between 435 and 784 square feet. Exhibit 1 provides a listing of the cottage complex with rental rates for the 2008 tourism season. Given the low rate of inflation and the need to set rental rates up to a year in advance, the Bakers were quoting and taking bookings for the 2009 season based on the 2008 rental rates.

Seventeen of the units were built many years earlier but, within the past three years, 11 had been upgraded with new interiors, windows, and flooring. Dishwashers and whirlpool

tubs were installed in some units. These upgrades were in addition to the yearly outlays for repairs and maintenance. Six of the units still required work. The real estate agent listing the property indicated that these units, while structurally sound, were "looking tired." The two executive 2-bedroom cottages were new additions to the property and were very popular. These units were usually the first to rent. Construction of these 784 square foot units had started in the fall of 2006, and were first rented in the spring of 2007. The owner's unit was 1,170 square feet with 3-bedrooms, and an office and laundry. There was also a 480 square foot garage on the property.

CCC was rated as a three-star rental accommodation by Canada Select. Canada Select was the only national accommodations rating program for all types of properties. Their ratings range from one star to five stars. There were at least 75 other accommodation providers within a five-minute drive of CCC. These included over 50 cottage operations ranging in size from two to three rental units to as many as 40 units. In addition, there were 10 motel properties, 11 B&Bs, and four campgrounds. The ratings of these properties range from 2 to 4 stars. Most properties in the Cavendish area were rated 2.5 to 4 stars. There were no properties that were rated less than two stars or more than four. About half of the properties were rated 3.5 or four stars. Exhibit 2 provides a brief discussion of some of the local competitors.

Many of the local competitors had 3.5 or higher star ratings (see Exhibit 2). As a consequence, CCC's average nightly rates were lower than many of their competitors. In addition to the cottages, the complex had an in-ground heated swimming pool, old-fashioned wooden swing benches, and a playground for children. All cottages had cable television, fridge, stove, microwave, barbeque, picnic table, as well as the other standard amenities normally expected with a rental unit.

Rental rates for cottages were often set six months to one year in advance since many repeat guests booked for the following year when checking out in the current year. Many cottage operators were fully booked for the peak season six to 12 months ahead of time. CCC's long history meant that many of their visitors were repeat. Recently, however, a few long-time clients had been lost to competitors who had newer and additional amenities such as ocean-view rooms, hot tubs, fireplaces, and fitness centres. Many competitors also had very well-designed Web sites featuring attractive pictures and detailed information concerning the property, the area, and PEI, in general.

In the high season CCC employed four workers, three full-time and one part-time. In the low season, this was reduced to one full-time and one part-time employee. They worked as housekeepers and on the front desk. Two of the employees had been on the staff for over 20 years. This provided a consistent vision and level of service for repeat guests. In the Cavendish area, it was relatively easy to hire low-skilled workers. Pay rates were usually \$6.50 to \$7.50 per hour, including benefits. Long-term employees often received \$2 to \$3 more per hour. The Bakers actively worked and managed the business and drew a salary.

Exhibit 3 provided income statements for CCC for the 2006-2008 fiscal years. Exhibit 4 provides balance sheets for the same period, while Exhibit 5 is the notes to the statements. The cottages were open from May 17 to September 30. Fran and Ted indicated that CCC's occupancy rate in 2007 and 2008 was 93 percent in the high season and 30 percent in the low. The asking price for CCC was \$800,000. In discussions with Sherry, the real estate agent listing the property indicated

that this was a reasonable price given that it was essentially a turn-key operation, the location of the property, the goodwill created by the Bakers, and given the high value of the assets.

Martin Heaney had told Sherry that there might be tax consequences for the Bakers from the sale. On the sale of a small business in Canada, each of the owners of the common shares would be exempt from tax on the first \$500,000 of capital gains. But, 50 percent of any remaining gain would be taxed at about 45 percent. Sherry wondered if this should be considered in her analysis of the business.

Marketing Issues

Fran and Ted believed that there were two primary target markets for their cottages. The principal market was middle-income families with children residing in the Maritime provinces who came to PEI for sightseeing and rest and relaxation. These customers stayed at CCC because they were close to all the major attractions of Cavendish, there was entertainment for their children, the price was affordable, and the accommodations were clean, friendly, and adequate. These were customers who might return year after year because they were satisfied with the services provided for the price paid, and they did not require luxuries.

The second and newer target market was more upscale consumers who came to PEI with friends for a golfing vacation. These customers were also from the Maritime provinces but tended to have more money to spend and visit primarily with other adults. CCC's location made it a good choice for these visitors since there were two exceptional golf courses within walking distance. CCC also offered their customers golf packages with reduced rates on green fees.

Fran and Ted listed CCC in the *PEI Visitors Guide*, and had brochures and a Web site. These were the only forms of advertising used, but that was the case with many of the smaller accommodation providers on PEI. The current Web site could be best described as "lean." The home page and all linked pages only used about 40 percent of the screen space due to a coding problem in the page design. The site itself provided basic information on the property including a brief description of the units, a list of amenities, rates, contact details, golf package details, four short reviews by guests totalling 24 words, and some pictures of the grounds, pool, and cottages. There was also a virtual tour of the grounds and of two cottages, but this was very slow and one of the cottages used looked very average with poor lighting. Most of the pictures were very small and lacked clarity and excitement. While it was not possible to make reservations online, there was a toll-free number and an email address available.

The competition in the accommodations sector in the Cavendish area was fierce. In the area there were four camp-

grounds, five hotels, and dozens of cottage rental properties. Exhibit 2 provides a listing of the major accommodation properties in the area, and some facts concerning each. With a short season, all operators aggressively competed for the tourist business.

Conclusion

Sherry Noonan considered all of the information she had collected and knew she had better get to work on trying to determine the amount she should offer for Cavendish Cove Cottages. If she bought the business, Sherry planned to be the manager. Her family had run a very successful hotel operation in Charlottetown for many years and she had worked in the business since she was 12. But still, there were many questions she had to consider: Was this a business worth buying? What marketing strategy would she use if she purchased the cottage? Was the \$800,000 asking price fair? How should she determine a fair price? With a fair price calculated, how would she finance the purchase?

Her parents indicated that they would provide a portion of the purchase price as equity. Sherry wondered how large an investment she should request from her parents and what rate of return her parents would require on this investment. From her corporate finance course, Sherry knew that the market risk premium on Canadian common shares over the 69 years to 2006 was 6.7 percent. Sherry also questioned where she would access the remainder of the money required. Borrowing from a bank was a possibility. But, after the courses she took, Sherry knew that a bank would not lend her the full purchase price. All lenders required someone to sign that the owners were committed to the business.

After phoning the bank, Sherry knew that prime rate was currently 4.5 percent, while commercial mortgage rates were 4.75 percent for a one-year term, 5.9 percent for a three-year term, and 6.45 percent for a five-year term. Sherry felt she should develop a monthly amortization schedule for the loan for at least the first five years of the planned loan amortization period so she would know the cash flow required to service the loan. But first she had to decide on the loan amortization period, the number of years she would take to repay the loan in full.

Sherry only had a few days to come up with the answers to these questions and to finalize an offer to Fran and Ted Baker. Martin Heaney had volunteered to review her analysis and Sherry wanted to be sure to take advantage of the free expert advice. Also, before making an offer, her parents had indicated that they wanted to review the work behind the proposed offer price. Sherry knew she had better get to work and develop answers to the ever-expanding list of questions that were popping into her head.

EXHIBIT 1 Cavendish Cove Cottages: Categories and Pricing of Cottages

Cottage Type	Number of Cottages	Daily Rate for 2008 ¹	
		High Season	Low Season
1-bedroom Deluxe	7	\$131	\$76
2-bedroom Standard	1	\$131	\$76
2-bedroom Deluxe	1	\$151	\$81
2-bedroom Executive	2	\$176	\$96
3-bedroom Standard	5	\$131	\$76
3-bedroom Deluxe	3	\$146	\$81
Total	19		

Notes:

- The stated rate for each cottage is for from 1 to 4 people. Extra people cost \$8.00 per day. The business is open from about May 17 (the date changes every year since the actual opening date is the Friday of the Victoria Day holiday that falls on the Monday preceding May 25 in Canada) to September 30. High season is from June 25 to Labour Day (the first Monday in September). Low season is before June 25 and after Labour Day. The Bakers were taking bookings and quoting the 2008 rates for the 2009 season. This was due to the need to set rental rates up to a year in advance, and the current low rate of inflation.

EXHIBIT 2 Competition in the Cavendish Area**Green Gables Bungalow Court 2.5***

40 cottages on beautiful treed grounds. Bed-sitting, one- and two-bedroom housekeeping bungalows. Kitchenettes and gas barbecues. Located beside Green Gables House and golf course. Excellent playground and heated pool. Ideal for families, golfers. Popular destination for families of all ages for 50 years. Walking distance to golf, restaurants, and shops. Walk, bike or jog to the beach and trails—less than 1 km by path through the National Park. Daily rate: \$65 to \$145; weekly rate: \$655 to \$980; based on cottage type and season.

Cavendish Bosom Buddies Cottages & Suites 3.5*

On Route 6, 1 km east of main route 6 and 13 intersection. Ten modern, heated, spacious, well-equipped deluxe two, three, and four bedroom cottages. Jacuzzi, dishwasher, microwave, skylight, gas barbecues, sun decks, laundromat. Deluxe efficiency suites with double Jacuzzis. Large, well-equipped, safe play area. Panoramic view of ocean and sunsets. Golf course, beach, and other major attractions nearby. Daily rate: \$85 to \$295; weekly rate: \$560 to \$2,065; based on cottage type and season.

Get a 2008/09 visitor guide at

www.cavendishbeachresort.com/search_maps_accommodations.php.

EXHIBIT 3 Cavendish Cove Cottages
Income Statements for the Year Ended December 31

	2006	2007	2008*
Rental Income	\$158,375	\$196,881	\$210,499
<i>less: Operating Expenses</i>			
Advertising	4,483	4,221	6,528
Amortization	20,258	25,965	27,573
Cable	1,284	1,095	2,088
Electric	8,753	9,281	10,270
Heat	1,146	1,436	1,183
Insurance	6,729	7,988	10,471
Interest and bank charges	2,216	4,131	3,149
Interest on long-term debt	10,321	14,966	11,700
Licences	6,963	7,159	6,706
Office	879	1,919	1,489
Professional fees	3,583	4,649	3,460
Repairs and maintenance	15,935	20,541	18,955
Supplies	11,586	6,844	8,479
Telephone	3,995	2,914	3,801
Vehicle and travel	4,965	2,911	3,035
Wages and benefits	63,425	49,460	47,388
Total Fixed Expenses	166,519	165,480	166,273
Earnings Before Taxes and Other	-8,144	31,401	44,226
Net Other Income	\$0	\$6,305	\$568
Earnings Before Taxes	-8,144	37,706	44,794
Taxes	1,340	8,174	9,436
Net Income after Tax	-\$6,804	\$29,533	\$35,358

* Note: The results for the 2008 fiscal year have not yet been certified.

EXHIBIT 4

Cavendish Cove Cottages
Balance Sheets as at December 31

	2006	2007	2008*
ASSETS			
Cash	\$0	\$8,113	\$4,084
Marketable securities	0	18,750	6,250
Accounts receivable	2,944	189	1,605
Income taxes receivable	1,340	0	0
Total Current Assets	<u>4,284</u>	<u>27,051</u>	<u>11,939</u>
Land	16,655	16,495	16,495
Gross fixed assets (Note 1)	518,700	580,604	612,986
less: Accum amortization	242,210	268,175	295,748
Net value	<u>276,490</u>	<u>312,429</u>	<u>317,238</u>
Total Fixed Assets	293,145	328,924	333,733
Other assets (Note 2)	1	1,919	1,493
Total Assets	<u>\$297,430</u>	<u>\$357,894</u>	<u>\$347,164</u>
LIABILITIES and EQUITY			
Line of credit (Note 3)	\$2,784	\$0	\$0
Accounts payable	7,223	4,300	4,818
Income taxes payable	0	8,209	8,405
Bonus payable	7,500	10,000	10,000
Demand loan (Note 4)	31,250	31,250	37,500
Curr portion of long-term debt	21,796	22,271	22,271
Total current liabilities	<u>70,553</u>	<u>76,030</u>	<u>82,994</u>
Long-term debt (Note 5)	116,040	149,544	127,273
Payable to shareholder (Note 6)	38,440	30,390	24,610
Total liabilities	<u>225,033</u>	<u>255,964</u>	<u>24,876</u>
EQUITY			
Common shares (Note 7)	3,125	3,125	3,125
Retained earnings	69,273	98,805	109,163
Net equity	<u>72,398</u>	<u>101,930</u>	<u>112,288</u>
Total liabilities & equity	<u>\$297,430</u>	<u>\$357,894</u>	<u>\$347,164</u>

* Note: The results for the 2008 fiscal year have not yet been certified.

EXHIBIT 5

Cavendish Cove Cottages Inc.
Notes to the Financial Statements (unaudited)

The company is incorporated under the Companies' Act of Prince Edward Island, and is primarily engaged in the cottage rental industry. The financial statements have been prepared in accordance with Canadian generally accepted accounting principles and include the following significant accounting policies:

1. Capital Assets

Capital assets are recorded at cost, net of government assistance. Amortization is computed using the declining-balance method at the following annual rates, which were the same as the Capital Cost Allowance (CCA) rates for the applicable asset classes.

Building	5%
Equipment	20%
Vehicle	30%
Pool	8%
Pavement	8%

	2008		2007	
	Cost	Accumulated Amortization	Net Book Value	Net Book Value
Buildings	\$350,804	\$104,636	\$246,168	\$237,478
Equipment	189,985	128,202	61,783	63,648
Vehicle	43,181	40,281	2,900	4,350
Pool	22,323	19,709	2,614	3,261
Pavement	6,693	2,920	3,773	3,693
Totals	\$612,986	\$295,748	\$317,238	\$312,429

Government assistance of \$27,953 has been deducted from the cost of the buildings while \$10,655 has been deducted from the cost of the equipment.

2. Other Assets

	2008		2007	
Web site development	\$2,131	\$639	\$1,492	\$1,918
Goodwill	1	0	1	1
Totals	\$2,132	\$639	\$1,493	\$1,919

Web site development costs are being amortized on a straight-line basis over a five year period.

3. Line of Credit

The line of credit is authorized to a maximum of \$20,000 and is payable on demand. The interest rate is based on prime plus 1.5%. The line is secured by land and cottages, and the personal guarantee and postponement of claims by shareholders.

4. Demand Loan

The demand loan is payable on demand and bears interest at prime plus 2%. The average prime rate during 2008 was 5% (2007 — 5%, 2006 — 6.5%). The demand loan is secured by a collateral first mortgage on the cottages, and personal guarantees of the shareholders.

EXHIBIT 5**Cavendish Cove Cottages Inc.****Notes to the Financial Statements (unaudited) [continued]****5. Long-Term Debt**

The long-term debt is secured by a mortgage on the land and cottages, personal guarantees of the shareholders, and life insurance on the shareholders.

	2008	2007	2006
Loan at 8.5%, payable to 2010 in annual amounts of \$5,000 plus interest	\$30,000	\$35,000	\$40,000
Loan at prime +1.5%, payable to 2012 in annual amounts of \$10,000 plus interest	\$80,000	\$90,000	\$43,750
Loan at prime +1.5%, payable to 2011 in annual amounts of \$2,271 plus interest	\$4,544	\$6,815	\$9,086
Loan at prime +1.5%, payable to 2011 in annual amounts of \$5,000 plus interest	\$35,000	\$40,000	\$45,000
Totals	\$149,544	\$171,815	\$137,836
less: Current portion	22,271	22,271	21,796
	<u>\$127,273</u>	<u>\$149,544</u>	<u>\$116,040</u>

Principal repayments required in each of the next four years are:

2009	2010	2011	2012
\$22,271	\$22,272	\$20,000	\$20,000

6. Due to Shareholders

This amount is due on demand without interest. However, the shareholders have indicated they will not request material repayment within the next fiscal year and consequently, the amount has not been classified as current.

7. Common Shares

There are 20,000 common shares at no par value authorized to be issued, 5,000 common shares are issued for a total value of \$3,125. No dividends were paid during the 2006 fiscal year.



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END-OF-TEXT CASES**CASE 1 WILLY DOG**

In 1989, having taken losses on a string of real estate plays, Kingston resident Will Hodgskiss found himself close to broke. Entrepreneurial to the end, he leveraged the last few dollars in his savings account and bought a hot dog cart. It wasn't much, but Hodgskiss was convinced that, with the right discipline and vision, he could start with his lowly hot dog cart and build a serious growth business.

He was right. In less than a decade, Hodgskiss's business, Willy Dog, had grown from a one-cart operation to a substantial franchise network with cart owners patrolling North American streets. And—thanks to Hodgskiss's decision in his first years as a vendor to trade in his standard metal cart for one in the shape of an eight-foot-long wiener—it had developed a distinct and instantly recognizable brand.

