

## CHAPTER 1 INTRODUCTION

### KEY TERMS

business model, 25	innovation, 21
business plan, 25	lifestyle firms, 18
corporate entrepreneurship, 6	moderate risk takers, 16
creative destruction, 21	passion for their business, 9
entrepreneurial firms, 18	product/customer focus, 11
entrepreneurial intensity, 6	salary-substitute firms, 18
entrepreneurship, 6	triggering event, 24
execution intelligence, 13	value, 18

### REVIEW QUESTIONS

**1. Increasingly, entrepreneurship is being practiced in countries throughout the world. Why do you think this is the case? Do you expect entrepreneurship to continue to spread throughout the world, or do you think its appeal will subside over time?**

The three primary reasons why people become entrepreneurs are: they want to be their own boss, pursue their own ideas and realize financial rewards. Entrepreneurship is being practiced throughout the world but mostly in low income countries like Peru or Argentina. People start businesses there out of needs. I do think that entrepreneurship will continue to spread since even high income countries like France or Germany have surprisingly high rates of entrepreneurial start-up.

**2. What key insights does the GEMS study provide us about entrepreneurship?**

The GEMS study identifies whether its respondents are starting a new business to take advantage of an attractive opportunity or out of necessity to earn income. It shows that in high income countries the majority of people are drawn to entrepreneurship to take advantage of attractive opportunities. The reverse is true about low income countries.

**3. What evidence is available suggesting that the often reported statistic that 9 out of 10 new businesses fail is an exaggeration? What is a more realistic failure rate for new firms?**

Brian Head (an economist for the US small business) shows that after four years 50% of new businesses are still open. A more realistic failure rate would be 33%.

**4. What is entrepreneurship? How can one differentiate an entrepreneurial firm from any other type of firm? In what ways is an entrepreneur who just launched a restaurant different from someone who just took a job as the general manager of a restaurant owned by a major restaurant chain?**

Entrepreneurship is the art of turning an idea into a business. He transforms an invention into a viable business. An entrepreneurial firm is a proactive innovator and is not risk averse to taking calculated risks, in contrast of conservative firms. The difference between an entrepreneur and a employee is that an entrepreneur is his own boss, and has his own idea, he is trying to assemble and integrate all the resources needed to make his idea viable.

**5. What are the three main attributes of firms that pursue high levels of corporate entrepreneurship? Would these firms score high or low on an entrepreneurial intensity scale?**

They are more proactive, less risk averse and they look for ways to cut bureaucracy. On the entrepreneurial intensity scale they would be highly entrepreneurial.

**6. What are the three primary reasons people become entrepreneurs? Which reason is given most commonly? Which reason best describes why you may choose to become an entrepreneur?** The three primary reasons are: become their own boss, pursue their own ideas and realize financial rewards. The most common reason is to “be their own boss”.

**7. Some people start their own firms to pursue financial rewards. However, these rewards are often far fewer than imagined and/or expected. Why is this so?** The average entrepreneur does not make more money than someone with a similar amount of responsibility in a traditional job. Also the financial rewards associated with entrepreneurship can be bitter sweet if they are accompanied by losing control of the firm.

**8. What are the four primary traits and characteristics of successful entrepreneurs?**

They are: passion for the business, product/customer focus (diligence to spot product opportunities), tenacity despite failure and execution intelligence (the factor that determines whether a startup is successful or fails).

**9. Why is passion such an important characteristic of successful entrepreneurs?**

**What is it about passion that makes it particularly compatible with the entrepreneurial process?** Passion is important because of: the ability to work and iterate, the willingness to work hard for an extended period of time, the ability to overcome setbacks and “no’s”, the ability to listen to feedback on the limitations of your organization and of yourself and the perseverance and persistence when the going gets tough. Passion is particularly compatible with the entrepreneurial process because the process of starting a business is demanding.

**10. Why is a product/customer focus an important characteristic of successful entrepreneurs?**

Because it involves diligence to spot product opportunities and to see them through to completion.

**11. What is it about “tenacity” that makes it such an important characteristic for entrepreneurs?** Setbacks and failures will inevitably occur and it tests an entrepreneur’s limit in terms of his ability to persevere through those.

**12. What are the five common myths of entrepreneurship?** They are: entrepreneurs are born not made, entrepreneurs are gamblers, they are primarily motivated by money, they should be young and energetic and an entrepreneur loves the spotlight.

**13. What evidence do we have that debunks the myth that entrepreneurs are born, not made?**

There is a consensus on many psychological studies that show that entrepreneurs are not genetically different from any other people. However there are certain personality traits commonly associated with entrepreneurs, such as: creative, decisive, energetic, a strong work ethic, persuasive, self-confident. Also, people that know an entrepreneur themselves, have a positive opinion about them since their ambiguity and uncertainty is reduced.

**14. What are the four distinctive parts of the entrepreneurial process and what is the relationship among the parts?** The distinctive parts are: deciding to become an entrepreneur (usually a triggering event), developing successful business ideas (here they need to write a business plan and to have a business model), moving from an idea to an entrepreneurial firm (prepare a proper ethical and legal foundation for a firm), managing and growing the entrepreneurial firm.

**15. How would you characterize the risktaking propensity of most entrepreneurs?**

Entrepreneurs are usually moderate risk takers. Their jobs however, are less structures so they face a more uncertain set of possibilities.

**16. What factors favor older entrepreneurs as opposed to younger entrepreneurs?**

They have an increasing desire for more personal fulfillment in their lives. They have substantial business experience, financial resources and excellent vigor and health.

**17. What did Joseph Schumpeter mean by the term *creative destruction*?**

It means that entrepreneurs develop new products and technologies that over time make current products and technologies obsolete.

**18. In general, what effects does entrepreneurship have on economies around the world?**

They innovate and they create jobs.

**19. How is the demographic makeup of entrepreneurs changing in the United States?**

**What do you believe is accounting for these changes?** There are more Latino entrepreneurs and Asian entrepreneurs. I believe these changes are accounted out of needs that these communities have.

**20. Describe several examples of the impact that entrepreneurial firms have on a society.**

There are new products and services that make our lives easier, enhance our productivity at work, improve our health and entertain us. In the other hand, they create moral and ethical issues with which societies are forced to grapple.

## CHAPTER 2 OPPORTUNITY RECOGNITION

### KEY TERMS

brainstorming, 59

corridor principle, 55

creativity, 57

customer advisory boards, 61

day-in-the-life research, 61

entrepreneurial alertness, 55

focus group, 60

idea, 44

idea bank, 63

intellectual property, 64

intranet, 63

network entrepreneurs, 57

opportunity, 43

opportunity gap, 43

opportunity recognition, 55

solo entrepreneurs, 57

strong-tie relationships, 57

weak-tie relationships, 57

window of opportunity, 43

### REVIEW QUESTIONS

**1. What is a product opportunity gap? How can an entrepreneur tell if a product opportunity gap exists?** An opportunity gap is an internally stimulated venture. An entrepreneur recognizes a problem and creates a business to fill it. The key opportunity recognition is to identify a product or service that people need and are willing to buy, not one that an entrepreneur wants to make sell.

**2. What is an opportunity? What are the qualities of an opportunity, and why is each quality important?** It is a favourable set of circumstances that creates a need for a new product, service or business. The qualities are: attractive, durable, timely and anchored in a product, service or business that creates or adds value for its buyer or end user.

**3. What four environmental trends are most instrumental in creating business opportunities? Provide an example of each environmental trend and the type of business opportunity that it might help create.** The environmental trends are: economic forces (a weak economy provides business for start-ups that help consumers save money), social forces (fast food isn't primarily because of people's love of fast food but rather

because people are busy and don't have time to cook their own meal), technological advances (they provide opportunities to help people perform their everyday tasks in better and more convenient ways, example: OpenTable is a website that allows you to make restaurant reservations online) and political action and regulatory changes (new laws create opportunities for entrepreneurs to start firms to help companies, individuals and governmental agencies comply with these laws).

**4. Explain how “solving a problem” can create a business opportunity. Provide an example that was not mentioned in the chapter of a business opportunity that was created in this way.**

Problems can be recognized by observing the challenges that people encounter in their daily lives and through more simple means such as intuition, serendipity or chance. A business created this way is...

**5. Explain how finding a gap in the marketplace can create a business opportunity.**

Many products that consumers need or want aren't available at a particular location or they aren't available at all. Large retailers, like Walmart or Costco, create this problem. They compete mostly on price and popular items. This is the reason why clothing boutiques and specialty shops exist.

**6. What is meant by opportunity recognition?**

It refers to the process of perceiving the possibility of a profitable new business or a new product or service. An opportunity cannot be pursued until it is recognized.

**7. In what ways does prior industry experience provide an entrepreneur an advantage in recognizing business opportunities?** By working in an industry an individual may spot a market that is underserved. Another possibility is that while working in a particular area, an individual builds a network of social contacts in that industry that may provide insights that lead to opportunities.

**8. What is the corridor principle? How does this corridor principle explain why the majority of business ideas are conceived at work?** Corridor principle says that once an entrepreneur starts a firm, new venture opportunities become apparent. It starts at work because once someone starts a firm and becomes immersed in an industry, it is much easier for that person to see new opportunities in the industry.

**9. What is entrepreneurial alertness? Why is it important?** Some think that entrepreneurs have a “sixth sense” that allows them to see opportunities that others miss, this is the entrepreneurial alertness. It is important because it allows entrepreneurs to notice things without engaging in deliberate search.

**10. In what ways does an extensive social network provide an entrepreneur an advantage in recognizing business opportunities?** It affects opportunity recognition. People who built substantial network of social and professional contacts will be exposed to more opportunities and ideas than people with sparse networks.

**11. Describe the difference between strong-tie relationships and weak-tie relationships. Is an entrepreneur more likely to get new business ideas through strong-tie or weak tie relationships? Why?** A strong-tie relationships are characterized by frequent interaction and ties between co workers, friends and spouses. Weak-tie relationships are characterized by infrequent interaction and ties between casual acquaintances. An entrepreneur would get a new business idea through a weak ties because strong-tie relationships are typically formed by like minded individuals.

**12. Define creativity. How does creativity contribute to the opportunity recognition process?**

This is the process of generating a novel of useful ideas. Teams of entrepreneurs working within a company are sources of creativity for their firm.

**13. Briefly describe the five stages of the creative process for an individual.**

The five stages are: preparation (background experience and knowledge that bring the entrepreneur to recognize an opportunity), incubation (a person considers an idea or thinks about a problem, “mulling things over”), insight (an idea is born, “eureka experience”), evaluation (idea is subjected to scrutiny and analyzed for its viability, and elaboration (details are worked out and the idea is transformed into something with value).

**14. Explain the difference between an opportunity and an idea.**

Ideas are typically generated to find the best way to capitalize on an opportunity. Entrepreneurs usually identify more ideas than opportunities.

**15. Describe the brainstorming process. Why is “no criticism” the number one rule for brainstorming?** It is the process of generating several ideas about a specific topic. The “no criticism” rule is there since it stymies creativity and inhibits the free flow of ideas.

**16. Describe how a focus group is set up and how it is used to generate new business ideas.**

A focus group is a gathering of 5 to 10 people who are selected because of their relationship to the issue being discussed. They can be used to generate new business ideas. They work best as a follow-up to brainstorming. They are usually conducted by trained moderators.

**17. Describe how library and Internet research can be used to generate new business ideas.**

The best approach to utilizing a library is to discuss your general area of interest with a reference librarian, who can point out useful resources such as industry-specific magazines, trade journals and industry reports. Internet research is also very important. If you start from scratch you can simply type “new business ideas” into Google or Yahoo!, and you have your starting point here.

**18. What is the purpose of day-in-the-life research?** A company may routinely send teams of testers to the homes and businesses of its users to see how its products are working and to seek insights for new product ideas.

**19. What is the purpose of an idea bank? Describe how an idea bank can be set up in a firm.**

An idea bank (or vault) is a physical or digital repository for storing ideas. An idea bank can be a password-protected location on a firm’s intranet that is available only to qualified employees. The purpose is to meet the challenge of encouraging, collecting and evaluating ideas.

**20. What are the three main steps to protect ideas from being lost or stolen?** The three main steps are: put the idea into a tangible form (make all entries in ink and have them witnessed), secure your idea (either with a patent protection or by restricting the access to it) and finally avoid making an inadvertent or voluntary disclosure of an idea in a way that forfeits your claim to its exclusive rights.

### CHAPTER 3 FEASIBILITY ANALYSIS

#### KEY TERMS

buying intentions survey, **84**

concept statement, **82**

concept test, **82**

feasibility analysis, **79**

financial feasibility analysis, **93**

industry, **88**

new-venture team, **91**

organizational feasibility analysis, **91**

primary research, **79**

product/service feasibility analysis, **81**

secondary research, **81**

## **REVIEW QUESTIONS**

### **1. What is a feasibility analysis? What is it designed to accomplish?**

Feasibility analysis is the process of determining if a business idea is viable. It is the preliminary evaluation of a business idea, conducted for the purpose of determining whether the idea is worth pursuing.

### **2. Briefly describe each of the four areas that a properly executed feasibility analysis explores.**

1- Product/service feasibility analysis: is an assessment of the overall appeal of the product or service being proposed.

2- Industry/target market feasibility is an assessment of the overall appeal of the industry and the target market for the product or service being proposed.

3- Organizational feasibility analysis is conducted to determine whether a proposed business has sufficient management expertise, organizational competence, and resources to successfully launch its business.

4- Financial feasibility analysis is the final component of a comprehensive feasibility analysis. For feasibility analysis, a preliminary financial assessment is usually sufficient; indeed, additional rigor at this point is typically not required because the specifics of the business will inevitably evolve making it impractical to spend a lot of time early on preparing detailed financial forecasts.

### **3. What is a product/service feasibility analysis?**

Product/service feasibility analysis is an assessment of the overall appeal of the product or service being proposed. There are two components to product/service feasibility analysis: product/service desirability (is this a good time? Does it make sense?), and product/ service demand (survey – will people buy this?).

### **4. Describe the difference between primary research and secondary research.**

Primary research is research that is collected by the person or persons completing the analysis. It normally includes talking to industry experts, obtaining feedback from prospective customers, conducting focus groups, and administering surveys.