By 2006, Hodgskiss's company was enjoying annual sales of about \$1 million. It had diversified from its roots as a franchiser and had become one of the world's leading manufacturers of specialty carts for street-food vendors. Hodgskiss had travelled a great distance from his humble roots—but he was not yet ready to call it a day. He had set a goal of growing Willy Dog's annual sales to \$5 million within three years. When he reached that goal, he planned to step back from the company to either retire or start another business. Meeting that target, however, wouldn't be easy. For all Hodgskiss's success, Willy Dog faced a number of issues. It wasn't growing as quickly as it had in the past, and it was facing heightened competition. On top of that, Hodgskiss was wrestling with staffing issues, customer relations, and breaking into new markets. In short, he needed to develop a fresh strategy to foster growth at his firm. But knowing that he needed a plan wasn't enough. Hodgskiss also needed time—something he didn't have, given the chaotic schedule that managing all the minutiae of his company forced him to keep. And without it, he was left wondering how he could plot a course to carry Willy Dog into the future.

Back in 1999, when Willy Dog was celebrating its 10th anniversary, Hodgskiss was sitting on top of a thriving franchise network. But his company was starting to have problems. The revenue from franchise fees that had fuelled growth during Willy Dog's first decade was starting to dry up, and Hodgskiss's margins were thinning rapidly.

Looking for ways to generate new income, he began to experiment with making and selling his firm's distinctive

carts. His revenue growth picked up dramatically. "I was making \$2,000 to \$5,000 per sale, with none of the follow-up of franchising," Hodgskiss recalls with a grin.

And so, a manufacturer was born: Hodgskiss changed his franchising revenue model to encourage owners to buy the cart rather than the franchise, and he moved production of the carts in-house, hiring a staff of fabricators to operate the production line.

But even though his company was back on a growth footing, Hodgskiss remained a classic founder, involved in every dimension of the firm he started. Three separate hotlines—for support, orders, and other inquiries—were often routed to his cellphone. As a result, that phone was practically glued to his ear.

Hodgskiss felt it was important that Willy Dog customers be able to reach the "top dog" directly; that personal touch had been a hallmark of the company since its inception. But since he was involved in all aspects of Willy Dog's operations, he could be anywhere when a call came in. Customers liked dealing with Hodgskiss directly, but were occasionally frustrated when he didn't have all their information on hand. Hodgskiss, for his part, loved talking with his customers—but hated having to spend time reciting information easily found on the company's Web site. He valued the relationships, but wished that there was a more effective way of handling inquiries.

Part of the problem stemmed from Willy Dog's internal structure. Almost all of the company's 18 employees worked on the shop floor as machinists and fabricators. Under the leadership of the shop foreperson, this staff spent its days producing the company's signature carts. The rest of the operations, from finance to marketing, were handled by Hodgskiss, his general manager, and an office clerk.

For Hodgskiss, this meant he had to keep up a frenzied pace of activity to manage the company's operations. In a typical day, he rose at 5:00 a.m. to tackle his email inbox before breakfast and his morning run. At the office, he would handle everything from clerical work to minor errands, though two-thirds of his usual day would be consumed by supervising staff.

Though Hodgskiss described his ideal leadership approach as "hands-off," he couldn't resist getting involved in the day-to-day details of the business, from staffing to equipment. But his enthusiasm for running the business, he realized, left Willy

This case was written by Lukas Neville, Ph.D. student, Queen's School of Business, and Professor Elspeth J. Murray, CIBC Teaching Fellow in Entrepreneurship, Queen's School of Business, Queen's University. This case was prepared with the assistance of Kimberley Mosher and Gillian Shiau. Developed with the support of the CIBC Curriculum Development Fund at Queen's School of Business, for purposes of classroom discussion.

Dog vulnerable. If he ever took ill, his general manager could handle only some of the company's operations for a limited time. But Hodgskiss knew he was personally still indispensable to the firm.

By this year, cart sales had come to account for 80 percent of Willy Dog's annual revenue. But as the cart business grew, Hodgskiss began running into stiff competition from an entrenched U.S. manufacturer called All-American Hot Dogs Co. With fierce rhetoric on their graphic-saturated Web sites, the two titans clashed over features, quality and, eventually, price. It was war, and the battles bit deep into Hodgskiss's margins. His price woes didn't end with a single competitor. He also competed against a range of small local players, who Hodgskiss described as "backyard mechanics." Worse, his market for high-end carts was being eroded by online marketplaces for used carts. On any given day, dozens of carts could be found for sale on eBay.

Short-handed on sales and marketing staff, and faced with intensifying competition, Willy Dog turned to a distributorship model. Though it involved parcelling out a portion of the company's modest margins, Willy Dog's five American distributors contributed marketing and sales resources, and their high-volume purchases cut down dramatically on the cost of shipping the bulky carts. Finally, the local presence allowed for improved customer service and local regulatory knowledge for new vendors.

But while the distributor network had improved Willy Dog's outlook, Hodgskiss still wondered how to sustain his firm's competitive advantage. With individual vendors accounting for most of his cart sales, the majority of revenue came from one-off purchases. Hodgskiss's customer service and personal touch had built customer loyalty, but it didn't often translate to repeat sales. And while Willy Dog had invested considerable effort in product innovation, customers were highly price-sensitive and often indifferent about the firm's higher-gauge steel or other technical improvements.

Having to fight for every last sale to small-scale customers was an unappealing part of Willy Dog's business model. Over 70 percent of the company's sales came from small-time owner-operators and seasonal "hobby" entrepreneurs—often leaving the company saddled with bad debt from failed clients. The last 30 percent of Willy Dog's sales, by contrast, was to business managers: franchised restaurants and professionally managed local chains. Earlier this year, for instance, Willy Dog

completed an order for 10 carts from an ice cream vendor. But how, Hodgskiss wondered, could he go about finding more customers in this appealing segment? His own market research offered clues about how strong the hot dog market was: At major-league baseball parks, hot dog sales had increased by over 13 percent between 2004 and 2005, Hodgskiss learned. And 'curbside takeout,' the market that included Willy Dog-built stands, was growing even more quickly. With street-side vendors propagating rapidly, Hodgskiss knew his market was relatively secure.

At the same time, with increasing health concerns and a globalizing palate, would the lowly hot dog be abandoned in favour of sushi or samosas? The demand for frankfurters was enough to sustain Willy Dog at its present level, but Hodgskiss wanted more than comfortable, flat growth. He wanted to quintuple his annual sales and then make a graceful exit.

To do that, he had to find a growth market, but he wondered how his modest manufacturing operation would scale up. Between resignations and seasonal layoffs, his staff suffered annual turnover of 30 percent. On top of that, it was hard to keep trained staff in a market starved for skilled workers. Earlier in the year, Hodgskiss had to establish employee health and dental plans as a retention measure.

Intermittently starved for production capacity, Hodgskiss had experimented with contracting out production. The strategy worked out exceptionally well—until the contracting firm decided to launch its own cart manufacturing business, directly competing with Willy Dog.

Willy Dog was also highly reliant on steel to build the carts. With slender margins, Hodgskiss wondered whether manufacturing was necessarily the most appealing part of his industry's value chain. With labour and input prices on the rise and mixed experiences with outsourcing, Hodgskiss would need to carefully consider how to grow his manufacturing operations to keep pace with the growth he hoped to foster.

Though growth was a priority for Willy Dog's founder, his schedule didn't afford him much time for strategic planning sessions. Busy revamping his cart models, dealing with his steel suppliers and handling the constant barrage of customer calls, Hodgskiss's days were already a flurry of activity. He had built Willy Dog into a million-dollar enterprise. But with so little time, he had no idea how to begin dealing with eroding margins and stiff competition.

CASE 2

HANDSHAKE VR INC.: INNOVATING WITH TOUCH

LAURIER
Business & Economics

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As the senior executives of Handshake VR walked out of the boardroom of their Waterloo, Ontario, office in June 2005, the same thoughts were going through all of their minds. Based on the market analysis, the company had a very promising future. However, it was not exactly clear what the proper evaluation criteria should be, given the very early stage of the markets. Also, it was far from certain how long it would take for each of the markets to develop, and what role Handshake should play in the development of each. Should they continue as a component technology, or middle-ware provider, inventing new technology and looking for ways to license that technology? Or should they help the early stage market break through the commercialization barrier by picking one vertical and developing it to at least the proof-of-concept stage?

The latest financial statements indicated that additional funding for the company to capitalize on new market opportunities would be required sometime between October and December in order to capitalize on "windows of opportunity." The company would need to present its case to potential investors by early August, only two months away, if agreements were to be in place in time. What would potential investors expect if they were going to commit substantial amounts of money to the young company? Different investors might be interested, depending on which strategy was chosen. The choice would also have an impact on how the company developed priorities and allocated resources over the next few years.

Background

Handshake was founded¹ in 2001 to commercialize telehaptic (the sense of touch over networks) technology that Dr. David Wang had developed at the University of Waterloo, where he was an Electrical Engineering professor. To assist him in his business venture, Wang brought in Dr. Kevin Tuer as vice-president of technology and Tim Ellis as vice-president of corporate development. Wang was on leave from the university and took on the role of president. The three partners raised angel financing and spent long hours developing strategy.

The founders of the company resisted the often-suggested strategy of focusing on one or two vertical segments, fearing that a forced choice too early in the product development process might mean that they would be missing out on significant opportunities in the future.

In 2001, the Handshake founders rejected a financing offer from a consortium of venture capital funds, thinking that a more attractive deal would be possible when customers had been signed. As a result, a lack of cash constrained product development and marketing activities for the next few years. In some cases, company stock was used to pay expenses. For example, the landlord at their original offices accepted shares in the company instead of rent payments.

Key sources of funds were the many government programs that encouraged research and development. Some of the programs that provided assistance to Handshake were the Canada Revenue Agency's Scientific Research and Experimental Design (SR&ED) tax credits, the National Research Council of Canada's Industrial Research Assistance Program (IRAP), and the Accelerator Investment Program of Communications and Information Technology Ontario (CITO).

The challenge for Handshake was that the need to maintain secrecy around the new technology meant that the Handshake people were the only ones who could make use of it. By its nature, the Handshake technology would be embedded in other applications, but that was going to be very difficult to do, when so few people had access to it. Given resource and time constraints, Handshake would not be building the commercial applications, so they needed to get the technology into the hands of the developers who would be creating the applications. In early 2004, a strategic decision was made to make the Handshake technology available to as many developers as possible. They needed to multiply the number of people with access to the technology, beyond the five Handshake developers.

In June 2004 Handshake secured \$3 million in seed financing from Tech Capital Partners Inc. (www.techcapital.com), BDC Venture Capital (www.bdc.ca), and Trellis Capital Corporation (www.trelliscapital.com). Throughout 2004 and early 2005, the company's main focus was on development of a product that would get the Handshake technology into developers' hands without compromising the company's intellectual property (IP). During this time, the management team was strengthened with the addition of several key players, with strong industry experience, and the number of employees grew from eight to 16.

Haptics and Telehaptics

Haptics referred to simulating the sense of touch in human-computer interactions. The most widely known, but very basic application of haptics was the video game controller that vibrated when cars collided or guns were fired. NASA had also employed haptics on the International Space Station, to allow astronauts to control robots outside the station to do repairs. Telehaptics referred to the use of haptics in a network environment, e.g., Internet. In order to demonstrate the concept of telehaptics, a number of science museums contained exhibits where visitors could 'arm-wrestle' with opponents over a computer network. The two opponents each pushed against a mechanical 'arm' while watching the other player on a monitor. The pressure applied by one player was transmitted to the mechanical arm of the other player.

The development and commercial application of telehaptic technology required further progress on the software and

¹This case was written by Dave Rose and Hugh Munro, for purposes of classroom discussion.

²The original name of the company was Handshake Interactive Technologies Inc. but it was later changed to Handshake VR Inc.

hardware (devices) fronts as well as considerable education and training of potential users. The increasing number of hardware 'feedback' devices that were becoming available was raising the level of interest in the subject. An American company, SensAble, had the largest share of the hardware market so compatibility with SensAble's technology had been a development priority for Handshake's software developers. Several other companies in North America and Europe produced haptics devices for specific applications.

A major issue affecting the use of telehaptics was the effect of network time-delay. Time-delay creates insurmountable problems in more sensitive, precise operations like those in medical training or surgery-based applications. The issue was that time delays over networks caused the devices that people were using to become unstable and behave very erratically—imagine a small robot swinging wildly out of control. The major advantage of Handshake's technology was that it eliminated, or greatly reduced, the problems associated with network time delays. The whole field of telehaptics had become much closer to reality with the development of Handshake's patented technology.

The Role of Venture Capital

For Handshake to grow to a profitable size, significant money would need to be spent on further product development and, more significantly, marketing and business development. Sources of funds for the commercialization of innovative technologies were generally restricted to venture capital firms (VCs). The VC industry used unique terms for investments in each stage of a company's growth, which reflected the fact that multiple rounds of financing were usually required for new technology companies. For example, one well-accepted categorization was: seed-money stage, start-up, and first-round to fourth-round financing.² Another way to describe the progression of investment fund sources was Family & Friends, Angel Funds, Seed Funds, Venture Capital Series A,B,C etc. and Initial Public Offering (IPO).³

VCs filled the void between sources of funds for innovation, such as the government programs, angel funding and personal investments that had financed Handshake so far, and traditional, lower-cost sources of capital available to ongoing concerns, such as bank loans. Venture capital investments were risky, and VCs expected a sufficient return on investment to compensate for the risk.⁴ The successful investments needed to generate large enough returns to make up for the investments that only returned the original investment or nothing at all. For every 10 investments, it was expected that in perhaps two cases the VC's original investment would be lost, six might see the initial investment returned with a modest return on investment and one or two would be winners. The profitable ventures needed to return 10 to 20 times the VC's initial investment for the average return on the portfolio to be within the VC's targeted range.

Typically VCs wanted to see an exit opportunity, through a sale to a larger corporation or a public share offering, within five years. Only certain businesses could grow fast enough and large enough to attract VC funding. Generally VCs concen-

trated on fast growing industries, where the capacity would be constrained in the next five years⁵ and looked for compelling technology, driven founders, and talented entrepreneurs with extraordinary vision.^{6,7}

The Launch of proSENSE

In March 2005 Handshake's first product, the Handshake proSENSE Virtual Touch Toolbox, was launched. The proSENSE Toolbox provided researchers and developers of haptic-enabled (sense of touch) applications a dramatic, new approach to product development. With its "drag and drop" functionality, developers could now quickly and easily embed haptic functionality into their applications. With the launch of proSENSE, Handshake had achieved its strategic goal of getting its technology into as many developers' hands as possible, while keeping the IP secure, as developers did not need to understand the 'secret sauce' behind proSENSE to use it. As well, TiDeC, Handshake's patented time delay technology, was instantly available to developers using proSENSE.

Vertical Market Development

While the proSENSE product was attracting considerable interest from the research community and, surprisingly, a couple of commercial developers, the Handshake executives felt there was still a need and an opportunity to get more involved in the development of end-user applications. A well-respected book in the field of high-tech marketing was *Crossing the Chasm*, by Geoffrey Moore. Moore described the chasm as the gap in the market between the adoption of a new technology product by the innovators and early adopters and its acceptance by the broader end-user market. Moore's prescription for crossing the chasm was to develop a 'whole product' that met the needs of a very specific target market. Moore's theory appeared to be very appropriate to Handshake's situation. Despite the broad acceptance proSENSE was receiving from the haptics development community, commercial applications would not gain market acceptance until at least one 'whole product' was developed. Was it Handshake's role to push one or more applications through to a commercially viable product, or at least to proof of concept, so that the chasm could be crossed?

Some of the markets that were currently being considered were:

ONLINE HAPTIC GAMING Local haptics had been available in the gaming industry for a number of years, but this generally involved fairly basic effects, e.g., rumble packs. More complex activities, such as sword fighting with someone in Tokyo, required telehaptics but this technique had not been developed for online games due to problems with time-delay. Handshake had a viable solution for online haptics, but it was difficult to adapt haptics to existing games. New games had to be written specifically to use haptics. The major game console manufacturers were no longer funding new game development, as they once did, and now required a complete solution before considering a new game. They appeared to be waiting for 'the next big thing.'

This meant that Handshake would need to find a partner willing to create online games that incorporated telehaptics.

LEARNING DISABILITIES The learning disabilities market was very fragmented but represented a substantial opportunity for total customer potential. The use of touch in learning for children with disabilities was proven to be of extreme benefit in their progress. To date, each child was assigned a therapist who worked with them in the classroom on tasks such as learning to write, spatial awareness, and basic skills. In the U.S., law mandated children's rights to therapy—the problem was the demand was outstripping the supply of therapists.

SPORTS REHAB AND FITNESS There were a number of promising applications in the sports rehabilitation and fitness markets. Basically, the concept involved either retrofitting existing exercise equipment or working with manufacturers to develop new equipment that incorporated motors that could drive haptics effects and also connect to the Internet. This would provide a new opportunity in personalization of workouts and sports rehab by allowing the user to take their "exercise card," insert it into the machine and pick up where they last left off.