Secondary research probes data that is already collected. The data generally includes industry studies, Census Bureau data, analyst forecasts, and other pertinent information gleaned through library and Internet research.

### **5. What is a concept statement?**

It is a one-page document that normally includes the following:

- A description of the product or service. This section details the features of the product or service; many include a sketch of it as well.
- The intended target market. Lists of the consumers or businesses who are expected to buy the product or service.
- The benefits of the product or service. This section describes the benefits of the product or service and includes an account of how the product or service adds value and/or solves a problem.
- A brief description of the company's management team

### **6. What is a buying intentions survey, and what does it accomplish?**

A buying intentions survey is an instrument that is used to gauge customer interest in a product or service. It consists of a concept statement or a similar description of a product or service with a short survey attached.

### **7. What are the two ways that entrepreneurs assess the likely product demand for the proposed product or service they are analyzing?**

1- ) Administering a buying intentions survey, and 2- ) conducting library, Internet, and gumshoe research.

**8. What is gumshoe research in the context of product/service feasibility analysis?**

A gumshoe is a detective or an investigator that scrounges around for information or clues wherever they can be found. Don't be bashful. Ask people what they think about your product or service idea

**9. What is industry/target market feasibility analysis?**

Industry/target market feasibility is an assessment of the overall appeal of the industry and the target market for the product or service being proposed.

**10. Describe the attributes of an attractive industry for a new venture.**

Industries that are young rather than old, are early rather than late in their life cycle, and are fragmented rather than concentrated are more receptive to new entrants than industries with the opposite characteristics. You also want to pick an industry that is structurally attractive—meaning start-ups can enter the industry (in various target markets) and compete.

**11. What is a target market? Why do most start-ups focus on relatively small target markets to begin with rather than larger markets with more substantial demand?**

A target market is a place within a larger market segment that represents a narrower group of customers with similar needs. Most start-ups simply don't have the resources needed to participate in a broad market, at least initially. Instead, by focusing on a smaller target market, a firm can usually avoid head-to-head competition with industry leaders and can focus on serving a specialized market very well.

**12. What are some of the ways to determine the attractiveness of a small target market within a larger industry?**

-To find a market that's large enough for the proposed business but is yet small enough to avoid attracting larger competitors at least until the entrepreneurial venture can get off to a successful start.

**13. What is organizational feasibility analysis?**

Organizational feasibility analysis is conducted to determine whether a proposed business has sufficient management expertise, organizational competence, and resources to successfully launch its business.

**14. Briefly describe each of the two primary issues to consider when conducting an organizational feasibility analysis.**

There are two primary issues to consider in this area: management prowess and resource sufficiency.

Management prowess: a proposed business should evaluate the prowess, or ability, of its initial management team, whether it is a sole entrepreneur or a larger group.

Resource Sufficiency is to determine whether the proposed venture has or is capable of obtaining sufficient resources to move forward.

**15. What is a new-venture team?**

A new-venture team is the group of founders, key employees, and advisers that either manage or help manage a new business in its start-up years.

**16. What is financial feasibility analysis?**

Financial feasibility analysis is the final component of a comprehensive feasibility analysis. For feasibility analysis, a preliminary financial assessment is usually sufficient; indeed, additional rigor at this point is typically not required because the specifics of the business will inevitably evolve making it impractical to spend a lot of time early on preparing detailed financial forecasts.

**17. Identify and briefly describe the three separate components of financial feasibility analysis.**

- 1- Total start-up cash needed: refers to the total cash needed to prepare the business to make its first sale.
- 2- Financial performance of similar businesses: estimating a proposed start-up's potential financial performance by comparing to similar, already established businesses.
- 3- The overall financial attractiveness of the proposed venture: such as evaluations that are based primarily on a new venture's projected sales and rate of return (or profitability).

**18. What are some of the techniques a start-up can use to estimate its potential financial performance by comparing it to similar, already established businesses?**

First, substantial archival data is available online, which offers detailed financial reports on thousands of individual firms. (example: BizStats.com)

There are additional ways to obtain financial data on smaller firms. If a startup entrepreneur identifies a business that is similar to the one he or she wants to start, and the business isn't likely to be a direct competitor, it's not inappropriate to ask the owner or manager of the business to share sales and income data.

**19. What are some factors that make a potential start-up attractive from an overall financial perspective?**

A more precise estimation can be computed by preparing pro forma (or projected) financial statements, including one- to three-year pro forma statements of cash flow, income statements, and balance sheets (along with accompanying financial ratios). This work can be done if time and circumstances allow, but is typically done at the business plan stage rather than the feasibility analysis stage of a new venture's development.

**20. What is the purpose of a First Screen analysis?**

First Screen is a template for completing a feasibility analysis. It is called First Screen because a feasibility analysis is an entrepreneur's (or a group of entrepreneurs') initial pass at determining the feasibility of a business idea. If a business idea cuts muster at this stage, the next step is to complete a business plan.

## CHAPTER 5 INDUSTRY ANALYSIS

**KEY TERMS**

barrier to entry, **153**  
 competitive analysis grid, **167**  
 competitive intelligence, **166**  
 competitor analysis, **149**  
 cost reduction strategy, **163**  
 declining industry, **161**  
 economies of scale, **153**  
 emerging industry, **161**  
 first-mover advantage, **161**  
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geographic roll-up strategy, **161**  
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 industry, **148**  
 industry analysis, **148**  
 leadership strategy, **163**  
 mature industry, **161**  
 multidomestic strategy, **163**  
 niche strategy, **163**  
 position, **149**

**REVIEW QUESTIONS**

**1. What is an industry? Provide an example of an industry and several firms in it.**

An industry is a group of firms producing a similar product of service, such as music, fitness drinks, or electronic games.

Ex: fast food industry-à McDonalds, Burger King, KFC, A&W, Harvey's

**2. What is the purpose of industry analysis?**

Industry analysis is business research that focuses on the potential of an industry. This analysis is needed to learn the ins and outs of the industry the firm plans to enter. It also

helps to determine if the niche of target markets it identified during its feasibility analysis are accessible and which ones represent the best point of entry for the new firm.

**3. What are the four primary categories of environment trends? Provide an example of how a trend in each category could affect the toy industry,**

Economic trends, social trends, technological advances, and political and regulatory changes are the most important environment trends for entrepreneurs to study.

Ex: Economic trends→ The fact the US and Canadian economies recovered is great news for the toy industry as more people will have an excess of disposable income to spend.

Social trends→ The aging population is not good news for the toys industry. More seniors means less kids to buy their toys.

Technological advances→ With more kids playing on phones and Ipads, the toy industry is very negatively affected. They could always try and use the technology available to their advantages but chances are slim.

Political and regulatory changes→ If the government suddenly judges a toy too dangerous, they could forbid the sale of that toy or put an age limit to it which would slow down the sales.

**4. Identify the five forces that determine industry profitability.**

1. Threat of substitutes
2. Threat of new entrants
3. Rivalry among existing firms
4. Bargaining power of suppliers
5. Bargaining power of buyers

**5. Describe how the threat of substitute products has the potential to suppress an industry's profitability.**

When close substitutes for a product do exist, industry profitability is suppressed because consumers will opt not to buy when the price is too high.

**6. How does the threat of new entrants have the potential to suppress an industry's profitability?**

When the threat of new entrants is high, it can suppress the profitability of an industry because more companies selling a similar product can enter easily and take away important market share from you.

**7. What is meant by the term *barrier to entry*? Describe the six major sources of barriers to entry that can restrict a firm's entry into a market.**

A barrier to entry is a condition that creates a disincentive way for a new firm to enter an industry.

1. Economies of scale: When mass-producing a product results in a lower average cost.
2. Product differentiation: Product that are different and it would be very hard to enter the industry without massive advertising.
3. Capital requirement: The need to invest large amounts of money to gain entrance to an industry
4. Cost advantages independent of size: Entrenched competitors may have cost advantages not related to size that are not available to new entrants.
5. Access to distribution channels: Distribution channels are often hard to crack. This is particularly true in crowded markets, such as the convenience store market.
6. Government and legal barriers: In knowledge-intensive industries, such as biotechnology and software, patents, trademarks, and copyrights form major barriers to entry. Other industries, such as banking and broadcasting, require the granting of a license by a public authority.

**8. How does rivalry among existing firms have the potential to suppress an industry's profitability?**

Some industries are fiercely competitive to the point where prices are pushed below the level of costs. When this happens, industry-wide losses occur.

**9. Describe the four primary factors that play a role in determining the nature and intensity of the bargaining power of suppliers. How does the bargaining power of suppliers have the potential to suppress an industry's profitability?**

1. Supplier concentration: When there are only a few suppliers to provide a critical product to a large number of buyers, the supplier has an advantage.

2. Switching costs: Switching costs are the fixed costs that buyers encounter when switching or changing from one supplier to another.

3. Attractiveness of substitutes: Supplier power is enhanced if there are no attractive substitutes for the products or services the supplier offers.

4. Threat of forward integration: The power of a supplier is enhanced if there is a credible possibility that the supplier might enter the buyer's industry.

(Suppliers can suppress the profitability of the industries to which they sell by raising prices or reducing the quality of the components they provide.)

**10. Describe the four primary factors that play a role in determining the nature and intensity of the bargaining power of buyers. How does the bargaining power of buyers have the potential to suppress an industry's profitability?**

1. Buyer group concentration: If the buyers are concentrated, meaning that there are only a few large buyers, and they buy from a large number of suppliers, they can pressure the suppliers to lower costs and thus affect the profitability of the industries from which they buy.

2. Buyer's costs: The greater the importance of an item is to a buyer, the more sensitive the buyer will be to the price it pays.

3. Degree of standardization of supplier's products: The degree to which a supplier's product differs from its competitors' affects the buyer's bargaining power.

4. Threat of backward integration: The power of a buyer is enhanced if there is a credible threat that the buyer might enter the supplier's industry.

(Buyers can suppress the profitability of the industries from which they purchase by demanding price concessions or increases in quality.)

**11. Identify the nontraditional barriers to entry that are particularly suitable for entrepreneurial firms.**

1. -Strength of management team
2. -First-mover advantage
3. -Passion of management team and employees
4. -Unique business model
5. -Internet domain name
6. -Inventing a new approach to an industry and executing the idea in an exemplary fashion

(See table 5.1 p.156 for more details)

**12. How can a start-up avoid or sidestep the pressure applied by one of the five forces on industry profitability by establishing a unique "position" in an industry?**

You have to establish a favorable position. For example see Panera Bread. People were tired of fast food but did not have the time to sit down in a restaurant. So Panera came up with a new category in the restaurant industry, "fast casual".

**13. Describe the characteristics of a fragmented industry. What is the primary opportunity for new firms in fragmented industries?**

A fragmented industry is one that is characterized by a large number of firms of approximately equal size.

The primary opportunity for start-ups in fragmented industries is to consolidate the industry and establish industry leadership as a result of doing so.

**14. Describe the characteristics of a mature industry. What is the primary opportunity for new firms in a mature industry?**

A mature industry is an industry that is experiencing slow or no increase in demand, has numerous repeat (rather than new) customers, and has limited product innovations.

Mature industries are huge with vast potential if product and/or process innovations can be effectively introduced and the industry revitalized. So the primary opportunity for new firms in this industry is to introduce new product innovations in order to surprise incumbents who thought nothing new was possible. Ex: launched soymilk in the milk market.

**15. What is a global industry? Describe the two most common strategies pursued by firms in global industries.**

A global industry is an industry that is experiencing significant international sales. The 2 most common strategies pursued by firms are:

-Multidomestic strategy: Firms compete for market share on a country-by-country basis and vary their product or service offerings to meet the demands of the local market.

-Global strategy: Firms use the same basic approach in all foreign markets.

**16. What is the purpose of a competitor analysis? Make your answer as complete as possible.**

It helps a firm understand the positions of its major competitors and the opportunities that are available to obtain a competitive advantage in one or more areas.

**17. Describe the differences between direct competitors, indirect competitors, and future competitors.**

-Direct competitors: These are businesses that offer products identical or similar to those of the firm completing the analysis \*Most important competitors

-Indirect competitors: These competitors offer close substitutes to the product the firm completing the analysis sells.

-Future competitors: These are companies that are not yet direct or indirect competitors but could move into one of these roles at any time.

**18. What is meant by the term *competitive intelligence*? Why is it important for firms to collect intelligence about their competitors?**

The information that is gathered by a firm to learn about its competitors is referred to as *competitive intelligence*.

It is important for firms to collect intelligence about their competitors because it will allow them to complete a meaningful competitive analysis grid. You have to know your competitors. The more you know, the better.

**19. Identify three sources of competitive intelligence.**

1. -Attend conferences and trade shows
2. -Purchase competitor's products
3. -Study competitors' Web sites
4. -Set up Google and Yahoo email alerts
5. -Read industry-related books, magazines, and web sites
6. -Talk to customers about what motivated them to buy your product as opposed to your competitor's product.

**20. What is the purpose of completing a competitive analysis grid?**

It can help a firm see how it stacks up against its competitors, provide ideas for markets to pursue, and, perhaps more importantly, identify its primary sources of competitive advantage. To be a viable company, a new venture must have at least one clear competitive advantage over its major competitors.

## CHAPTER 6 BUSINESS MODEL

### KEY TERMS

business concept blind spot, **191**  
business model, **180**  
business model innovation, **181**  
core competency, **192**  
core strategy, **189**  
cost leadership strategy, **192**  
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differentiation strategy, **192**  
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supply chain, **194**  
supply chain management, **194**  
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target market, **197**  
value chain, **186**

### REVIEW QUESTIONS

**1. Define the term *business model*. How can entrepreneurial firms benefit by developing and using a business model? What are the downsides for entrepreneurial ventures when an effective business model isn't put in place?**

A business model is a firm's plan or diagram for how it competes, uses its resources, structures its relationships, interfaces with customers, and creates value to sustain itself on the basis of the profits it earns.

The business model is like a guide that firms have.

When an effective business model is not put in place, your company can fail as was the case of WebHouse card where suppliers didn't want to participate.

**2. Explain what business model innovation means. Provide an example of business model innovation other than the examples included in the chapter.**

Business model innovation refers to a business model that revolutionizes how a product is produced, sold or supported after the sale.