STROKE AND TRAUMATIC BRAIN INJURY REHAB

Stroke rehab was a sub-segment of a general category called traumatic brain injury. The combination of increasing numbers of North Americans requiring rehab, declining therapist resources and pressure from increasing hospital and clinic costs was pointing to a need to establish a more reliable home-based approach. The underlying concept was for a patient to pay a monthly subscription fee for hardware and access to a Web-portal. From there, they could interact with their therapist and other patients and also track their progress.

REMOTE HEALTH DIAGNOSTICS In an effort to address a shortage of doctors, nurses, and other health care providers in remote communities, the Romanow Report advised Canadian politicians to accelerate initiatives in telehealth. Millions of dollars were being spent transporting patients, for example, from places like Yellowknife to medical centres in Edmonton. The industry was still in its infancy but great use was being made of video conferencing for conferring with patients. Ontario had set up a program called North Network, with over 20 centres linking health experts in Southern Ontario and patients in the North.

MEDICAL TRAINING AND SIMULATION Haptic solutions for medical training and simulation already existed with products on the market by at least six companies. What was lacking was the ability to network these devices for remote training opportunities. Early indications were that there was a need for remote training of medical students, medical sales forces, and end customers. Both medical schools and large medical companies were showing interest in developing applications.

TELESURGICAL OPERATIONS Telesurgery sounded like something from Star Wars, but by 2005 a Canadian doctor in Hamilton, Ontario, had already conducted more than 20 telesurgeries to address "acid reflux" conditions in patients located in Ontario and Québec. This success was generating great interest from NASA and the U.S. military. There were about three players developing surgical robots—usually with a price tag of more than US\$1 million. Handshake had participated in a joint NASA/U.S. military/

Canadian project in 2004 and was working on new projects to expand the use of haptics.

Current Situation

FINANCIAL POSITION A common metric used to assess the burn-rate for a new technology company was to assume a cost of \$100,000 per employee, including salary, expenses, and space for them to work. Revenues from the sale of proSENSE would decrease the burn rate, but with 15 employees and rapidly increasing people requirements, the company's cash was expected to run out within the next year. Further capital from the seed round investors was certainly a possibility, but their \$3-million investment had been intended to provide a clear picture of the market potential for Handshake's products. The next round of financing would be expected to fund the targeted development and marketing activities for specific verticals. At an estimated cost of \$2 million to \$5 million per vertical, on top of the current burn rate, and the cost of filling existing organizational gaps, a very promising market potential would need to be identified. Costs would include marketing, intellectual property, legal and development expenses. Investment from other venture capital firms was also a possibility, but it would be difficult to attract any new investors if the existing ones would not contribute more money.

ORGANIZATIONAL CONSIDERATIONS Attracting talented people had not been a problem for Handshake. The company's close relationship with the University of Waterloo and downsizing at a number of area technology companies had created an excellent pool of developers and executives to choose from. The company had never used a recruiting firm to attract the people they needed. The exciting technology, the talented founders, and the opportunity to be part of a high-potential start-up had led promising candidates to approach Handshake and to join the firm for competitive rates of pay. The main problem the company faced was being able to afford to hire the necessary talent before they were needed rather than after the need had become critical.

MARKETING CHALLENGES The founders of Handshake were convinced of the potential for Wang's technology to revolutionize the field of telehaptics. In many ways, they were creating new markets and acting as visionaries to educate customers on what was now possible with the new technology. As a result, much of the work that had been done so far was based on a theoretical view of what was possible, i.e., a 'technology push' rather than a 'market pull' approach to product development.

THE DECISION While there were viable opportunities for Handshake to remain as a component technology provider, relying on others to develop commercial applications, the Handshake executives looked to Microsoft's development of Windows-based applications for an analogy to the situation facing them: Microsoft's decision to allow others to develop applications based on the Windows platform, resulting in scores of new applications, was similar to Handshake's decision to launch proSENSE. However, Microsoft had seen certain areas where it made sense to get involved in end-user applications, for example, Microsoft Office. So now they were looking at the different verticals where haptics would play a role in the future, and wondering if they should be pushing towards a commercial application in any of them.

² Ross, Westerfield, Jaffe, and Roberts, *Corporate Finance*, 3rd Canadian ed. (Toronto: McGraw-Hill Ryerson, 2003), 590.

³ Timmons and Spinelli, *New Venture Creation: Entrepreneurship for the 21st Century* (New York: McGraw-Hill/Irwin, 2004), 470.

⁴ Bob Zider, "How Venture Capital Works," *Harvard Business Review*, November-December 1998.

⁵ Ibid.

⁶ www.woodsdefund.com.

⁷ www.techcapital.com.

The management team had also discussed other possible strategies that might not need another round of venture capital financing, or perhaps a smaller amount of capital. Relying on sales of proSENSE was an option, but it would require more aggressive and devoted attention to rapidly penetrate the global, niche market of developers. Securing funding from the U.S. military for development of specific telehaptic applications was another possibility. The associated intellectual property would be owned by the military for their applications but might be available to Handshake for non-military applications. Selling the technology to a larger firm might also be an option, but the team preferred to focus their energy on

CASE 3 SWEET SUCCESS

Dairy Queen® is a fast-food restaurant franchise that was founded in 1940. With 5,900 restaurants in 22 countries as of 2008, it is one of the largest chains in the world. Much of its early growth occurred in rural areas of the United States, and references to “DQ” occur repeatedly in both the popular and literary culture. For many years the franchise’s slogan was “We treat you right!” in recent years it has been changed to “DQ” something different.” The company is a wholly owned subsidiary of Berkshire Hathaway.

The Dairy Queen® franchisee-franchisor relationship is simple yet effective. Prospective franchisees are required to have a certified operator working in the store. To qualify as a certified operator, one must attend training at Dairy Queen’s head office. The program offers training in employee and financial management, hiring and recruitment, product training, community involvement, customer service, and Dairy Queen® procedures and policies. To successfully complete the training program operator candidates must complete a set of examinations covering all of these different areas. After completing the program and commencing the operation of a franchise location, operators are required to adhere to DQ® Procedures and Policies, follow national marketing campaigns, pay monthly royalties, and pass quarterly on-site evaluations. DQ® District Managers conduct these evaluations by spending a full day on site examining operations, product consistency, cleanliness, and customer service. Franchise locations that fail these evaluations are given a warning and opportunity to rectify shortcomings. If shortcomings are not remedied by a specified date, the franchisor (Dairy Queen® Inc.) has the right to terminate the contract. As consistency and customer service are of the utmost importance, Quarterly Evaluations are often supplemented by the use of mystery shoppers.

The franchisor-franchisee relationship is facilitated through the use of a DQ® Field Consultant from and to whom the franchisee is encouraged to seek guidance and communicate questions or concerns.

St. Thomas

St. Thomas (population 36,110) ranks 51st in size among 912 Ontario cities. Residents of St. Thomas are mostly upper-middle class to wealthy individuals and families, mostly of French

building the value of the company through development and commercialization of their technical expertise.

Final thoughts before the executives broke from the boardroom were focused on what needed to go into the presentation to potential venture capital firms. The pitch had to clearly and crisply outline the specific market applications that would be developed, the model for how those applications would be commercialized, how the funds would be used, what kinds of returns (i.e., profits and company value) could be expected and the associated timelines. Financial support would be dependent on how confident investors felt about the plan as well as the ability of Handshake’s management to successfully execute the plan.

roots and Catholic. The small size of the city allows better acquaintance between its residents and for word of mouth to travel quickly. It is a prosperous city with ample opportunity for business growth and success.

St. Thomas Dairy Queen

The St. Thomas Dairy Queen® was first opened in 1995 by Ted Smith and his wife Ronnie. They opened it as a “full Brazier store,” which is the Dairy Queen® terminology for a fast food restaurant that serves “hot eats” and “cold treats.” Prior to opening the St. Thomas location Ted and Ronnie had gained experience as owners of the Dairy Queen® location in White Oaks mall in neighbouring London, Ontario. With their lease expiring at the mall, the Smiths decided to open up a new DQ® location in the emerging city of St. Thomas. With the assistance of two full-time managers, Ted and Ronnie created a successful business realizing nearly \$550,000 in revenue in their second year of operation.

St. Thomas’s DQ® was perceived as the “cool” place to work by the local high school students. Each year tens of applicants would apply in hopes of a part-time position. During summer weekends DQ® would open until midnight making it a popular hangout for teens, families, and couples alike. The St. Thomas DQ® also became involved in the community through sponsorship of local baseball and hockey little league teams.

Although Ted was both proud and loyal to the brand, he was very cynical of the Franchisor. He often wanted to do things his way and found it difficult to follow DQ® Policies. He often challenged head office and had developed a very antagonistic relationship. He was also known to be strict and firm in managing his business and employees often viewed him as a tyrant, avoiding him at all costs.

After six successful years of running the St. Thomas DQ®, Ted and Ronnie decided they were ready for retirement and put the store up for sale in 2000.

The Hashem Family

In 1990 Sayed Hashem and his family immigrated to Canada from civil war-torn Lebanon. The Hashem family consisted of Sayed, the patriarch, his wife Nora, and their six children, the

youngest of which was born in Canada shortly after arrival. In January 2001 the Hashem family purchased the St. Thomas Dairy Queen® from the Smiths.

At the time of the Dairy Queen® purchase, Sayed’s two eldest children, Yasmine and Khalil, were enjoying living away from home to complete their professional educations. Yasmine, a dentist, and Khalil, a doctor, had always described living at home as “boot camp” living with the discipline of a strict father. Sayed’s parenting skills were much like those of parents from any war-torn and dangerous region; where strict discipline was a necessity more than an option.

The four youngest children; Aliya, Mira, Hanna, and Basil were to become integral parts of the Hashem family Dairy Queen. Nora, on the other hand, had no intention of becoming involved with the newly acquired Dairy Queen®. Past experience had taught the Hashems that Nora and Sayed working together put a tremendous strain on their relationship and created problems and unhappiness.

SAYED—FATHER, MANAGER, BOSS In June 2001, five months after purchasing the St. Thomas Dairy Queen®, Sayed Hashem completed his three-week training course and officially became a Dairy Queen® operator. While Sayed had immigrated to Canada in 1990 at the age of 37, he still struggled to perfect the English language and assimilate into the Canadian culture. Although Sayed had previous business experience in Canada, the fast food industry was a completely new venture. Prior to being interested in purchasing a Dairy Queen® franchise, Sayed’s only experience with Dairy Queen® had involved a single visit during which he enjoyed a banana split and a sunny day with his children.

In Lebanon, Sayed had simultaneously worked three jobs to support his relatively large family. He was a math teacher, the first sales manager for Lebanon’s first and largest super store, and an exporter on the side. Clearly not a stranger to hard work, Sayed would soon learn that the restaurant industry would require much more.

ALIYA—DAUGHTER, EMPLOYEE, MANAGER Aliya, the eldest of the Hashem children remaining at home, had completed the Dairy Queen® training program with her father and was also qualified to operate the franchise. Her father had been concerned about failing the training program due to the language barrier and as such had asked her to attend as a backup. At the time the Hashem family took over the St. Thomas Dairy Queen®, Aliya was a 19-year-old first year university student. Aliya also played a key role in the acquisition of the business as both translator and negotiator for her English-challenged father. Sayed often referred to Aliya as his “right hand man” or his “tongue” because of his less than perfect English.

Having been brought up in Canada, Aliya had several advantages over her father. She was fluent in English and completely understood and fit in with the Canadian culture. At the same time, she had been born in Lebanon and spent the first eight years of her life there. This gave her the ability to appreciate the differences in culture and society and communicate from both perspectives. Aliya was a quick learner who, as a teenager raised in Canada, had far more exposure to the fast food industry. Through school, sports, and extra-curricular activities Aliya had gained experience in group work and leadership.

In contrast to Aliya’s perspective, her father considered much of the Dairy Queen® requirements, managerial tasks,

roles, and tactics to be “just another way to steal money from the Franchisee.” He often expressed his opinion that \$10,000 for a transfer of ownership, \$8,000 for new menu boards, and \$10,000 for a required training course were just a few of the many techniques DQ® was using to gouge the Franchisee. Aliya on the other hand was able to understand, appreciate and explain the necessity and benefits of these and other costs.

With Aliya by his side, Sayed would grow to value the DQ® trademark and operating procedures. More importantly, he would learn to train, manage, and retain approximately 25 employees, 90 percent of which are Caucasian teenagers who in the past would have certainly clashed with Sayed’s way of doing things.

MIRA Mira was 16 years old when her father acquired the St. Thomas DQ®. She began working for her father immediately after the end of the 2001 school year. She was a quick study and within a short period of time became a key employee in the store. She disliked working at the family business and avoided taking on any additional responsibility. On a given shift, Mira would come in and get straight to task. She would have little communication with other staff except the occasional reminder to get something done or stop “fooling around.” She felt that it was easier to get things done on her own and delegated little to the staff. She constantly complained about the staff being slow and inefficient.

Mira and Sayed were very similar and as such would often bump heads resulting in a low tolerance for one another. Unlike Aliya, Mira had little compassion for issues troubling her father. If he told her that a staff member was underperforming and needed retraining her immediate recommendation was to fire them. When asked to do anything outside her normal shift duties she would conveniently “forget.”

Today, Mira is 21 years old. She is an efficient and fast employee that makes excellent products and offers great customer service. She still dislikes her job, mainly because she does not enjoy working with her father, and continues to avoid responsibility. Mira works very flexible hours and covers shifts whenever needed. She feels this is a significant contribution to the family business and to expect anything more of her is unreasonable.

HANNA Hanna was 14 years old at the time her father acquired the St. Thomas DQ®. Working at the family business was her first job. Like her sisters, she was quick to absorb and had perfected her role as a cashier. She displayed great customer service and was often complimented by customers on her attitude.

Today, Hanna is 19 years old. She has a pleasant personality but can also be very stubborn. She insists on doing tasks her own way and on her own schedule. Sayed depends on his children and as such has given them authority over the other employees. Hanna often abuses her authority and uses it to avoid work by ordering the staff around.

Hanna has difficulty taking orders and refuses the authority of her older sisters, Aliya and Mira. Mira and Hanna often get into “sisterly fights” at work. Hanna and Aliya have also butted heads. Hanna has been known to refuse Aliya’s orders and display rude behaviour to the point of having to be sent home. Hanna often takes out her frustration by ordering around her younger brother Basil, which results in countless arguments at work.

After five years of working at DQ®, Hanna refuses to learn supervisory responsibilities, and her capabilities are limited.

BASSIL Bassil is the youngest member to the Hashem family. He started working at DQ® only a year ago, at the age of 13. When he started working his primary responsibilities were to keep the dining room tables clean and the floors spotless. A year later, he is a top kitchen worker.

Why DQ®?

Prior to 2001, the Hashem family resided in London, Ontario. Sayed had purchased a failed variety store that he remodelled, restocked, and reopened. The business was a success! The store location had failed under the previous management of Becker's and Mac's Milk, but Sayed was able to get it back on its feet.

Sayed and the family operated the store for nearly six years before Sayed decided he had enough. He was unhappy with the nature of the job. He did not enjoy standing on his feet all day in what seemed a mindless job. He detested dealing with his three employees who he felt were unreliable or not worthy of trust. In addition, neither he nor his wife Nora enjoyed living in London. They wanted to relocate to St. Thomas as they had many family and friends in the area. They felt that being near family would benefit the children and their own social life and happiness. With this in mind, Sayed sold the variety store in September of 2000, and with a mere \$150,000 travelled to St. Thomas in search of the perfect opportunity.

After nearly nine months of networking and searching for an appropriate business, Sayed began to run out of time. A family of eight with two children in medical school could not sustain itself without a substantial income. Sayed had to move quickly to avoid having to tap into the \$150,000 business investment account.

The St. Thomas market made Sayed's business searching task a difficult one. Businesses in the appropriate price range were far too risky and less risky businesses were not for sale. Finally, a realtor approached Sayed about a business for sale in St. Thomas where the owner was willing to finance a mortgage. Immediately, Sayed's interest was piqued.

Sayed met with Ted Smith the owner of the St. Thomas Dairy Queen® that was for sale. Sayed noticed it was a very well run and clean facility that had a constant inflow of customers. He also loved the location and the manageable size of the business. Ted had prepared all of the appropriate financial statements, which he revealed to Sayed as soon as he had communicated his interest and signed a confidentiality agreement. Sayed was impressed by the numbers. Over \$550,000 in sales, profits were still healthy even though Ted was paying four managerial salaries each year!

Sayed considered the facts. The St. Thomas Dairy Queen® was already established and in a growing area at a busy intersection. Also the staff was already trained and experienced. In addition, the business had a competitive advantage; it was a fast food restaurant that also served soft serve treats that the competition could not compete with. The financials of the business looked great and with Ted willing to finance a five-year mortgage, Sayed could get the most for his money. He knew he had no experience in the industry, but he was determined to learn quickly.