Ex: Dell (in the book)... see figure 6.1

**3. List at least three reasons that demonstrate why having a business model is important.**

1. Serves as an ongoing extension of feasibility analysis (a business model continually asks the question, Does the business make sense?)
2. Focuses attention on how all the elements of a business fit together and how they constitute a working whole.
3. Describes why the network of participants needed to make a business idea viable is willing to work together.
4. Articulates a company's core logic to all stakeholders, including the firm's employees.

**4. Why did WebHouse's business model fail?**

WebHouse failed because its business model was flawed. The company just couldn't motivate its suppliers or customers to participate at a sufficient scale to support the overhead of the business.

**5. How does an understanding of the value chain help explain how business models emerge?**

The value chain helps us explain how business models emerge because the value chain help entrepreneurs use to identify opportunities in order to enhance their competitive strategies.

**6. What are the two fatal flaws that can render a business model untenable?**

Two fatal flaws can render a business model untenable from the beginning: a complete misread of the customer and utterly unsound economics. Business models that fall victim to one of these flaws have lost the race before leaving the starting gate.

**7. What are the four primary components of a firm's business model? Briefly describe the importance of each components.**

1. Core Strategy: Describes how a firm competes relative to its competitors. You should have a focused core strategy or else it can go wrong quickly.
2. Strategic Resources: A firm is not able to implement a strategy without adequate resources.
3. Partnership Network: Some ventures (especially new ones) do not have the resources to perform all the tasks required to make their business work, so they rely on partners to perform key roles.
4. Customer Interface: Especially for new ventures, the customer interface that it chooses is central to how it plans to compete and where it is located in the value chain of the products and services it provides.

**8. Describe what is meant by the term *core strategy* and why it is important.**

Core strategy describes how a firm competes relative to its competitors. It is important because it includes the firm's mission statement, the product/market scope, and the basis for differentiation. If not focused, things can go wrong quickly.

**9. Describe the purpose of a mission statement.**

A mission statement describes why the firm exists and what its business model is supposed to accomplish.

**10. What is meant by the term *business model blind spot*? Provide an original example of a firm that suffered as a result of having a business model blind spot.**

The business model blind spot prevents a firm from seeing an opportunity that might fit its business model.

Ex: Xerox viewed itself as a company that reproduced documents that already existed, causing the firm to be a late entrant into the market for computers printers, which print original documents stored electronically.

**11. What is a firm's product/market scope? Why is the concept of product/market scope important in regard to crafting a successful business model?**

A company's product/market scope defines the products and markets on which it will concentrate. It is important to a firm's business model because often the company has to evolve and will change their product/market scope. You must evolve your firm's product/market scope at the right time.

**12. Why is it important for firms to differentiate themselves from competitors?**

It is important because if a new firm's products or services aren't different from those of its competitors, why should anyone try them?

**13. In what ways does a focus on a cost leadership strategy lead to a very different business model than a focus on a differentiation strategy?**

The cost leadership strategy strives to have the lowest prices while the differentiation strategy strives to have a unique and different product. It may be hard for new ventures to use that strategy because it requires economies of scale.

**14. Define the term *core competency* and describe why it's important for a firm to have one or more core competencies help shape its business model?**

A core competency is a resource or capability that serves as a source of a firm's competitive advantage over its rivals.

By have a core competency, you have a competitive advantage over your rivals so the more you have the better.

**15. What is meant by the term *resource leverage*? How does an understanding of this term help a firm exploit new product or service opportunities?**

The process of adapting a company's core competencies to exploit new opportunities is referred to as resource leverage.

By understanding this, a firm might decide to move or adapt their core competencies towards another product that is profitable or should be in the future.

**16. What is meant by the term *strategic asset*? Provide examples of the strategic assets of three well-known firms.**

Strategic assets are anything rare and valuable that a firm owns. They include plant and equipment, location, brands, patents, customer data, a highly qualified staff, and distinctive partnerships.

Ex: Starbucks à brand

Walmart à distribution channels

Apple à brand, innovation (R&D staff)

**17. Why do firms typically need partners to make their business models work?**

Because the firms do not have the required resources to perform all the tasks their business model require. For example, Dell relies on UPS and FedEx to deliver its products.

**18. What is meant by the term *supply chain management*?**

Supply chain management is the coordination of the flow of all information, money, and material that moves through a product's supply chain.

**19. What is meant by the term *customer interface*? Explain how Dell and Hewlett-Packard differ from each other on this core dimension.**

Customer interface is how a firm interacts with its customers.

Dell interacts with the customers via phone and Internet.

Hewlett-Packard interacts with retailer who then interact directly with the customer.

**20. Describe the impact of a firm's pricing structure on its business model.**

Pricing is a way for firm's to differentiate themselves.

**\*CHAPTER 4\*  
BUSINESS PLAN**

**KEY TERMS**

assumptions sheet, **131**

board of advisers, **130**

board of directors, **130**

business plan, **112**

competitor analysis, **124**

contribution margin, **126**

costs of goods sold, **126**

executive summary, **122**

fixed costs, **127**

full business plan, **118**

market analysis, **124**

market segmentation, **124**

marketing strategy, **127**

milestone, **124**

mission statement, **123**

operating leverage, **127**

operational business plan, **118**

organizational chart, **130**

position, **124**

pro forma (or projected) financial statements, **131**

product prototype, **128**

ratio analysis, **131**

service prototype, **128**

sources and uses of funds statement, **131**

summary business plan, **118**

tagline, **123**

variable costs, **127**

virtual prototype, **128**

**REVIEW QUESTIONS**

**1. What is a business plan?**

A business plan is a written narrative, typically 25 to 35 pages long, that describes what a new business intends to accomplish and how it intends to accomplish it. For most new ventures, the

business plan is a dual-purpose document used both inside and outside the firm.

Inside the firm, the plan helps the company develop a “road map” to follow to execute its strategies and plans.

Outside the firm, it introduces potential investors and other stakeholders to the business opportunity the firm is pursuing and how it plans to pursue it.

**What are the advantages of preparing a business plan for a new venture? Explain your answer.**

One academic study found that potential entrepreneurs who completed a business plan were six

times more likely to start a business than individuals who did not complete a business plan.

**2. When is the appropriate time to write a business plan?**

-The time to write a business plan is midway through the step of the entrepreneurial process titled “Developing Successful Business Ideas.”

-It is a mistake to write a business plan too early.

-The business plan must be substantive enough and have sufficient details about the merits of the new venture to convince the reader that the new business is exciting and should receive support.

-Much of this detail is accumulated in the feasibility analysis stage of investigating the merits of a potential new venture.

**3. What are the two primary reasons for writing a business plan?**

1. INTERNAL REASON: Writing a business plan forces a firm’s founders to systematically think through each aspect of their new venture.

2. EXTERNAL REASON: It creates a selling document for a company. It provides a mechanism for a young company to present itself to potential investors, suppliers, business partners, key job candidates, and others.

**4. A business plan is often called a selling document for a new company. In what ways does a business plan provide a mechanism for a young company to present itself to potential investors, suppliers, business partners, and key job candidates?**

-The entrepreneur who has a business plan can not only provides detailed information about the venture but also suggests that he has thought through each element of the business and is committed enough to the new venture to invest the time and energy necessary to prepare the plan. Having a business plan also gives an investor something to react to.

-Very few, if any, investors will free up time to “listen” to your idea for a new business, at least initially. Investors prefer to vet or evaluate business ideas by looking through business plans (or the executive summaries of business plans) initially before they are willing to invest more of their time and effort.

**5. It is often argued that the process of writing a business plan is as important as the plan itself, particularly for the top management team of a young firm. How is this so?**

Writing a business plan forces a business’s founders to systematically think through every aspect of their business and develop a concrete blueprint to follow.

**6. Who reads the business plan and what are they looking for?**

A Firm’s Employees

-A clearly written business plan, which articulates the vision and future plans of a firm, is important for both the management

team and the rank-and-file employees.

-The availability of a formal business plan that talks about all aspects of the business and the business's future strategies and goals can help you make sure that what you're doing is consistent with the overall plans and direction of the firm.

#### Investors and Other External Stakeholders

-External stakeholders who are being recruited to join a firm such as investors, potential business partners, and key employees are the second audience for a business plan.

-To appeal to this group, the business plan must be realistic and not reflective of overconfidence on the firm's part.

-A business plan should disclose all resource limitations that the business must meet before it is ready to start earning revenues.

#### **7. Why is it necessary for a business plan to be realistic? How will investors typically react if they think a business plan is based on estimates and predictions rather than on careful thinking and facts? Where can entrepreneurs obtain facts to substantiate their business plans?**

-A firm must validate the feasibility of its business idea and have a good understanding of its competitive environment prior to presenting its business plan to others.

-Sophisticated investors, potential business partners, and key recruits will base their assessment of the future prospects of a business on facts, not guesswork or platitudes, as emphasized in Chapter 3.

-The most compelling facts a company can provide in its business plan are the results of its own feasibility analysis and the articulation of a distinctive and competitive business model.

-A business plan rings hollow if it is based strictly on an entrepreneur's predictions of a business's future prospects.

#### **8. Why is it important for a business plan to follow a conventional structure rather than be highly innovative and creative?**

-To make the best impression, a business plan should follow a conventional structure, such as the outline shown in the next section.

-Although some entrepreneurs want to demonstrate creativity in everything they do, departing from the basic structure of the conventional business plan format is usually a mistake.

-Typically, investors are very busy people and want a plan where they can easily find critical information.

-If an investor has to hunt for something because it is in an unusual place or just isn't there, he or she might simply give up and move on to the next plan.

#### **9. What are the differences among a summary business plan, a full business plan, and an operational business plan?**

Summary Business Plan: 10–15 pages, Works best for new ventures in the early stages of development that want to “test the waters” to see if investors are interested in their idea.

Full Business Plan: 25–35 pages, Works best for new ventures that are at the point where they need funding or financing; serves as a “blueprint” for the company's operations.

Operational Business Plan: 40–100 pages, Is meant primarily for an internal audience; works best as a tool for creating a blueprint for a new venture's operations and providing guidance to operational managers.

#### **10. Why should the executive summary, which is one of the first things that appears in a business plan, be written last?**

-The plan itself will evolve as it's written, so not everything is known at the outset.

-In addition, if you write the executive summary first, you run the risk of trying to write a plan that fits the executive summary rather than thinking through each piece of the plan independently

**11.What is the difference between the industry analysis and the market analysis sections of a business plan?**

-The market analysis is distinctly different than the industry analysis.

-Whereas the industry analysis focuses on the industry that a firm will participate in (i.e., toy industry, software industry, men's clothing industry), the market analysis breaks the industry into segments and zeroes in on the specific segment (or target market) to which the firm will try to appeal.

**12.What is the difference between a concentrated and a fragmented industry? What type of industry is usually more open to new firms?**

Industry structure refers to how concentrated or fragmented an industry is. Fragmented industries are more receptive to new entrants than industries that are dominated by a handful of large firms.

**13.What is the purpose of “The Economics of the Business” section of a business plan?**

It addresses the basic logic of how profits are earned in the business and how many units of a business's product or service must be sold for the business to “break even” and then start earning a profit.

**14.If you're developing a completely new product or service, what type of information should you include in your business plan regarding the status of the development efforts?**

-If you're developing a completely new product or service, you need to include a section in your business plan that focuses on the status of your development efforts. (Product or Service Design and Development Plan)

-You should describe specifically the point that your product or service is at and provide a timeline that describes the remaining steps.

-If you are in the very early stages of your business and only have an idea, you should carefully explain how a prototype, which is the first physical depiction of a new product or service, will be produced.

-A section labeled “Challenges and Risks” should be included and disclose any major anticipated design and development challenges and risks that will be involved in bringing the product or service to market.

-A final section should describe any patents, trademarks, copyrights, or trade secrets that you have secured or plan to secure relative to the products or services you are developing. If your start-up is still in the early stages and you have not taken action on intellectual property issues yet, you should get legal advice so you can, at a minimum, discuss your plans in these areas.

**15.What is the purpose of the “Operations Plan” section of a business plan?**

The operations plan section of the business plan outlines how your business will be run and how your product or service will be produced.

**16.Why is the “Management Team and Company Structure” section of a business plan often touted as one of the most important sections?**

Many investors and others who read business plans look first at the executive summary and then go directly to the management team section to assess the strength of the people starting the firm. Investors read more business plans with interesting ideas and exciting

markets than they are able to finance. As a result, it's often not the idea or market that wins funding among competing plans, but the perception that one management team is better prepared to execute their idea than the others.

**17. What is the purpose of a sources and uses of funds statement?**

The first thing to include is a sources and uses of funds statement, which is a document that lays out specifically how much money a firm needs (if the intention of the business plan is to raise money), where the money will come from, and what the money will be used for.

**18. What is the purpose of an assumptions sheet? Why is it important to include an assumptions sheet in a business plan's financial section?**

-It is the explanation of the most critical assumptions that your financial statements are based on.

-The importance of identifying the most critical assumptions that a business is based on and thoroughly vetting the assumptions is illustrated in the "What Went Wrong" feature. StyleHop, the company that is the focus of the feature, failed largely because it neglected to plan and at least one of the key assumptions that business was based upon turned out to be incorrect.

**19. What are the differences between historical financial statements and pro forma financial statements?**

-The pro forma (or projected) financial statements are the heart of the financial section of a business plan.

-A firm's pro forma financial statements are similar to the historical statements an established firm prepares, except they look forward rather than track the past.

-Pro forma financial statements include the pro forma income statement, the pro forma balance sheet, and the pro forma cash flow statement. They are usually prepared in this order because information flows logically from one to the next.

**20. What is the number one rule in making an investor presentation?**

-The first rule in making an oral presentation is to follow instructions. If an investor tells an entrepreneur that he or she has one hour and that the hour will consist of a 20-minute presentation and a 40-minute question-and-answer period, the presentation shouldn't last more than 20 minutes.