DQ®'s Senior Staff

SAYED AND ALIYA'S RELATIONSHIP Sayed became heavily reliant on Aliya. Sayed took care of the ordering, cost control, scheduling, maintenance, and training. He expected Aliya to communicate with head office and to train and manage front counter staff. The DQ® staff generally consists of five kitchen workers and 20 cashiers. Kitchen workers would prepare food while cashiers were responsible for taking orders, preparing soft serve treats, making frozen cakes, stocking, and cleaning. Aliya is also responsible for keeping up to date with policies, rules, and regulations and making sure that staff understands and follows them. Further, she has to ensure that the employees are performing to their fullest potential, providing superior customer service, and keeping their morale up. She was also responsible for disciplining those employees that were not performing to standard.

Often Sayed would express a concern, frustration, or problem to Aliya and expect her to resolve it. If a shift task was not completed (e.g., staff not making enough frozen cakes) then Sayed would confront Aliya. He would often say something along the lines of: "Didn't you tell so-and-so to make 20 cakes last night? Why didn't they? What kind of manager are you if your staff won't listen to you? So-and-so is just good at talking and fooling around! Before her next shift you talk to her!"

Although Sayed was often critical of, and hard on, Aliya, she usually did not let it get to her. She remained task oriented and got the job done. She knew that her father's concerns were valid, but she also knew that he had difficulty expressing them fairly and/or calmly. She adapted to his hostile style and was able to calm him down, make him feel better about a situation and eventually solve it. She also realized that it was not easy for her siblings and other staff to cope with his behaviour. Aliya cared about the well-being of both her father and the business and for that reason could put up with the stress and demand. But she knew that it was unrealistic to expect regular staff to deal with her father's style. Aliya vocalized this concern to her father and he apologized for his behaviour and noted that he should be more careful. In time Sayed learned to better control himself in front of employees, but remained hard on Aliya. She accepted this and assumed the role of "counsellor" to her father. She allowed him to vent to her and after he was done his spiel she would dilute the problem making him feel that "it's not a big deal, we'll take care of it."

In 2006, after five years of working hand in hand with her father, Aliya got married and abruptly distanced herself from the family business. She became a full-time graduate student juggling two other part-time jobs while working on building a career in banking. Career combined with married life left her no time to help with the family business. Sayed was left to pick up all of Aliya's responsibilities. He found himself hiring as many as six cashiers in order to be able to retain two of them. He quickly realized that he needed a more gentle management style, especially with the younger and newer employees. He left the training up to Mira and senior staff members Rose and Meredith but constantly interfered with his own input. For example, Meredith would teach a new employee how to make a certain product one way, and then he would tell that employee that he wants it done another. Sayed attempted to have Mira pick up Aliya's responsibilities, but she was not interested. She made it clear to her father that she was working because he was making her and that she did not want to be there or get involved any further. Soon thereafter, Hanna and

Bassil carried the same attitude towards the family business. Sayed felt that dealing with the employees was not his job. In an attempt to solve his problem, he promoted Meredith to chief of staff and made her responsible for communicating his needs and expectations to the staff while at the same time training and resolving employee problems.

OTHER SENIOR STAFF Rose and Meredith were two senior employees that had worked at the St. Thomas location for six years even before Sayed had purchased it. They were the most experienced and only full-time employees. They often resisted any change but eventually adapted to the new management and did as asked. They were hard working, dedicated employees that cared about the business as if it were their own. But they often did not see eye to eye with Sayed. They quickly came to respect and follow Aliya, for she proved she was competent and caring as well as a hard worker who always set a good example. Aliya often met with them to discuss new changes or ideas and ask for their opinion. Sayed on the other hand, often met with them to complain about an issue and try to get consensus from them.

ROSE Sayed and Rose did not always get along. In one incident, Sayed was speaking to Rose about incomplete tasks on a previous shift that she had supervised and he said, "You know Rose, that kitchen staff Adam is terrible. I've told him a million times not to leave the lettuce uncovered. He doesn't listen, he doesn't care. You know there's some stupidity in his head, he doesn't understand."

Rose, clearly upset by Sayed's constant attacks and language replied in a seemingly mocking and patronizing voice, "Sayed, I think he's a great worker and very intelligent, he wants to be a doctor one day. I think he's doing fine."

At this response, Sayed became upset with her lack of support and her inability to accept Adam's underperformance. He responded in an aggressive tone "A doctor? He'll never be a doctor; he can't even make an order correctly. None of the kitchen staff is doing well, even you don't perform the kitchen duties perfectly! You need to see that and make things better, not say 'ohhhh, it's okay!'"

Another issue that often created friction between Rose and Sayed was how Sayed would say "my kids are not to be treated as employees here and they are free to do whatever they want. When I'm not here, they are here in charge in my place." On any given summer afternoon, if business was more than expected, Sayed would simply call one of his children to pop in to work for just an hour or so during the peak period. Often, Mira, Hanna, Bassil and even Aliya would have to leave whatever they were doing just to come in for an hour to help out. In these situations they were likely to come in wearing jeans and a t-shirt and provide the necessary support until things were under control and then head out again.

Rose almost always complained about what they were wearing. Sayed would remind her that his kids were also owners and that they came in unscheduled to help so they could do as they pleased. As owners who were just there as unscheduled help, he felt they could wear and do as they pleased. Rose considered this to be unfair treatment and often voiced her opinion in front of the staff.

In another point of conflict, Rose would often say or imply that the Hashem children were spoiled. It was common for Sayed to instruct Rose to have her staff accomplish certain

tasks during her shift. Rose often replied, "Well, what if we're busy? You should have Aliya come in to do the extra work!" Sayed replied, "I always told you customer comes first so if it is busy I'll understand. But it's not busy now, so why are you arguing? Also, Aliya works very hard, she was in earlier today making blanks!" Rose replied, "Well she should work hard, you gave her a car and everything!" Sayed was outraged by her comment and told her to mind her own business, he said "she's my daughter, and it's my responsibility to give her everything she wants. She works harder than everyone here and without her I would have lost the business long ago."

MEREDITH Meredith and Sayed on the other hand had an easier time communicating because Sayed found it easier to explain things to her. He perceived her as being less cynical, where he felt that Rose just always wanted to disagree first regardless of the issue.

Meredith was a diligent employee. She displayed great customer service and always completed her required tasks. Meredith was very task oriented and had great difficulty planning ahead, forecasting product needs, and disciplining employees. For example, if an employee called in sick multiple times and was frequently late she would accept whatever excuse she was given.

It was not long before Sayed realized that Meredith was not management material, so he began interacting directly with the employees. When business was going well and tasks were being completed as needed Sayed would often compliment the staff and give them free desserts and meals. He attempted to be flexible with the employee needs and scheduled them as conveniently as possible. He encouraged them to talk to him about any concerns or problems they may have at work and reminded them that if they did not understand him because of his English or his accent to please ask him to explain again. He also gave raises as soon as he saw an employee show slight improvement. Things seemed to be going great until an employee would call in sick or a customer would complain. After these mistakes Sayed would often say something like "When you want you can be excellent and other times you are terrible." He would call employees into his office and interrogate them on their mistake. Employees would often respond with an apology. But the mistakes were often repeated.

When Sayed called an employee into the office Meredith would attempt to interfere and try to find out what is going on. Sayed's direct management of the employees and Meredith's disagreement with his approach soon created friction between them as well. Meredith became easily irritable and often voiced her disagreements.

Employee Crisis

With Aliya gone Rose and Meredith were integral despite their relationships with Sayed. Soon, the difficult relationships would create an employee crisis for the St. Thomas Dairy Queen®. Meredith began to come in late, ask for more days off, and stopped returning calls on days she was called to cover a shift. Rose submitted a note saying that she would be retiring in May, which was only six months away. Further, nearly all of the remaining employees were newly hired and not very reliable. Their willingness to work depended on how much money they needed at the time. They often exhibited no sense of responsibility or dedication.

Currently

Aliya discusses the business with her father on a daily basis and visits the DQ[®] periodically. Lately, she has been consumed with worry. She feels that her father is over worked and has become quite unhappy. For the past five years her father has worked seven days a week every week. He appears to be physically and mentally exhausted. He told Aliya that he was worried about the behaviour of Meredith and Rose, but he felt helpless because without them he cannot develop and retain employees. He also mentioned to her that although a high employee turnover rate is expected in the fast food restaurant industry, he has noticed his turnover rate is excessively high.

There is also a concern about the increasing number of customer complaints being delivered to him through head office. Yearly revenues have remained steady and are not growing at the same rate as in previous years. He confessed that "I feel like I am losing the business and I don't know what more to do. Your sisters and brother don't care about the business. If they don't care how are the employees going to care?"

Aliya knows that by correcting some of the main problems at work she would also be able to ensure her father's health and well being. She realizes that she does not have the time to go back to work at DQ[®] because her schedule was still being consumed by school, career, and marriage. She feels she has to find a way to pin-point the root of the problems and help her father resolve them. She suspected that part of the problem was her father's expectation that she would solve his problems for him. She knew that the first step was to make him realize that he had to change his ways and take responsibility for his business and actions.

But how does she tell her father he needs to change his ways? How does she tell him that he needs to work on his managerial skills or that he may need outside help? She worries that figuring out the problems and solutions would be the easy part, but implementing them would be near impossible. Regardless, she feels that she must intervene for the sake of the family business and her father's well being.

CASE 4 WYSE DESIGN & DEVELOPMENT INC.

Brian Lundrigan typed his company's name, Wyse Design & Development Inc., into Google. Then he clicked on the link leading to a promotional video for its main product—a portable winch system—that he had posted on YouTube. The clip told a simple story: A man driving an all-terrain vehicle through soggy muskeg suddenly becomes stuck in a deep mud hole. He hops off his vehicle and pulls out a small case holding the winch. He hooks one end of the winch's cable to his ATV, the other to a tree, with the winch's motor slung between the two points. He flips on the motor and, a few moments later, is out of the muck and back on his way.

"Putting the demo on YouTube was a good idea," Lundrigan thought to himself as he watched the clip one more time. It helped him deal with one of the key tasks facing his St. John's, N.L.-based firm—specifically, educating consumers and retailers accustomed to fix-mounted winches about his unique, portable product, dubbed the Wyse Mid-Span Winch System. Instead of listening to him explain it, potential customers could see it in action. Best of all, posting videos on YouTube was free—a major consideration for a young company like Wyse, which had little money to spend on a full-scale advertising campaign yet dearly needed to get word out about its product.

Until this point—approximately three years since he launched Wyse—Lundrigan had built up a small but enthusiastic roster of clients that included individual customers as well as local institutional users such as Fisheries and Oceans Canada, the Newfoundland and Labrador Search and Rescue Association, and the Newfoundland Department of Resources. But long-term success could only be achieved if he extended his reach. On the plus side, Lundrigan was convinced there was a much wider market for his winch, as well as a soon-to-be-launched kit option that would allow owners of fix-mounted winches to convert their units into portable devices using Wyse's design. He saw his biggest opportunity in the

mass retail market, even though it was (and remains) dominated by cheaper imports. He believed his product's quality and flexibility would convince consumers to accept his price.

The problem was, how could he get the word out when he had no resources to invest in a major marketing campaign? Posting videos on YouTube was a start. But Lundrigan knew he'd need to do much more than that. But what?

Lundrigan, who had worked for a major food distributor before founding Wyse, came up with the idea for his winch system in 2003. It happened one day while he was visiting a friend, sitting in the man's garage and talking about a new snowmobile he had bought.

"This man, who was about 50 years old at the time, was telling me about how he had been out in the backcountry by himself and had gotten his new snowmobile stuck," Lundrigan recalls. "He complained that it had taken him an hour to walk back to his cabin, an hour back to the sled, and a third hour to dig the machine out." While the man was talking, Lundrigan found himself staring at an ATV in the corner of the garage that had a fix-mounted winch system. "I'm an avid fan of snowmobiles myself and I'd been in a lot of similar predicaments. I kept looking at the winch on the ATV and thinking: This can be made much more useful."

Inspired, Lundrigan spent the next few months sketching out his idea for what would become the Wyse (an acronym for "When You've Struggled Enough") mid-span winch. In 2004, he pulled some funding together and applied to a local business incubator for technology start-ups called the Genesis Centre, which was affiliated with Newfoundland's Memorial University. The centre believed that Lundrigan's concept had potential to compete in the global market and accepted his fledgling company as a client.

Initially, Lundrigan simply planned to design his winch system and license it to a manufacturer. As it turned out, his

timing couldn't have been worse. Since early in the decade, the domestic winch industry had been facing stiff competition in the form of cheap imports from Asia. Mass merchandisers had been selling the imports for as low as \$69, much cheaper than the \$200 to \$600 charged for winches made in North America. The Asian winches were of lesser quality, but they had gained market share rapidly. "The traditional winch manufacturers were going through a particularly hard time trying to recapture market share they had lost to the cheaper Asian products," he says. "It seemed that most were in survival mode and focused primarily on cutting costs, not so much on new product development."

Undaunted, Lundrigan continued to test designs and develop prototypes. In the end, he decided to build the business on his own. In 2006, after sourcing his own components and finding a manufacturer, he went to market with the final version that retailed in the range of \$300 to \$400. Lundrigan decided to call his product a mid-span winch—not a "portable winch"—because he wanted to avoid being confused with various imported winches, some of which gave the impression of being a portable product. "It can be confusing to the consumer because these 'portable winches' are only portable while you are carrying them from the place of purchase to your home," Lundrigan says. "Then they have to be permanently bolted down to something for it to be used."

The name of Lundrigan's winch system may have been a mouthful for casual consumers, but that didn't stop it from having a successful launch. It scored great reviews and generated decent business, much of it via word of mouth. While that interest alone was enough to convince Lundrigan that he needed to reach a wider market, the issue grew more acute when he came up with the idea of the conversion kit.

From his research and meetings with retailers, Lundrigan knew that many consumers had purchased imported fixed winches

on a whim, either due to the low shelf price or for a specific but infrequent use. But industry contacts were also telling Lundrigan that many of these winches were not actually being put to use by the people who bought them, due to their impracticality and the added cost of having them mounted on vehicles.

This insight led him back to the design process to develop a product he would call the Wyse Winch Kit. The final version was essentially his mid-span winch system, minus the winch. The customers he was targeting already owned those. What they lacked was the true portability that came with his midspan concept—and, thus, the motivation to pay to have their inexpensive Asian winches fix-mounted on a single vehicle. Lundrigan was hoping that his solution to the mounting issue would give winch owners a whole new reason to open their pocketbooks.

Lundrigan is now ready to launch the Wyse Winch Kit and is looking for an affordable marketing strategy for both his mounting kit and his mid-span system. "The question is, how do we effectively educate potential customers about our products?" he asks. "If consumers realized how useful their winches—either fix-mounted or sitting unused—could be with our kit, I'm confident that they would look for our products at their local retailers. And if they wanted a full winch system, we'd gladly be able to serve their needs as well."

Lundrigan also faces another, related hurdle—getting his products placed at retailers. "Every major retail chain is offering winches in their product line, but what they seem to forget is that every winch they sell will require a mounting solution," he says. "We think we have the solution with our kit, but I'm having a hard time convincing the retailers. How can I get them to see the potential profit that walks out their door every day?"

Indeed, although word about Wyse products is spreading, Lundrigan needs something more to take his business to the next level—specifically, a marketing strategy that's both high-impact and low-cost. What to do?

CASE 5 QIAOLINX INC.'S CHALLENGE: CONVINCING CANADIAN BUSINESS OF THE IMPORTANCE OF CRACKING CHINA'S BUSINESS CODE

The Birth of QiaoLinX

Luc Fournier and Brian Hobbs, co-founders of QiaoLinX Inc., met while doing their Executive MBAs. Luc had seen evidence of the ill-preparedness of Canadian firms during his time spent in China. He believed there to be an opportunity providing a service that would offer insight to understand the Chinese and prepare companies to do business in China. Upon completion of his EMBA, Luc got into consulting and marketing. He wanted to pursue the aforementioned project relating to China, however, his co-workers did not see the need.

In mid-2005 Luc was presented a chance to use his China expertise to do some work for the National Bank of Canada. His consulting colleagues were not interested, so he decided to ask his former classmate Brian Hobbs to join him. They met with the National Bank's international division. This divi-

sion handled export financing for Québec-based businesses, and dealt with China on an increasingly frequent basis. They wanted to know what their options were to establish a presence in China—should they open an office and set up shop? Should they simply have an agency there?

The idea for QiaoLinX came to life one afternoon in Luc's backyard. Luc and Brian were trying to define the service that they would provide to Canadian companies. They decided their enterprise would serve as a "bridge" between Canadian business and the Chinese. Brian asked Luc what the Chinese word for bridge was. Luc indicated the translation for bridge was "Qiao" and so was formed the name of the company: QiaoLinX—the bridge that would link Canadian and Chinese business. The core idea of their venture was to help companies understand the Chinese and prepare for dealing with China.