## CHAPTER 9

### BUILDING AN ENTREPRENEURIAL TEAM

#### KEY TERMS

advisory board, **302**  
board of directors, **300**  
consultant, **306**  
founding team, **292**  
heterogeneous, **294**  
homogeneous, **294**  
inside director, **300**  
liability of newness, **291**

networking, **296**  
new-venture  
team, **290**  
outside director, **300**  
prior entrepreneurial experience, **295**  
relevant industry experience, **295**  
signaling, **301**  
skills profile, **296**

#### REVIEW QUESTIONS

**1. What is a new-venture team? Who are the primary participants in a start-up's new-venture team?**

A new-venture team is the group of founders, key employees, and advisers that move a new venture from an idea to a fully functioning firm.

## **2. What is liability of newness? What can a new venture do to overcome the liability of newness?**

Liability of newness, which refers to the fact that companies often falter because the people who start them aren't able to adjust quickly enough to their new roles and because the firm lacks a "track record" with outside buyers and suppliers.<sup>3</sup> Assembling a talented and experienced new-venture team is one path firms can take to overcome these limitations.

Another way entrepreneurs overcome the liability of newness is by attending entrepreneurship-focused workshops, speaker series, boot camps, and similar events. These types of activities are often sponsored by local universities, small business development centers, and economic development commissions.

## **3. Do new ventures started by a team have an advantage over new ventures started by a sole entrepreneur, or is the opposite the case?**

Teams bring more talent, resources, ideas, and professional contacts to a new venture than does a sole entrepreneur.

## **4. Describe the difference between a heterogeneous and a homogeneous founding team.**

If the members of the team are heterogeneous, meaning that they are diverse in terms of their abilities and experiences, rather than homogeneous, meaning that their areas of expertise are very similar to one another, they are likely to have different points of view about technology, hiring decisions, competitive tactics, and other important activities. Typically, these different points of view generate debate and constructive conflict among the founders, reducing the likelihood that decisions will be made in haste or without the airing of alternative points of view.

## **5. Describe the two potential pitfalls of using a team to start a firm.**

First, the team members may not get along.

This is the reason investors favor teams consisting of people who have worked together before. It is simply more likely that people who have gotten along with one another in the past will continue to get along in the future.

Second, if two or more people start a firm as "equals," conflicts can arise when the firm needs to establish a formal structure and designate one person as the chief executive officer (CEO). If the firm has investors, the investors will usually weigh in on who should be appointed CEO. In these instances, it is easy for the founder that wasn't chosen as the CEO to feel slighted. This problem is exacerbated if multiple founders are involved and they all stay with the firm.

## **6. What are the personal attributes that affect a founder's chances of launching a successful new firm? In your judgment, which of these attributes are the most important? Why?**

Level of education, prior entrepreneurial experience, relevance to the industry and networking skills.

## **7. Explain why having relevant industry experience helps the founder of a firm.**

Entrepreneurs with experience in the same industry as their current venture will have a more mature network of industry contacts and will have a better understanding of the subtleties of their respective industries. The importance of this factor is particularly evident for entrepreneurs who start firms in technical industries such as biotechnology.

## **8. Define *networking*. Why is it important for an entrepreneur to have a vibrant social and professional network?**

Founders must often "work" their social and personal networks to raise money or gain access to critical resources on behalf of their firms. Networking is building and maintaining

relationships with people whose interests are similar or whose relationship could bring advantages to a firm. The way this might play out in practice is that a founder calls a business acquaintance or friend to ask for an introduction to a potential investor, business partner, or customer.

**9. What are the reasons for completing a skills profile for a new firm?**

To help prioritize their hiring needs a skills profile is a chart that depicts the most important skills that are needed and where skills gaps exist.

**10. What is a board of directors? What is the difference between inside and outside directors?**

If a new venture organizes as a corporation, it is legally required to have a board of directors—a panel of individuals who are elected by a corporation’s shareholders to oversee the management of the firm.

An inside director is a person who is also an officer of the firm.

An outside director is someone who is not employed by the firm.

**11. Describe the three formal responsibilities of a board of directors.**

(1) appoint the firm’s officers (the key managers),

(2) declare dividends, and

(3) oversee the affairs of the corporation.

**12. Explain why recruiting a well-known and highly respected board of directors lends legitimacy to a firm. and 13. Define *signaling* and explain its potential value for a new venture.**

Well-known and respected board members bring instant credibility to the firm. For example, just imagine the positive buzz a firm could generate if it could say that Jack Dorsey of Twitter or Mark Pincus of Zynga had agreed to serve on its board of directors.

This phenomenon is referred to as signaling. Without a credible signal, it is difficult for potential customers, investors, or employees to identify high-quality start-ups. Presumably, high-quality individuals would be reluctant to serve on the board of a low-quality firm because that would put their reputation at risk. So when a high-quality individual does agree to serve on a board of a firm, the individual is in essence “signaling” that the company has potential to be successful

Achieving legitimacy through high-quality board members can result in other positive outcomes. Investors like to see new-venture teams, including the board of directors that have people with enough clout to get their foot in the door with potential suppliers and customers. Board members are also often instrumental in helping young firms arrange financing or funding.

**14. Discuss the purpose of forming an advisory board. If you were the founder of an entrepreneurial firm, would you set up an advisory board? Why or why not?**

An advisory board is a panel of experts who are asked by a firm’s managers to provide counsel and advice on an ongoing basis. the main purpose of a board of advisers is to provide guidance and lend legitimacy to a firm.

**15. Describe the different ways advisory boards meet and conduct their business.**

Boards of advisers interact with each other and with a firm’s managers in several ways. Some advisory boards meet three or four times a year at the company’s headquarters or in another location. Other advisory boards meet in an online environment.

In some cases, a firm’s board of advisers will be scattered across the country, making it more cost-effective for a firm’s managers to interact with the members of the board on the telephone or via e-mail rather than to bring them physically together. In these situations, board members don’t interact with each other at all on a face-to-face basis, yet still provide high levels of counsel and advice

**16. Describe several of the guidelines to setting up a board of advisers.**

First, a board of advisers should not be organized just so a company can boast of it. Advisers will become quickly disillusioned if they don't play a meaningful role in the firm's development and growth. Second, a firm should look for board members who are compatible and complement one another in terms of experience and expertise. Unless the board is being established for a specific purpose, a board that includes members with varying backgrounds is preferable to a board of people with similar backgrounds. Third, when inviting a person to serve on its board of advisers, a company should carefully spell out to the individual the rules in terms of access to confidential information. Some firms ask the members of their advisory board to sign nondisclosure agreements.

Finally, firms should caution their advisers to disclose that they have a relationship with the venture before posting positive comments about it or its products on blogs or on social networking sites.

**17. In what ways do lenders and investors lend legitimacy to a firm?**

As with the other nonemployee members of a firm's new-venture team, lenders and investors help new firms by providing guidance and lending legitimacy and assume the natural role of providing financial oversight.

In some instances, lenders and investors also work hard to help new firms fill out their management teams. Sometimes this issue is so important that a new venture will try to obtain investment capital not only to get access to money, but also to obtain help hiring key employees.

**18. Explain why new ventures often turn to consultants for advice.**

Those leading an entrepreneurial venture often turn to consultants for help and advice because while large firms can afford to employ experts in many areas, new firms typically can't.