Their challenge was and continued to be: how to sell this idea. They wanted business people to see their service as something valuable and necessary—something that would guarantee success in China. Thus far, few had responded to this value proposition. Clients remained elusive.

Company Profile

QiaoLinx Inc. was essentially a consulting company. Its primary goal was to allow Canadian companies to become increasingly effective when buying, selling, or establishing operations in China. Luc and Brian used their extensive knowledge of international business and consulting expertise, coupled with a proficient understanding of Chinese business practices, cultural, and regional influences to aid organizations in their quest to establish and successfully continue business relationships in China.

How it Works. QiaoLinx sought to offer companies an unprejudiced and thorough assessment of how various aspects including business culture, regional priority, regulations, and government affects the plans of Canadian organizations. The end-result would allow these companies to analyze this information, and incorporate it in an effort to create more successful business strategies.

QiaoLinx Inc. possessed cultural and regional knowledge in addition to a superior understanding of business planning, market development, legal aspects, operations, and technical know-how. The synergy of all of this knowledge was QiaoLinx's recipe for success for Canadian firms wishing to venture into the economic giant that was China.

Creating Awareness

Workshops. In late 2005, Luc and Brian decided to run workshops entitled "How to Win in China." The goal was to establish a client base, gain some revenue, and create awareness as well as do some marketing. The goal of these workshops was for attending managers to be able to apply their newly expanded knowledge of China to create and/or develop business relationships. Of course the workshops were simply intended to get companies started, and understand the importance of enlisting QiaoLinx to aid them in their quest for success in doing business with China. The drawback to these workshops was that companies started to see QiaoLinx Inc. as a training company.

Marketing and Advertising. The partners of QiaoLinx had a limited budget for marketing and advertising. As two well-established businessmen they realized the importance of "getting the word out," however, could not afford to risk a great deal for elaborate advertising, which was extremely expensive.

They were able to get an advertisement on the *Ottawa Business Journal* Web site in the Fall of 2006. The ad cost them \$750 for two weeks. It generated 30,000 hits per week on the QiaoLinx Web site, in comparison to the average couple of hundred hits the Web site normally got. After the advertisement period, the QiaoLinx Web site was visited more frequently at an average of 300-400 hits per week.

They were able to hire a media consultant, Shaun Markey, who had credibility, contacts, and access to the media. He was able to give them a complimentary hour of his time, and some ideas and insight about media relations. The partners of QiaoLinx Inc. realized that he would be an indispensable contact to have on a permanent basis, however, his services began at a costly price of \$2,000.

Brian had taken on the project of designing a Web site. Although he had no prior experience in doing this, he was able to design a respectable Web site that contained all of the information about the company, its partners, and the services it could provide to its customers. The only problem that existed with this Web site was the fact that it was not a fancy, hi-tech, media-enabled experience, which was what people had come to expect. The content of the Web site was top-notch, however, for today's Web-savvy businesspeople a more complex and elaborate Web site might be expected, and would serve to contribute to the credibility of a potential business partner.

Struggle to Provoke a Call to Action

By early 2007, QiaoLinx Inc. had hosted a number of workshops, and had formed links with several organizations in both the private and public sectors. One problem that they were faced with was that though these organizations were very interested in the services provided by QiaoLinx, they were only prepared to enlist the new company for small projects. They did not see the need for continued coaching in the area of China.

Brian and Luc believed in the serious need for their services. Not only that, there was concrete evidence for the need in these types of services due to the significant failure of Canadian business in China. The challenge was "How do we show companies that this is something that is worth investing in; something that they can't afford *not* to do?"

Their cash flow at this point was still limited, covering business expenses, a little advertising, and bringing in a small income from a few projects. Brian's project was to address the question, "why should they call us?" and "why do they need our services?" The reasons mentioned in newspaper and magazine articles as well as the statistics supporting these facts should have been enough; but evidently, more was needed to provoke a call to action.

Realizing the Need for Consulting Services

Luc and Brian wanted to be there to help companies prepare a contingency plan so that the only problems that they would encounter would be those that were beyond their control.

Companies, by contrast simply wanted a channel partner out of QiaoLinx—a company that would help them form relationships in China *not* prepare them to work with the Chinese culture. Channel partners sell products and services on behalf of the brand owner to other businesses or customers. They may resell the product "as is," or they may add value to the product by enhancing it or embedding it into their own products and complementary services. They also go by a number of different names—for example, in financial services and insurance, channel partners are brokers or agents; in retail and distribution, they are often called dealers or wholesalers.

Canadian companies wanted QiaoLinx to help them find these types of contacts in China. What these companies did not realize was that without proper development of relationships with Chinese contacts there was a great possibility that individuals who got their hands on the companies' intellectual property could steal it, and release it to a friend in China, and do business at a much more reasonable price.

To help them, QiaoLinx hired a Chinese Lawyer, Lisa Li, to provide them with increased depth and credibility. She also had contacts in the Beijing Ministry of Justice, some low-key firms, and the communist party.

A number of people and organizations wanted to hire Luc for this knowledge, not really for the consulting part of QiaoLinx.

CASE 6 ROCKY MOUNTAIN SOAP

It was meant to be a coup de grâce. Cam Baty and Karina Birch, owners of Canmore-based Rocky Mountain Soap, were offered an opportunity at a national trade show to create a new packaged-goods brand and were given space to sell it on retail shelves in supermarkets nationwide. They jumped at the chance, buoyed by the success of their own thriving trio of retail shops. After all, they reasoned, in the decade since they first founded their company, Rocky Mountain's all-natural soaps and skin-care products had inspired near-fanatical devotion in their customers and created a vibrant, highly profitable regional brand.

The new packaged-goods line was called Glacier, in a nod to the glacier water used in all of Rocky Mountain's soaps, and it was distributed to large-scale retailers across the country. Based on their initial assumptions, Baty and Birch projected at least \$800,000 in annual sales for their new line.

But what began as a victory march onto retail shelves ended in bloody trench warfare. The distribution and logistics involved in serving hundreds of retail locations were challenging. Glacier's packaging and branding, though far more sophisticated than Rocky Mountain's previous products, were nonetheless lost in the visual clutter of crowded retail shelves. And, most importantly, supermarket retailers weren't prepared to engage in the loyalty-building customer-education campaigns that were the daily norm at Rocky Mountain's own stores.

Consumers, unfamiliar with the Glacier brand and unmoved by its presentation, reacted tepidly. Annual sales for the Glacier line fizzled, finishing just shy of \$100,000 for the year.

The failed project left Rocky Mountain's owners with a dilemma. In early 2006, after winding down the Glacier brand and returning their focus to their three stores, they had to reconcile their ambitions for the brand with the dissatisfying results of their growth experiment. Baty still longed to build a national brand, and looked with a degree of envy at their competitors in the natural skin-care market. Burt's Bees of Durham, North Carolina, for instance, had grown from a small honey bottler to a \$250-million hyper-growth consumer brand, while the U.K.'s Lush Handmade had expanded internationally, ratcheting its annual sales well beyond \$100 million. While Baty's and Birch's aspirations for Rocky Mountain weren't quite on that scale, they nonetheless hoped to build their company into a national presence—and add to their sales by an order of magnitude.

They had reason for their enthusiasm. Since the start of 2000, Rocky Mountain's same-store sales had grown at a healthy clip, and per-square-foot sales in its stores (the touchstone metric for all retailers) ranged from an enviable \$900 to a staggering \$1,700. But the brand's impact on its consumers was even more evident in their correspondence than in their cash-register receipts. Gushing, evangelical testimonials arrived at the company's headquarters almost daily. One eczema sufferer tried their soap once, and then described returning to the store for four more bars the same day. A chemotherapy patient weighed in on the relief afforded by

Rocky Mountain's foot butter, and noted that they frequently gave the cream as a gift to others.

Rocky Mountain had also developed a successful brand imprint in Alberta. Their logo was a stylized depiction of the Three Sisters mountain range outside Canmore—Baty's mountain-bike stomping grounds and the company's birthplace. Their slogan, "Be Kind, Be Real, Be Natural," was as much a personal mantra as a corporate motto. Since the company's inception, it had eschewed the usual lineup of chemical cleansers, preservatives and colouring agents. Instead, Rocky Mountain's soaps deployed a range of essential oils, grains, and berries. As natural products moved from a niche market in the 1990s to mainstream consciousness in this decade, enthusiasm picked up for the company's high-priced but all-natural offerings. Once converted, customers would frequently spread the word: "Customers are often our best salespeople," Baty noted with a laugh.

Wasting little time after mothballing Glacier, Rocky Mountain's owners started to ruminate about the potential for another type of expansion. Rather than turning their products over to another retailer, Baty and Birch began to consider the prospect of expanding their own retail chain. After all, they figured, the failing of their Glacier-brand, packaged-goods venture was primarily the result of their lack of control over the retail environment. What they recognized was that a customer visit to one of their stores wasn't mere shopping—it was a well-rounded body and mind experience.

It started with the smells of the company's 27 different soaps. Upon entering a store, you might first catch a whiff, say, of pumpkin patch soap, whose pumpkin pulp was designed to soothe rough, sore skin—or of Citrus Smoother, a soap whose sweet orange essential oils were a panacea for acne-prone faces.

But equally important was the embrace of its service. Rocky Mountain didn't owe its success just to its products; it owed it to the company's staff, its intimate, personal marketing efforts and its unique approach to product development. The small chain's employees were remarkably knowledgeable and conscientious.

They could readily match customers' skin conditions to the right product. Their capability wasn't an accident—nor was it easy to achieve. Throughout this decade, Rocky Mountain had worked hard to build employee talent. It recognized the contributions of individual staffers on their Web site, was in the midst of launching a daycare program, had instituted open-book management, and a profit-sharing plan, and had worked out a sales incentive scheme that rewarded teams for sales achievement without encouraging overzealous commission-chasing.

Employees were also intimately involved with the products. For the dozens of items, staffers could recite ingredients and explain how specific oils, extracts, and grains each affected the skin. The staff were also a conduit for customer knowledge, relaying feedback, suggestions, and requests to the owners. Such customer requests were still at the heart of the company's product-development process. Where a competitor like The

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Body Shop had access to the R&D resources of French parent firm L'Oréal, Rocky Mountain's products sprang forth from small-scale experiments conducted by Birch in the company's Canmore factory. Product ideas came from (and were often tested by) customers and staff. Some, like a salt scrub, went through 17 iterations before the founders settled on the final formulation. Others came about more quickly. Their strong-selling Summer Lemonade Soap, for instance, was the result of a suggestion from a local eighth-grade student.

These tight-knit customer relationships had been reinforced in the decade since Rocky Mountain's inception through its marketing efforts. Customer newsletters read like personal notes from Birch, sharing internal goings-on (their Wednesday morning staff yoga sessions, for instance) and describing new products. As the company grew, it began experimenting with more sophisticated marketing techniques, including opt-in email marketing and custom tailored mailings offering premiums such as a free bar of soap on customers' birthdays. The company's marketing also served to help educate consumers, deepening their clients' commitment to natural products. Alongside product updates and contests, Rocky Mountain's newsletters often contained information about natural products and aromatherapy trends. This type of communication was critical, because consumer education took time, particularly when clients had to adjust to things like unorthodox packaging—the stores' body butters, for instance, were packaged in plastic containers more commonly used for men's deodorant.

The owners had also leveraged the tourist economies of Banff and Canmore to grow their brand. Many local hotels in these tourist hubs offered Rocky Mountain soaps in their guest suites, providing customers with an all-important first trial. And from experience, the owners knew that much of the company's sales came from tourists eager for mountain-themed Canadiana. Their retail locations and branding catered to these distinctly local dynamics.

Traditional marketing at Rocky Mountain wasn't quite an afterthought—but it came close. Print advertising was lim-

ited and exclusively local. The company took out small ads in low-circulation local newspapers and often left rack cards in hotel lobbies. In Banff and Canmore, whose small populations were served by a single newspaper each, such advertising was relatively inexpensive. In Edmonton, they had tried to scale up their efforts by purchasing billboards, mall posters, and space in the *Edmonton Journal*—all with limited success. On reflection, Baty and Birch realized that they weren't as comfortable managing high-gloss campaigns as they were building deep relationships with customers, one at a time.

With wholesaling all but ruled out, Rocky Mountain needed a unique strategy if it truly wanted to grow nationally. As Baty and Birch discussed their experiences—both their successes with retailing and setbacks with wholesaling—their aims began to crystallize. They decided they should open 30, perhaps 40 stores, with a rollout schedule of four to seven new company-owned outlets per year.

Envisioning growth was easy—getting there, the owners knew, would be an entirely different story. After the failed Glacier launch, Baty and Birch felt a natural trepidation about entering new markets without answers to a range of questions. Among them: How could they translate their personal marketing techniques to a much larger chain? Would the Rockies-themed brand resonate outside the Canadian West? Could they keep their intuitive and organic approach to product development as they entered the turf of larger competitors like The Body Shop? Could they replicate the personal service provided by their long-serving staff members as the chain grew?

Burt's Bees and Lush had both transformed themselves from tiny start-ups to retailing juggernauts on the strength of their organic and natural product niches. Baty hoped to follow in their footsteps but, as a final question, wondered how much space was left in this already crowded market—particularly for a small company with a limited marketing arsenal. As he and Birch surveyed their factory floor and watched employees carve out blocks of soap, they wondered: Did they have what it takes to build a national retail brand?

and applications—this included everything from devices that allowed full Internet access to simple day planners and electronic dictionaries.

Despite the strength of local brands, such as Lenovo (which had grown to acquire IBM's PC division), Meijin Computer, GSL (Group Sense International Limited), Digital China, Legend, and Hi-Tech Wealth, the most popular devices in China continued to be ones that either incorporated imported technology or were imported altogether. Palm's operating system and Linux based systems both found application in Chinese PDAs, while Palm continued to attempt to market its hardware to Chinese consumers.¹ Other firms such as Research In Motion (RIM) found themselves in a peculiar position as they attempted to navigate a very competitive PDA market surrounded by institutional barriers.

Despite the obstacles, the Chinese market was not one that could be ignored by any firm. In February 2006 China had a base of over 400 million cellphone users (which had eclipsed land line phone users in late 2003 or early 2004 at the 250 million mark) and the highest growth rates in new cellphone sales in the world making China a destination that could make or break a company and determine its long-term success in an industry that continued to mature.

China Mobile Communications Corporation (China Mobile), RIM's partner in China held two-thirds of the domestic cellphone market with over 250 million customers. In contrast, the entire U.S. wireless market was 204 million subscribers. The latest statistic from the government's official Xinhua News Agency was that Chinese mobile handset users 'thumbed' 22.8 billion text messages in March 2006, 66 percent more than in March 2005. Meanwhile, the Canadian Embassy in Beijing continued to intervene on RIM's behalf to help RIM pass technical tests and finally enter this market.

On April 6, 2006, Jim Balsillie, co-chief executive officer of RIM announced BlackBerry's unveiling in China was imminent. "We are on the verge of launching BlackBerry service with China Mobile and expect to launch by the end of May." A week later Norm Lo, VP of Asia-Pacific for RIM told reporters that mid-summer was more likely: "Our talks with China Mobile are going very well. We are working very tightly with them, and a deal is expected very soon, probably by the middle of this year." But Lo discovered that China Mobile would introduce a rival service "PushMail" in Shanghai next month. It would allow China Mobile customers to receive email on their existing handsets.

Norm Lo learned on April 10, 2006—after an almost two year regulatory delay blocking the introduction of RIM's BlackBerry to mainland China—that a "RedBerry" had just been launched by China Unicom. The state-owned enterprise China Unicom—the second largest mobile operator in mainland China—revealed in a press release "The RedBerry name extends the vivid name of BlackBerry that people are already familiar with, and it also combines the new red symbol of China Unicom." The RedBerry was driven by software from Chinese firm Facio. Tony Chan, CEO of Facio Software, believed they could win the battle with RIM: "The RedBerry is not afraid, neither did David fear Goliath!" Norm Lo felt like he was David, RIM was the one going to battle against giants.

Research In Motion aimed to increase sales by forming new "partnerships with up to 10 Asian carriers over the next six months to tap strong demand. 'The market is huge. We have just started,' said Norm Lo, vice president for Asia Pacific at RIM. [RIM] enters markets worldwide by signing agreements with local wireless carriers, which then offer services using the BlackBerry name and signature PDA-like devices."² As of April 2006 RIM had ties with 21 telecom providers in 11 markets including India, Singapore, Malaysia, Hong Kong, Australia, New Zealand, Indonesia, Sri Lanka, Thailand, and the Philippines.

Despite signing a memorandum of intent in the fall of 2004 with Chinese wireless service provider China Mobile—the largest mobile telecommunications firm in China, and one of six Chinese state-controlled telecommunications firms—RIM

had yet to launch its BlackBerry on the mainland. Nevertheless, it was estimated that there were hundreds of BlackBerry devices in mainland China that were paying hefty roaming fees for service all beyond the watchful eye and eavesdropping ability of the Chinese authorities.

Prior Experience in Asian Markets

RIM signed agreements with Hutchison Telecom and CSL of Hong Kong in 2002, but by October 2004 Hutchison Telecom had landed only 500 corporate customers for the BlackBerry device. The deals in Hong Kong, however, gave RIM the opportunity to test its product and business strategy in a Chinese market. Cultural similarities—not to mention language and political attachment—with the mainland made Hong Kong a perfect test market. Analysts concluded that RIM's limited success in Hong Kong was due to the company's "pricing structure" and the fact that demand for product "has been hit by the high licensing fees for the BlackBerry server software in Hong Kong."³

Competing with technologically inferior, but cheaper, local PDA products was expected to be the key to succeeding in Hong Kong and would likely also be vital to success in the Chinese market. This said, BlackBerry had been welcomed as a god-send by many Chinese firms, including Hutchison and China Mobile, who stated that the product would help them offer "users higher margin data service" and thus improve profit margins and slow the rapid "decline in average revenue per user."⁴ The BlackBerry had been seen similarly in other Asian markets, where anxious telecom companies partnered with RIM to launch the BlackBerry in hopes of improving margins and increasing the value of services provided to customers.

In India, for example, "mobile operators are turning to higher end products such as BlackBerry . . . to capitalize on growth."⁵ The Indian market's 43 million mobile phone users were demanding more sophisticated products, and RIM hoped that BlackBerry would be a star in the world's fastest growing wireless market. Three different BlackBerry devices able to receive email messages on the go had been introduced in India since the firm entered the market in October 2004, partnering with mobile service provider AirTel.

The Red Factor

More than 15 months after signing a letter of intent with China's largest mobile telephone company—the state-controlled China Mobile—RIM had yet to see its product launched. A variety of China-specific problems seemed to pose barriers to RIM's entry into the vast market. Of these, the most pressing issues revolved around the fact that the technology used by RIM would make it near impossible for the Chinese government to monitor the communication activities of private citizens and businesses using a BlackBerry.

It was thought that those users from Hong Kong, Singapore, the United States, and elsewhere living in China brought the product into the country and refused to give it up. This led some to argue that the Chinese government could do little to stop the use of new communications technologies in the country as mon-

CASE 7 RESEARCH IN MOTION'S CHINA ENTRY

Dashing out of his modern Beijing condo, Chang Zhou, hopped into a taxi. Opening a Coach briefcase, Zhou put on a pair of Armani shades, pulled out the Financial Times, grabbed his handheld device and began his morning routine—trading a few stocks wirelessly. The taxi darted in and out of traffic as Zhou thumb-typed, moving a few of those volatile B shares listed on the Shanghai exchange. Now if only he could get a decent cup of western coffee . . .

Zhou was a member of the rapidly growing and increasingly prosperous Chinese middle-class that chose to use PDAs (personal digital assistants) in order to access conveniences that living in one of China's major cities could offer. The specific brand that Zhou used, the GWcom PDA, was just one of many niche players in a Chinese market dominated by home-grown companies that had developed a full range of PDAs

This case was written by Nicholas P. Robinson, Faculty of Law, McGill University, and Prescott C. Ensign, for purposes of classroom discussion. A french version of this case (no. 9 00 2009 002) can be found at <http://web.hec.ca/centredecas/catalogue/>. HEC Montreal.

¹ Michelle Levander, "Handheld Combat: As China's PDA Makers Battle for Market Share, Cautious Global Giants Play a Waiting Game," *Time Magazine (Asia)*, August 6, 2002.

² Reuters, "BlackBerry Maker Aims for More Asian Partners," October 19, 2005.

³ *The Standard*, "Telco Leader Signs Deal for BlackBerry," October 5, 2004.

⁴ *Ibid.*

⁵ Dinesh C. Sharma, "RIM Takes BlackBerry to India," *ZDNet Asia*, October 20, 2004.

itoring the ever-increasing volume of information, and cracking the increasingly complex encryption algorithms was not feasible. In fact, the world-renowned Nobel economist Milton Friedman argued that the threat posed by rapidly advancing technology and a rapidly growing middle class would ultimately lead to "future Tiananmen Squares."⁶ Improvements in technology and the general welfare of Chinese citizens may mean democratization, just as an authoritarian government could constitute an economic disadvantage.

Telecommunications Industry in China

The Chinese telecommunications industry was characterized by high government involvement and extraordinarily tight controls on foreign investment and private enterprise. The sector, which had been identified by the Communist Peoples' Party government as being key to China's economic development was controlled by a plethora of provincial and federal organizations, with the State Council ultimately having power to override other decisions in many cases. Adding to this control was that all the major telecommunication companies were, at a minimum, partly government owned.

The Chinese government introduced numerous reforms to the telecommunications sector in the mid-1990s to speed up the development of networks that were seen as critical to economic growth. Though all these firms were state-controlled, this was still a far cry from the days when foreign investment in the telecom sector was barred. These changes began in 1994, when the monopoly of the government-run China Telecom ended with the establishment of China Unicom as a direct competitor in the domestic mobile and fixed markets.

These changes had been spurred on by demands that China open its economy to more investment if it wished to trade with the free-market nations of the world. In the past, "the classification of telecommunications as a restricted industry for foreign investment purposes arose from the central government policy of ensuring that control of vital national industries does not fall into foreign hands."⁷

China's entry into the WTO was forcing the country to give increased access to foreign investors who were anxious to profit from China's booming telecom market. More specifically, in the mobile market, the number of subscribers "continues to increase at the phenomenal rate of 5 million per month" giving China the "mantle of the world's largest mobile phone market."⁸ Another reason why China wanted to keep investment in its telecom sector restricted was that telecom had been "an extremely profitable" industry and had been a substantial source of government revenue.⁹

Policies such as these, which hit outsiders like Nortel and Lucent very hard, were representative of the lack of transparency that many foreign businesses saw as a major barrier to investing in China. "Foreign companies noted the difficulty in finding and obtaining copies of regulations and other measures undertaken by various ministries" and the issue had forced China to change its practices and establish a set of national

gazettes to inform the business community of Chinese laws and regulations.¹⁰

In addition, the prospect of exporting a product to China was largely dependent on the nature of the product and Peoples' Republic policies with regard to the industry in question. The laws on the books stated, "the free import and export of goods and technologies" was wholly allowed "except otherwise provided for by other laws or administrative decrees."¹¹ However, importers had to first obtain a licence to import and an extraordinary number of government orders and decrees severely limited the range of products that could be brought into China.

In March 2002, preparing for China's accession to the WTO, MOFTEC issued an order identifying mobile phones and mobile communications systems as being sectors in which foreign investment would be encouraged. Although the only outright control on the importation of PDAs and other mobile telecommunications devices was a stipulation that imports be subject to tendering, there were numerous other regulatory, legal, and political barriers that made it possible for the Chinese government to halt imports without any sort of government order. Furthermore, the fact that the industry had been identified as being of national importance to develop could make RIM's entry into China more difficult than initially assumed. RIM's manufacturing and design facilities were almost exclusively located in North America (with a factory at Waterloo, Ontario) and the firm would not invest in China, but rather, simply create new competition for domestic manufacturers of similar products.

Institutional Environment

Entering the Chinese market involved overcoming challenges that were unique to economies that have made, or were in the process of making, a transition from a controlled economy to a more free, market-oriented economy. In China, an immature financial system, weak intellectual property protection, and tight labour controls characterized an economy that was shedding the vestiges of socialism. Though many of these issues might not be of direct concern to RIM, all would likely have impact on the firm's experience in China and Norm Lo gave them consideration as they provided good insight into the Chinese business environment.

Repatriating Profits. China's financial system was tightly controlled by the Peoples' Republic government and contained minimal private involvement. The most pressing concern that an immature financial system raised for RIM or any firm involved with China was getting paid. Given that the Chinese currency, the Renminbi (also known as the Yuan), was fixed to a basket of foreign currencies, predominantly the U.S. dollar, exchange rate risk for RIM would be limited to fluctuations in value between the Canadian and U.S. dollars. Because the rate of exchange was fixed by the People's Bank of China (influenced by the interbank foreign exchange market), transferring funds into and out of the country was expected to be more difficult than in more liberalized markets.

The process of repatriating RMB to the home currency typically involved receiving approval from the Foreign Exchange Adjustment Centre, which registered the firm's foreign exchange and completed the transaction. Specific Chinese banks could perform these transactions.

Intellectual Property. China's reputation as a safe haven for companies involved in piracy and other violations of intellectual property was grounded in cultural attitudes toward ownership. After years of socialism, the cultural importance of private property to the Chinese people had been partly eroded and was reflected in weak enforcement of intellectual property laws. Officially, however, China was a party to the Paris Convention and thus recognized patent protection:

A foreigner can apply for patent protection in China in accordance with the Patent Law and the Paris Convention. If a foreign patent holder has a residential or business address in China, the foreigner will be treated as the equal of any Chinese citizen in accordance with the National Treatment . . . under the Paris Convention, a foreign applicant will enjoy National Treatment in China only if his or her home country is a signatory of the convention or provides Chinese applicants with National Treatment in that country.¹²

Despite this assurance, other Canadian companies had had difficult experiences protecting their intellectual property in China. For instance, Canadian bomb-suit and riot-gear maker, Med-Eng, was shocked to discover that suits provided for a Chinese government agency had been cloned in near perfect detail and were then being marketed throughout the world by a Chinese company.¹³ Med-Eng's response was to take legal action against buyers—a manoeuvre that was both successful and costly. The threat for RIM was incredibly significant as the BlackBerry was valuable precisely because of the intellectual property involved. Any violation of the company's proprietary intellectual property, or patents involving key elements of its technologies (hardware or software), could run the firm out of business.

Cultural Barriers. Business in China was not as impersonal as it was in North American where RIM had seen the majority of its success. As the former CEO of Ericsson, Kurt Hellstrom, put it, "personal relationships based on mutual understanding are the key to success" in the Chinese business environment.¹⁴ From a North American perspective, Chinese attitudes toward relationships almost bordered on corruption, as favouritism and camaraderie took precedence over other factors such as price and quality. In fact, some contemporary Chinese legal scholars theorized that this emphasis on relationships could be partly due to old mind-sets, which were gradually changing in China.

Transition from a centrally planned economy to the socialist market economy in China is expressed by many contemporary Chinese legal philosophers as the

transition from the rule of man (renzhi) to the rule of law (fazhi) or from supremacy of power to supremacy of law.¹⁵

Chinese attitudes toward relationships were reflective of the pre-laissez faire mindset, which some expected would gradually dissipate as Chinese businesspeople were held accountable to their shareholders, partners, and international institutions (like the WTO). The emphasis on "guan-xi" (a Chinese word for connections) meant that business in China must cultivate meaningful relationships, which could be the "difference between getting the contract or not."¹⁶ For this reason, many Canadian businesses in China chose to hire Chinese nationals "with contacts in China to help promote their business."¹⁷ RIM was hoping that Norm Lo, the VP for the Asia-Pacific Region would be able to make such inroads.

Man on a Mission

Norm Lo was appointed VP for the Asia-Pacific in July of 2005 after five years with Research In Motion. His mandate was to expand RIM's regional presence and "drive BlackBerry mind-share and market penetration across the Asia-Pacific."¹⁸ RIM had offices in Hong Kong, Singapore, and Australia with a staff of about 50 employees. His initial plan included doubling the number of carriers RIM worked with in Asia. This represented a substantial increase from the 16 alliances RIM had in eight countries, but in the eight months since taking charge Norm Lo moved closer to this goal—the April 2006 tally was 21 partnerships in 11 countries. According to Lo, RIM was just "scratching the surface . . . Everything in Asia-Pacific is wide open. We're talking to basically everybody. There isn't one country that we are not currently involved in a business discussion."¹⁹

Norm Lo's career spanned 20 years in high-tech research, product development, management, sales, and marketing. Prior to his present task, Lo had been responsible for two business units focused on the North American market. Before joining RIM in 2000, he worked at Nortel Networks. He had a B.Sc. in Engineering Physics from the University of British Columbia, M.Eng. and Ph.D. degrees in Electrical Engineering from Carleton University, and an M.B.A. from the University of Ottawa.

Like everyone at RIM, Lo had followed daily accounts of the saga between RIM and NTP. Gartner had placed RIM in the lead (Exhibit 1) but at the same time Gartner had recommended clients not go with BlackBerry devices until legal issues were resolved. Gartner's December 5, 2005 news release suggested BlackBerry users in the U.S. might lose service. While U.S. customers and potential ones were being made nervous, headquarters in Waterloo, Ontario were scrambling. Executive attention had been focused almost exclusively on this issue. Market development and the impasse in China were well off the radar for everyone back in Canada.

¹² Ibid.

¹³ Richard L'abbe, CEO of Med-Eng, onsite interview Ottawa, Ontario, August 2005.

¹⁴ Martin Krott and Kent Williamsson, *China Business ABC: The China Market Survival Kit* (Denmark: Copenhagen Business School Press, 2003).

¹⁵ Kui Hua Wang, *Chinese Commercial Law* (UK: Oxford University Press, 2000).

¹⁶ Martin Krott and Kent Williamsson.

¹⁷ Ibid.

¹⁸ Vivian Yeo, "New Asia-Pacific Head Drives RIM's Expansion," *ZDNet Asia*, July 12, 2005.

¹⁹ Ibid.

⁶ *The Charlie Rose Show*, PBS, December 26, 2005.

⁷ Jingzhou Tao and Diarmuid O'Brien, *Non-tariff Trade Barriers in China* (Hong Kong: Sweet & Maxwell, 2003).

⁸ Ibid.

⁹ Ibid.

¹⁰ Ibid.

¹¹ Kui Hua Wang, *Chinese Commercial Law* (UK: Oxford University Press, 2000).

Norm Lo reviewed recent numbers. Global sales in the fourth quarter of 2005 suggested Palm was ahead of RIM (Exhibit 2). But the yearly totals placed RIM in the lead for the year (Exhibit 3). Norm Lo scrutinized the footnotes to these reports closely. Totals did not include smartphones, such as the Treo 650 and BlackBerry 7100. Palm shipped 2.77 million PDAs in 2005, down 25 percent from 2004, but these results excluded sales of Palm's Treo smartphone, which amounted

to 1.95 million units in 2005. Gartner pointed out that Palm's PDA sales were being cannibalized by its Treo products, which were expected to surpass Palm's PDA sales in 2006. On March 29, 2006 Gartner documented smartphone sales at 16.1 million units in the fourth quarter of 2005—a 139-percent increase over the same quarter in 2004 (figures released by Canals are reported in Exhibits 4 and 5).

EXHIBIT 1 Worldwide Preliminary PDA Vendor Shipment Estimates 3Q 05 (units)

Company	Q3 2005	Market Share	Q3 2004	Market share	Growth
RIM	862,000	25.0%	565,000	14.8%	52.6%
HP	548,338	16.0%	692,113	30.5%	-20.2%
Palm	478,575	13.9%	748,950	21.0%	-36.1%
T-Mobile	206,800	6.0%	51,000	0.0%	305.5%
Nokia	200,000	5.8%	-	6.0%	N/A
Others	1,149,633	33.3%	801,744	27.7%	43.4%
Total	3,449,346	100.0%	2,858,807	100.0%	20.7%

Source: Gartner Dataquest (October 2005) Press Release "Gartner Says Worldwide PDA Shipments Increased 21 Percent in the Third Quarter of 2005," www.gartner.com/it/page.jsp?id=492211.

Please note that Gartner research is meant to be viewed historically and may not represent current market trends.

EXHIBIT 2 Worldwide Preliminary PDA Vendor Shipment Estimates 4Q 05 (units)

Company	Q4 2005	Market Share	Q4 2004	Market share	Growth
Palm	1,037,680	23.5%	1,226,525	29.9%	-15.4%
RIM	780,000	17.7%	698,000	17.0%	11.7%
HP	660,463	15.0%	869,000	21.1%	-24.0%
T-Mobile	305,000	6.9%	96,000	2.3%	217.7%
Mio Technology	220,214	5.0%	83,645	2.0%	163.3%
Others	1,405,569	31.9%	1,135,788	27.6%	23.8%
Total	4,408,926	100.0%	4,108,958	100.0%	7.3%

Source: "Gartner Dataquest (February 2006) Press Release "Gartner Says Worldwide PDA Shipments Reach Record Level in 2005," www.gartner.com/it/page.jsp?id=492242.

Please note that Gartner research is meant to be viewed historically and may not represent current market trends.

EXHIBIT 3 Preliminary PDA Vendor Shipment Estimates 2005 (units)

Company	2005	Market Share	2004	Market Share	Growth
RIM	3,193,000	21.4%	2,178,000	17.4%	46.6%
Palm	2,773,025	18.6%	3,726,172	29.8%	-25.6%
HP	2,264,666	15.2%	2,668,627	21.3%	-15.1%
Nokia	1,010,000	6.8%	250,000	2.0%	304.0%
T-Mobile	812,600	5.5%	191,400	1.5%	324.6%
Others	4,839,701	32.5%	3,499,314	28.0%	38.3%
Total	14,892,992	100.0%	12,513,513	100.0%	19.0%

Source: "Gartner Dataquest (February 2006) Press Release "Gartner Says Worldwide PDA Shipments Reach Record Level in 2005," www.gartner.com/it/page.jsp?id=492242.

Please note that Gartner research is meant to be viewed historically and may not represent current market trends.

EXHIBIT 4 Worldwide Smart Mobile Device by Vendor, Q3 2005

Company	Q3 2005	Market Share	Q3 2004	Market Share	Growth
Nokia	7,130,120	54.8%	2,951,450	39.7%	141.6%
Palm	1,053,390	8.1%	1,076,470	14.5%	-2.1%
RIM	977,940	7.5%	619,020	8.3%	58.0%
Motorola	693,650	5.3%	61,630	0.8%	1025.5%
HP	551,140	4.2%	689,410	9.3%	-20.1%
Others	2,598,440	20.0%	2,031,060	27.3%	27.9%
Total	13,004,680	100.0%	7,429,040	100.0%	75.1%

Source: Canals estimates, © canals.com Ltd. October 25, 2005.

Smart mobile device market: handhelds, wireless handhelds, smart phones.

EXHIBIT 5 Worldwide Smart Mobile Device Market by Vendor, Q1 2006

Company	Q1 2006	Market Share	Q1 2005	Market Share	Growth
Nokia	8,616,530	51.6%	5,394,900	50.0%	59.7%
RIM	1,399,090	8.4%	758,300	7.0%	84.5%
Palm	1,030,610	6.2%	1,009,040	9.4%	2.1%
Mitsubishi	1,016,320	6.1%	86,420	0.8%	1076.0%
Sharp	951,410	5.7%	31,960	0.3%	2876.9%
Others	3,688,680	22.1%	3,501,760	32.5%	5.3%
Total	16,702,640	100.0%	10,782,380	100.0%	54.9%

Source: Canals estimates, © canals.com Ltd. 2005-2006. April 25, 2006.

Smart mobile device market: handhelds, wireless handhelds, smart phones.

Norm Lo and the Balance of Probabilities

Riding the elevator to his Hong Kong office, Norm Lo reflected on an increasingly complex web of issues faced by his company. Over the past few years RIM had seen its PDA become the market leader in terms of sales and reputation for quality. The firm had successfully built a multi-billion dollar company out of a start-up, and had managed, against the odds, to conquer a U.S. market filled with competition from companies such as Nokia, Samsung, and Palm. Despite past triumphs, the future of RIM was at stake. The NTP threat had subsided with a US\$612 million pay out to prevent the devastation of BlackBerry's existence in the U.S. market, but events had taken their toll. The threat to the BlackBerry network caused some customers to delay purchases and others to defect. More importantly, however, Lo understood that RIM's corporate performance would be dependent on its success overseas.

China had emerged as the largest telecom market in the world, an incredible opportunity seemed to lie ahead for any firm that could make sense of the government's complicated regulatory scheme and win favour with local decision makers and organizations, all of which would be essential in order to put BlackBerrys in the hands of people in mainland China. Considering that rogue users from other markets had already been using their BlackBerrys in China, and considering the modest success the company had experienced in Hong Kong and Singapore, Lo pondered the product's future in the Chinese market.

It was confirmed; Norm Lo had an appointment at the end of the week at China Mobile's office to review technical testing—essentially to determine compliance with government policies. Lo knew that, being responsible for Asia Pacific, he would be accountable for RIM's success or failure in this vital market—a market that could become more important than the North American market. China's admission to the WTO, political concerns, and regulatory hurdles all posed a serious challenge to the BlackBerry's future in this colossal country. Considering China's interest in developing its domestic market and considering the intricacy of political issues (even dragging the U.S. military into the milieu) Lo weighed the balance of probabilities in his mind: Could the Chinese block the introduction of RIM's products through regulatory measures and institutional barriers, and what were the chances that the Chinese would actually cooperate to allow the introduction of BlackBerry to the Chinese market?

The introduction of the "RedBerry" was particularly alarming—though it should not have been entirely surprising. China could be expected to reverse engineer or copy and improve many existing products. The Chinese penchant for borrowing technology and pushing it forward was remarkable. If RIM was to enter this tremendous market, could its technology remain in tact? Should operating system and hardware be equally guarded? What were the next steps RIM should take?

administrative staff at the UBC Registrars and Records Office, Jeff realized that he had a serious dilemma on his hands. "Get me proof of your educational background and credentials by tomorrow morning at 10 a.m." the recruiter had stated. The high-tech firm urgently needed to fill the position, and they needed proper verification of Mr. McLeod's successful completion of the Master's degree and records outlining information on his thesis and academic background.¹

This evidence, however, could not be obtained within 36 hours. Typically, the university would require a signed letter requesting that confirmation of a degree be sent, and would then mail transcripts directly to those concerned. Communicating confirmation of a degree granted by fax, over the telephone, or any other method besides 'snail-mail' would have violated the university's privacy policy, and could lead to a Pandora's Box of legal issues.

Ultimately, this meant that it would be near impossible for Jeff to provide the information requested by the recruiter by the deadline of 10 the next morning. This meant that Mr. McLeod and the Kanata high-tech firm were both at a loss—a dilemma which one Ottawa businessman and former civic leader thought he could solve.

Conception of RepositBox

In April 2001, Jamie Fisher, a former Deputy Mayor of the City of Ottawa and business consultant, heard about Jeff's dilemma while casually talking with a colleague. "He would have been perfect for the position," remarked Jamie's friend, but "he just couldn't make the deadline." Listening attentively, Jamie was astonished that, despite the incredible power of software and the Internet, problems of this nature could persist. This realization marked the birth of GradChek, a company that aimed to provide immediate, instantaneous verification for its user base.

However, prior to actually formally registering the firm, Jamie and his friend—and soon to be business partner—Janet Wilkinson decided to consult with Dr. Vernon Sulway, a software specialist at the National Research Council, a research-intensive government science and engineering entity whose mission was to encourage innovation in Canada. With the NRC headquartered in Ottawa, this allowed Jamie to take advantage of the know-how that this organization provided. At the core of Jamie's concerns when he approached Dr. Sulway, was the viability of the business concept and the software product that he wished to be developed. He wanted to know:

1. If the software could be developed to solve Jeff McLeod's dilemma, especially considering security and privacy issues.
2. Whether the innovation would provide a unique service for which a market exists.

After a thorough analysis of the proposed technology, which would allow a user to store a variety of sensitive education related documents (such as transcripts, etc.) in a database, and then grant or deny permission to access these authenticated documents to potential employers and others, Dr. Sulway concluded that the answer to both questions was a resounding "YES."

The GradChek concept was unique and would serve a previously untouched market, and the software could be developed to allow the storage of authenticated documents

that could be viewed instantaneously without breaching the privacy or security of the subject of the information. After thinking through the concept a little further, the partners realized that this system could be used for far more than just education, and renamed GradChek "RepositBox." This new product concept was further refined to the following:

RepositBox System is an Internet-based service that will provide certified, secure, personal online records and records management for individuals. The service is national and international in scope, and the technology is compatible with current and future Internet technology and multiple information distribution channels. Subscribers, e.g., businesses and institutions, are sold a kit (RepositStation) that enables them to distribute Internet Credential Storage Files (called RepositBoxes) to employees and clients.

A RepositBox is a private, secure container for individuals to access and manage their documents in a structured collection using the Internet and other Virtual Private Networks (VPN) and communication management systems. An individual can store, aggregate, and self-manage personal records or credentials, and uniquely can share a "warranted authentic" copy with a third party without recourse to the issuing institution.² (See Exhibit 1.)

This system would offer full control to the owner of the information and documents placed into the system while enabling this person to share them instantaneously when merited. This meant that, had RepositBox existed in 2001 when Jeff McLeod was identified as a prime candidate for a job in "Silicon Valley North," he would likely be working for the high-tech firm today as a result of RepositBox's document verification system. Jamie Fisher likened the product to "those large glass tubes used to sort rough diamonds—with rubber gloves that protrude in. The diamonds may be manipulated, sorted, viewed, but you can't get your hands on 'em—except through those rubber gloves. Once diamonds are placed in that glass tube you can look but there's no direct contact. It's a very secure system that works well."

CASE 8 REPOSITBOX

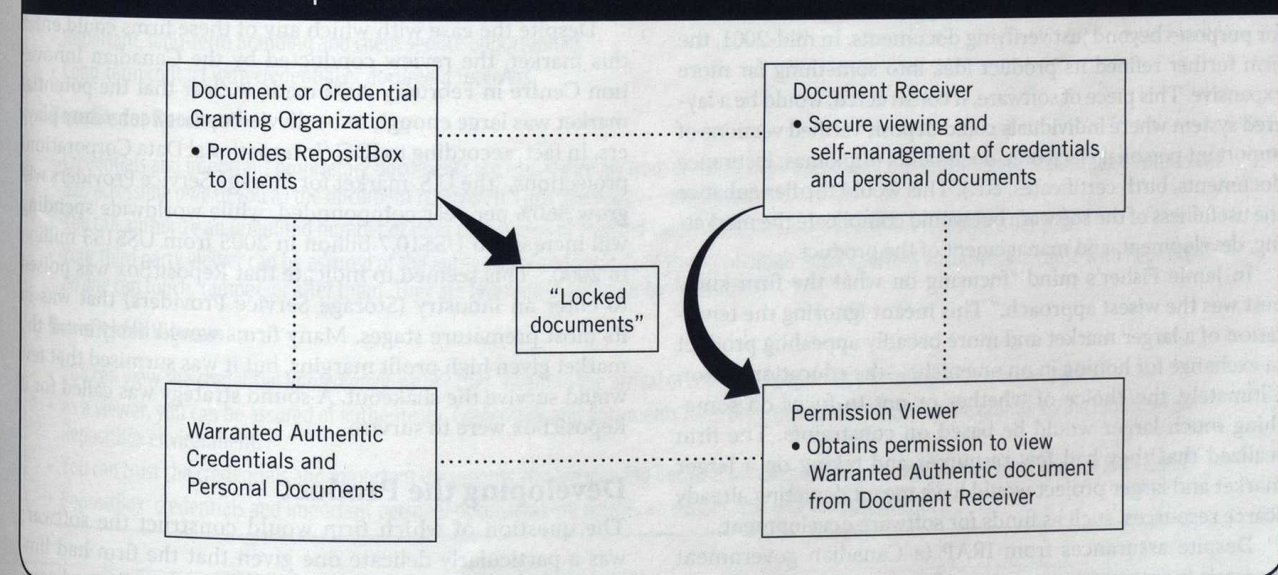
The Dilemma

Jeff McLeod, a graduate of the Master's programme in Electrical Engineering at the University of British Columbia mulled over an issue of serious importance. Only hours earlier, in the late afternoon, he had received a call from a locally based "head hunter" who had earmarked Jeff as a superior candidate for a high-profile job, working as a senior engineer in a well-respected hi-tech firm located in Kanata, Ontario.

The job seemed to be out of a dream for Jeff, who had considerable experience working in both management and engineering positions. Further, Jeff's reputation as a skilled engineer whose involvement in numerous projects had driven the development of innovative technologies made him a specifically attractive catch for any firm. His education, expertise, work experience, and reputation made him an indispensable asset, at least so the recruiter thought. The uniqueness of Jeff's skill set made him one of the few individuals able to fill the position in Kanata leading a product development team.

Altogether, the opportunity seemed like a match made in heaven. Jeff McLeod was out of work and the firm was in need of someone with Jeff's exact capabilities. Ideally, this would have meant that Jeff would have been the successful candidate for the position. However, after hanging up the phone with the

EXHIBIT 1 How RepositBox Works³



This case was written by Nicholas P. Robinson, Faculty of Law, McGill University, and Prescott C. Ensign, for purposes of classroom discussion.

¹ Federal and provincial privacy laws, including the Personal Information and Protection of Electronic Documents Act, make sharing personal information in Canada a tricky undertaking. The law stipulates that the subject of the personal information must give clear consent (written preferred) for an organization to share personal information.

² Excerpt from Market Preview Report for the RepositBox System prepared by the Canadian Innovation Centre, Waterloo, Ontario, February 2002.

³ www.repositbox.com/.

Warranted Authentic Credentials and Personal Documents

However, in order to ensure that this system was feasible, it not only had to be inspected by professional engineers, it also had to be examined by other stakeholders. For precisely this reason, Jamie Fisher chose to contact two other groups:

1. An educational institution: Jamie met and discussed the RepositBox concept with representatives from Algonquin College in Ottawa, Ontario. Jamie met with the Registrar and several members of her team. The response was very positive.
2. Jamie then met with the president of the Canadian Federation of Students, who saw the potential of the innovation to create value for graduates seeking a job. This group also endorsed the RepositBox concept, believing it to be a workable solution to a longstanding problem that graduates faced—verification of educational background.

Having received positive feedback from the previous three sets of people (NRC engineers, college representatives, and student associations) Jamie proceeded to consult with the last key stakeholder. He needed validation of the business concept from a top technology group and decided to approach IBM. Jamie met with John Kutcy, an executive at IBM Canada overseeing the education sector. After several telephone discussions and a meeting, Mr. Kutcy confirmed in a letter that, "if Mr. Fisher and Ms. Wilkinson could build out the software, along the lines discussed, IBM would work with RepositBox to market and sell the product."

After such positive feedback from all these groups, it would have been difficult to not move ahead with the design and development of the software. Potential customers seemed to be lining up, the product solved a previously unaddressed dilemma, and the business partnerships needed to make the concept a reality in the marketplace were being solidified.

Financing the Start-up

The validation of the usefulness of their business idea and the technology supporting it by students, educational institutions, and a major technology firm got Janet Wilkinson thinking of even more elaborate versions of the software that could be used for purposes beyond just verifying documents. In mid-2001, the firm further refined its product idea into something far more expansive. This piece of software, if constructed, would be a layered system where individuals could deposit verified versions of important personal electronic documents (diplomas, insurance documents, birth certificates, etc.). This would further enhance the usefulness of the software but would complicate the marketing, development, and management of the product.

In Jamie Fisher's mind "focusing on what the firm knew best was the wisest approach." This meant ignoring the temptation of a larger market and more broadly appealing product in exchange for honing in on one niche—the education sector. Ultimately, the choice of whether or not to focus on something much larger would be based on constraints. The firm realized that they had few resources and taking on a larger market and larger project would have meant depleting already scarce resources, such as funds for software development.

Despite assurances from IRAP (a Canadian government research incentives program) the firm just simply could not afford to sustain the costs that a large more complex system would entail. That was, until late 2001 when an angel investor entered the picture. This individual, having an interest in

seeing some sort of return on his money, offered to finance the development of the software. Only two questions needed to be addressed before RepositBox could get the cash infusion it needed:

1. How much will it cost to build the product?
2. If the product is built, can RepositBox go into business and successfully generate profits?

After having provided convincing arguments to answer both of these questions, the investor signed on and provided RepositBox with a generous injection of cash, to be used in the construction and development of the software. It was now Jamie's responsibility to find a contractor who could put together the system.

The Data Storage Market

RepositBox had commissioned a market review on the potential for the product given the business climate in Canada and the U.S. This review uncovered that at least one other company could compete directly with RepositBox, if it decided to enter the firm's market space, and that several other smaller firms possessed the basic document storage software that would be required to enter the market. This prospect raised the spectre that if RepositBox were to enter the market first, a far larger player with more resources could enter and wipe out the company. The conclusion that the review came to was that relationship-based marketing approaches, such as direct sales would build trust and thus increase customer/user switching costs. This approach, RepositBox hoped, would lead to long-term clients and deter new competition. FleetBoston Financial, a large U.S. bank, had developed a service for its clients that allowed them to store important electronic documents: "customers are given their own personal FileBox." This service, called fileTRUST and initially marketed as "an electronic safe deposit box," could pose a serious challenge to RepositBox if it decided to enter the company's market space. Other smaller California-based firms such as Xdrive Technologies, Anuvio Technologies (formerly i-drive), StoragePoint, and Driveway already produced technologies similar to the one RepositBox had developed and therefore posed a risk as well.

Despite the ease with which any of these firms could enter this market, the review conducted by the Canadian Innovation Centre in February 2002 made it clear that the potential market was large enough to be divided up between many players. In fact, according to IDC (International Data Corporation) projections, "the U.S. market for Storage Service Providers will grow 360% per year compounded, while worldwide spending will increase to US\$10.7 billion in 2005 from US\$153 million in 2000." This seemed to indicate that RepositBox was poised to enter an industry (Storage Service Providers) that was in its most premature stages. Many firms would likely enter the market given high profit margins, but it was surmised that few would survive the shakeout. A sound strategy was called for if RepositBox were to survive.

Developing the Product

The question of which firm would construct the software was a particularly delicate one given that the firm had limited cash on hand but wanted to protect its intellectual capital (the software itself). Perhaps more importantly, the firm wanted the software to be completed by professionals who would stand by their work and produce a quality piece of

software with few glitches. Given that the hi-tech meltdown had put countless software engineers on the street, it would be relatively easy to recruit a local programmer to perform the work. However, Jamie quickly realized that, "most of these individuals had millionaire dreams and wanted more than they deserved given that they didn't provide the same type and quality of service as a larger firm." Ultimately this led Jamie to decide to go with a consulting firm rather than an individual—but he still had to determine which firm to go with. The following criteria were set:

1. RepositBox had to be able to work with the firm and have a smooth relationship with the principals.
2. The firm would have to be willing to complete the project on a phase-by-phase basis in order to control costs and monitor progress:
 - Relational database would be constructed first
 - Supporting code would be built out
 - An alpha test would be performed⁴
 - A beta test would take place⁵
3. Jamie also wanted to ensure that costs were fixed and that the firm would not charge trailer fees and ongoing consulting fees in the case that the job was not correctly completed.

4. Lastly, Jamie wanted the firm to have constructed a software product in the past that had been commercially successful.

Six months later, after intense searching and analysis of possible options, RepositBox chose Loki Innovations of Toronto, Ontario to build the software. Loki was well established, had great experience in projects similar to RepositBox's and met all the other conditions set by Jamie and Janet. With this completed, they incorporated RepositBox Canada Inc. and issued shares while Loki developed the software. RepositBox's aspiration of becoming the principal provider of warranted authentic online credentials or "the Kleenex of online credential's business" was well underway. As Jamie put it, "RepositBox's technology represents the fifth generation of credentials verification: First there was the stone tablet, then there was papyrus, then parchment, and then paper . . . and now today, finally, RepositBox!" (See Exhibit 2.)

Now that progress was being made on all other fronts, Jamie refocused on strategies for future growth, and concluded that the U.S. market was key for RepositBox and that RepositBox would have to establish a solid U.S. presence before selling into this market. A business school professor at the University of Ottawa and member of RepositBox's advisory board since

EXHIBIT 2 About RepositBox⁶

Overview of Technology

- Thin client Internet application, runs on a Web browser.
- Privacy and authenticity of information are ensured for document and credential grantors, receivers, and viewers.
- Data cannot be compromised.
- The identity of the server and source are verifiable.

Benefits for Grantors

- A significant reduction of paper-based operations.
- Zero payments to RepositBox, plus potential revenue-sharing opportunities.
- Confidence that only the receiver and his/her authorized viewers can view the warranted authentic information.
- Protection of your corporate integrity—assurance that credentials and important personal documents of your clients have not been replicated or tampered with.
- Important, long-term branding and client service opportunities.
- Long-term contact with credential or document receivers.

Benefits for Receivers

- Credentials and important proprietary documents are issued directly from granting organizations to the highly secure RepositBox environment and accessible *only* to you as the document receiver. It's just like paper—only faster and easier!
- You can authorize an unlimited number of third party views of selected credentials, instantly, at one low fixed price per year.
- Your third party viewer can be assured of the authenticity and veracity of your credentials and important documents because with RepositBox, *no one* can touch, tamper, or alter them. They are *Warranted Authentic* by RepositBox.

Benefits for Viewers

- You can view the credential *immediately*, rather than awaiting the arrival of a certified paper copy from a granting organization.
- As a viewer, you can be assured of authenticity. Credentials and documents have been deposited directly by the grantor to the highly secure RepositBox environment.
- You can trust the credentials and important documents you are viewing because with RepositBox, no one can touch, tamper, or alter them.
- RepositBox: credentials and important personal documents are online, accessible, and *Warranted Authentic*.

⁴ Testing an early version of the software that may not contain all of the features that are planned for the final version. This first stage of testing is often performed only by developers involved in the product's creation.

⁵ The second stage of software testing involves a limited number of 'real world' external users.

⁶ Information obtained from the company Web site, www.repositbox.com/.

the beginning, David Large, stumbled across a technology that seemed to complete RepositBox's package. Jamie pursued this lead to Rochester, New York and the first U.S. initiative was to enter into a licensing agreement with the University of Rochester to use their patented AuthentImage, digital sealing technology on an exclusive basis in the "virtual credential space." RepositBox would integrate this proprietary technology into the RepositBox solution and also market AuthentImage as a stand-alone security product. In exchange, the University of Rochester would become a minority equity partner in RepositBox's new U.S. corporation and would share a small percentage of the cash flow. Over time the University of Rochester relationship solidified and became a major asset to the new company—providing promising leads.

Financial Fuel and New Connections for RepositBox

It would be through a combination of partnerships with larger organizations in similar industries and a dedicated sales team that RepositBox expected to experience considerable growth soon after the implementation and introduction of its product. In order to ensure this growth, a U.S. partner company was established (jointly owned by a cohort of private New York investors, the University of Rochester, and majority shareholder RepositBox Canada Inc.) and Jamie Fisher decided that aggressively pursuing the U.S. market would be a wise first step given its size. The choice of the University of Rochester was strategic for a few reasons. Most importantly though, upstate New York, where the University of Rochester was situated, had a high concentration of post-secondary higher education institutions—over 300, making it a great target market.

RepositBox's new investors brought substantial relationships and marketing skills to the new company. The new company was invited to present at UNYTECH 2005 (a showcase for technology emanating from upstate New York universities) to be exposed to a variety of different opportunities. All this would not have occurred without the doors opened by the University of Rochester. Jamie was also put in contact with a New York based lawyer who acted as a "rainmaker" for many entrepreneurs seeking venture capital. This individual expressed interest in arranging for substantial funding for RepositBox, but was concerned that a previously unidentified competitor had a similar product in the works. Knowing this information, and knowing that succeeding would be at least partly dependent on economies of scale (and therefore available capital), Jamie tussled with the ways of getting this prominent businessperson onside, and securing even more funding for the firm's future.

Initially, Jamie Fisher's thoughts were to focus on what he felt best prepared for, the education sector. Furthermore, this particular market segment fit into the ideal target profile. Universities and colleges managed enormous amounts of personal information, had large numbers of sensitive documents, could easily afford (yet could cut costs by) investing in the system, and the market was large enough to be lucrative. Furthermore, RepositBox was initially conceptualized in response to a problem that originated from a university's inability to provide expedient verification of official documents. The alternative to this was, of course, to take a more general approach and attack a larger market. Both the insurance industry and the human resources management function looked attractive. This would mean far larger revenues and profits, but could

lead to a weaker brand identity and more complications in terms of managing RepositBox while catering to a wide spectrum of firms. RepositBox wanted to go after larger firms (over 10,000 clients or employees), but could the new venture be all things to all people?

A Critical Inflection Point

It was late August 2005 as Jamie Fisher sat in his office in downtown Ottawa—with air conditioner running full force—he began to question whether he was biting off more than he could realistically chew. "There are so many applications for a product that can verify and maintain the heritage of a document," he thought aloud above the hum of the fan blowing cold air. "We take a document suspended in time and permit access to the glass tube, regulating who looks in and who puts their fingers in those rubber gloves."

Loki Innovations had designed the software to handle a variety of different document types and "big money" might be found in offering RepositBox's verification services to a broader range of clients. Jamie Fisher and Janet Wilkinson started to have second thoughts about which market segment(s) to tackle. Given their background, connections, and the evidence provided by market research, the education sector might be the easiest to crack. However, at the same time, Janet Wilkinson brought up that "this would essentially constitute turning away big business in exchange for a smaller piece of pie." This was purely a question of risk and reward—could RepositBox, a young venture, manage to be a success if it attacked the general document authentication market, which included insurance, health management, and other big-profile markets? Conversely, would it make more sense for the firm to stay on track with the segment it knew best, education? This seemed like the sure thing to do, but the appeal of larger fortunes loomed in front of them.

In any event, a decision had to be made soon; the software was near completion and the firm had to move ahead with its strategy. As the 50-something year-old Ottawa businessman reclined in his chair, he asked himself, given the firm's resources and potential, what direction should be taken in order to make RepositBox the business success story it could be? Jamie turned to Janet, "Do we set our sights on the general credentials verification market or limit ourselves to the education market with the aim of improving chances of success?" Janet replied, "And what did you think of that info I sent you about Ascertia?" Janet had come across a local high-growth company—Med-Eng, a producer of bomb disposal gear—that had been used in endorsements for "PDF Sign&Seal"—an advanced digital signing product from Ascertia in Surrey, England (see Exhibit 3). Janet's investigation of Ascertia turned up IdenTrust of San Francisco (see Exhibit 4). Not knowing if this most recent revelation was bad news or good, Janet bit her lip and murmured, "this market space may not be as vacant as we initially imagined."

Despite the hot dry summer, the "rain" had really come down hard earlier in the month. The rainmaker promised quite a shower of U.S. dollars for RepositBox. This secured capital would provide a foreseeable future for RepositBox. The competitor that was previously unknown, but that had been identified in the nick of time by this astute lawyer/rainmaker had been taken out of the picture—sidelined when a licensing deal had been struck. This serious venture capital would fuel the possibilities.

In less than a month the president of RepositBox USA would have an opportunity to "pitch" to a roomful of several hundred bankers and other potential investors. On September 22 at the UNYTECH 2005 Venture Forum RepositBox could shine among the other 15 or so presenters. These start-ups with no product in hand would be full of wild ambition but empty on cash. Mark Petersen, president of RepositBox USA, would stand up and deliver the script that he and Jamie Fisher had been rehearsing for weeks: "We are RepositBox, we've just come to market with our product—a revolutionary approach to online credential management; we've just completed a

round of financing—so we don't need your money today—just your attention for the next few minutes and hopefully your support after that." Jamie had driven his car down to upstate New York a lot lately, but this was one five-hour trip he was really looking forward to making. (See Exhibit 5.)

Things had been going so well lately, that Jamie wondered if he hadn't left anything out. And even if he wasn't forgetting anything, he surmised that despite the sunny skies and smooth sailing that appeared ahead—things could change. Jamie and Janet needed to work on next steps for their new venture if they were going to bring RepositBox to its full potential.

EXHIBIT 3 Ascertia⁷

Ascertia is a privately funded company, managed from the UK with globally located development units. Founded by Industry Professionals to provide services and products for realization of commercial use of cryptography. The company's mission is to provide high quality, cost-effective products and solutions that integrate with existing and widely deployed software products, enhancing their security transparently. The Company uses its own distributed technologies to prove that they provide value for businesses in real world deployments.

Product Line

Secure Desktop: Desktop product range provides the most advanced security functionality imaginable—no other vendor comes close! Together with a revolutionary simple Graphical User Interface (GUI) ensures digital signatures can now become truly as powerful as hand-signatures were in the past!

- PDF Sign&Seal
- Office Sign&Seal
- File Sign&Seal
- Advanced Revocation Provider
- PDF Signer plugin

Server-side Signing: If you require server-side signing, time-stamping and validation of any type of document you have come to the right place. Ascertia's server-side signing products take the hassle out of deploying PKI applications to every end-user; instead users can log on to the server and perform their required security operation on the server. This minimizes the software and cryptographic key material required on the user's desktop.

- PDF Signer Server
- Advanced Digital Signature Service

Management Tools: Ascertia's Management Tools product range is aimed at the administrator, who can now control all aspects of the corporate security policy from one central location. Helping to minimize the amount of training required for users, helpdesk call costs, and taking the hassle out of deployment as well as dynamic update of all your Ascertia Desktop applications.

- Trust Console
- PolicyUpdate
- Online Certificate Status Protocol Client Tool
- Online Certificate Status Protocol Client Crusher

Infrastructure Products: Ascertia is a recognized, global leader in certificate validation servers. We focus on all aspects of certificate validation with a range of servers which take all the hassle out of certificate path building, certificate path validation and certificate status checking.

- TrustFinder OCSP Server
- TrustFinder Time Stamping Authority Server
- TrustFinder Simple Certificate Validation Protocol Server
- TrustFinder XML Key Management Specification Server
- PureCA

⁷ Information obtained from the company Web site, www.ascertia.com/.

EXHIBIT 4 IdenTrust⁸

IdenTrust is a global leader in trusted identity solutions accepted by global financial institutions, government agencies, and corporations spanning five continents. As the only government regulated, bank-built identity company, IdenTrust provides a worldwide network of trusted credentials based on global standards.

IdenTrust not only addresses the technical aspects of identity management but also provides a legally and globally interoperable environment for using identities. The IdenTrust solution consists of three key components: (a) trusted identity blueprint, (b) proven network and delivery capabilities based on "best of breed" technology, and (c) unmatched expertise in establishing and managing at trusted identity infrastructure.

The IdenTrust platform enables financial institutions, governments and commercial entities to effectively manage the risks associated with identity authentication; minimize investment in creating their own legal frameworks; and deploy a Trusted Identity infrastructure smarter, faster, and more cost effectively.

IdenTrust|DST (formerly Digital Signature Trust Company) is one of the premier providers of digital identity authentication services to the United States federal government, numerous U.S. state governments, the U.S. Department of Defense as well as Energy and supply chain markets.

The U.S. General Services Administration awarded IdenTrust|DST the designation of "Access Certificates for Electronic Services" Certification Authority to issue digital certificates to businesses and consumers to conduct business with the U.S. government electronically. IdenTrust|DST also gained accreditation by the U.S. Department of Defense to issue digital certificates to DoD external contractors under the DoD's Interim External Certification Authority program. IdenTrust|DST has contracts with U.S. state governments such as Washington State.

IdenTrust|DST has been awarded Ernst and Young's WebTrust Seal of Assurance for Certification Authorities.

Key Offerings:

IdenTrust Trust Blueprint

The only government-regulated, bank endorsed, globally interoperable framework for managing identities, including an entire legal, operational and technical framework for trusted identity management.

IdenTrust Trust Infrastructure

A complete set of operational, logistical, network, and technical capabilities for building a foundation of trust across all business applications within an enterprise.

IdenTrust Trust Counsel

Expertise and implementation assistance to design, build, and operate trusted identity infrastructure quickly and cost-effectively.

IdenTrust Trust Sign

Leading collaboration solution for trusted documents, enabling enterprises to prepare, digitally sign and deliver business-authenticated, trusted documents over the Internet.

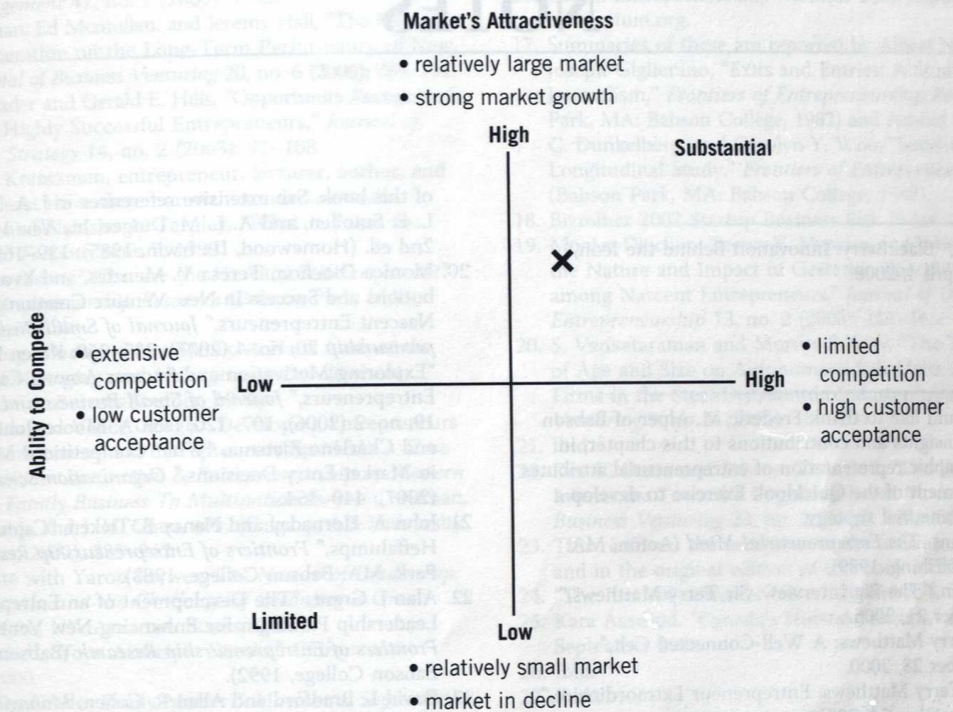
IdenTrust Trust Financial Applications

A complete set of operational, logistical, network, and technical capabilities to Trust Enable financial applications in order to provide full identity assurance across the financial supply chain.

⁸ Information obtained from the company Web site, www.identrust.com.

EXHIBIT 5 Market Opportunity Matrix: RepositBox System

Using the Market Opportunity Matrix as an illustrative tool, the market opportunity for the *RepositBox System* is represented as follows:



Based on its market size and market growth, market attractiveness is assessed as 'high', based on the industry's competitive structure, and the market's acceptance of the product, the *RepositBox System*.

* The items that are mapped in the upper right hand quadrant have a relatively high probability of success. Those items mapped in the lower left hand quadrant are characterized as having a relatively low likelihood of success.