**19. Describe the purpose of SCORE. What type of advice and counsel do SCORE volunteers provide?**

SCORE is a nonprofit organization that provides free consulting. SCORE mentors are retired business owners who counsel in areas as diverse as cash flow management, operations, and sales.

**20. As noted in the chapter, SBDCs (Small Business Development Centers) seem to contribute positively to the launch of an entrepreneurial venture. In your opinion, what accounts for this positive relationship? If you were launching an entrepreneurial venture today, would you seek the services of an SBDC? Why or why not?**

SBDC allow small businesses and startup to have access to a wide range of resources and counsel that larger firms usually pay a lot of money for. It enables startups to start with a solid foundation.

**CHAPTER 10  
FINANCING**

**KEY TERMS**

7(A) Loan Guaranty Program, **338**  
bootstrapping, **324**  
burn rate, **321**  
business angels, **329**  
carry, **331**  
corporate venture capital, **333**  
crowdfunding, **338**  
debt financing, **325**

due diligence, **333**  
elevator speech (or pitch), **326**  
equity financing, **325**  
factoring, **338**  
fast-track programs, **340**  
final prospectus, **335**  
follow-on funding, **333**  
general partners, **331**  
initial public offering (IPO), **335**

investment bank, **335**  
lease, **339**  
limited partners, **331**  
line of credit, **336**  
liquidity event, **325**  
peer-to-peer lending, **338**  
preliminary prospectus, **335**  
private placement, **336**  
road show, **335**  
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Sarbanes-Oxley Act, **335**  
SBA Guaranteed Loan Program, **338**  
SBIR Program, **340**  
secondary market offering, **335**  
single-purpose loan, **336**  
STTR Program, **341**  
sweat equity, **323**  
vendor credit, **338**  
venture capital, **330**  
venture-leasing firms, **339**

## REVIEW QUESTIONS

### 1. What are the three most common reasons most entrepreneurial ventures need to raise money in their early life?

There are three reasons that most entrepreneurial ventures need to raise money during their early life: cash flow challenges, capital investments, and lengthy product development cycles. (p.321)

1. Cash Flow Challenges: Inventory must be purchased, employees must be trained and paid, and advertising must be paid for before cash is generated from sales.
2. Capital Investments: The cost of buying real estate, building facilities, and purchasing equipment typically exceeds a firm's ability to provide funds for these needs on its own.
3. Lengthy Product Development Cycles: Some products are under development for years before they generate earnings. The up-front costs often exceed a firm's ability to fund these activities on its own.

### 2. What is meant by the term *burn rate*?

A company's **burn rate** is the rate at which it is spending its capital until it reaches profitability.

### What are the consequences of experiencing a negative burn rate for a relatively long period of time?

Although a negative cash flow is sometimes justified early in a firm's life—to build plants and buy equipment, train employees, and establish its brand—it can cause severe complications. A firm usually fails if it burns through all its capital before it becomes profitable. This is why inadequate financial resources is a primary reason new firms fail.

### 3. What is meant by the term *sweat equity*?

**Sweat equity** represents the value of the time and effort that a founder puts into a new venture. Because many founders do not have a substantial amount of cash to put into their ventures, it is often the sweat equity that makes the most difference.

### 4. To what extent do entrepreneurs rely on their personal funds and funds from friends and families to finance their ventures?

Friends and family are the second source of funds for many new ventures. This type of contribution often comes in the form of loans or investments, but can also involve outright gifts, foregone or delayed compensation (if a friend or family member works for the new venture), or reduced or free rent.

### What are the three rules of thumb that a business owner should follow when asking friends and family members for start-up funds?

There are three rules of thumb that entrepreneurs should follow when asking friends and family members for money.

1. **First**, the request should be presented in a businesslike manner, just like one would deal with a banker or investor. The potential of the business along with the risks involved should be carefully and fully described.
2. **Second**, if the help the entrepreneur receives is in the form of a loan, a promissory note should be prepared, with a repayment schedule, and the note should be signed by both parties. Stipulating the terms of the loan in writing reduces the potential of a misunderstanding and protects both the entrepreneur and the friend or family member providing the funding.
3. **Third**, financial help should be requested only from those who are in a legitimate position to offer assistance. It's not a good idea to ask certain friends or family members, regardless of how much they may have expressed a willingness to help, for assistance if losing the money would cripple them financially. Entrepreneurs who are unable to repay a loan to a friend or family member risk not only damaging their business relationship with them, but their personal relationship as well.

**5. What is bootstrapping? Provide several examples of how entrepreneurs bootstrap to raise money or cut costs. In your judgment, how important is the art of bootstrapping for an entrepreneurial venture?**

Bootstrapping is a third source of seed money for new ventures. Bootstrapping is finding ways to avoid the need for external financing or funding through creativity, ingenuity, thriftiness, cost-cutting, or any means necessary.

**TABLE 10.1 EXAMPLES OF BOOTSTRAPPING METHODS**

- Buy used instead of new equipment
- Coordinate purchases with other businesses
- Lease equipment instead of buying
- Obtain payments in advance from customers
- Minimize personal expenses
- Avoid unnecessary expenses, such as lavish office space or furniture
- Buy items cheaply, but prudently, through discount outlets or online auctions such as eBay,
- rather than at full-price stores
- Share office space or employees with other businesses
- Hire interns

**6. Describe the three steps involved in properly preparing to raise debt or equity financing.**

Step 1 Determine precisely how much money the company needs

Constructing and analyzing documented cash flow statements and projections for needed capital expenditures are actions taken to complete this step.

Step 2 Determine the most appropriate type of financing or funding

Equity and debt financing are the two most common alternatives for raising money.

Step 3 Developing a strategy for engaging potential investors or bankers

There are three steps to developing a strategy for engaging potential investors or bankers.

- 1) **First**, the lead entrepreneurs in a new venture should prepare an elevator speech (or pitch) —a brief, carefully constructed statement that outlines the merits of a business opportunity.

- 2) **The second step** in developing a strategy for engaging potential investors or bankers is more deliberate and requires identifying and contacting the best prospects.
- 3) **The third step** in engaging potential investors or bankers is to be prepared to provide the investor or banker a completed business plan and make a presentation of the plan if requested.

**7. Briefly describe the difference between equity funding and debt financing.**

**Equity financing (or funding)** means exchanging partial ownership of a firm usually in the form of stock for funding in return. The money received from an equity investor doesn't have to be paid back. The investor receives a return on the investment through dividend payments and by selling the stock.

Advantage +	Access to capital
Disadvantage -	The primary disadvantage of equity funding is that the firm's owners relinquish part of their ownership interest and may lose some control.

**Debt financing** is getting a loan.

Advantage +	<ol style="list-style-type: none"> <li>1. None of the ownership of the firm is surrendered</li> <li>2. Interest payments on a loan are tax deductible in contrast to dividend payments made to investors, which aren't.</li> </ol>
Disadvantage -	<ol style="list-style-type: none"> <li>1. Must be repaid, which may be difficult in a start-up venture in which the entrepreneur is focused on getting the company off the ground. Cash is typically "tight" during a new venture's first few months and sometimes for a year or more.</li> <li>2. The second is that lenders often impose strict conditions on loans and insist on ample collateral to fully protect their investment. Even if a start-up is incorporated, a lender may require that an entrepreneur's personal assets be collateralized as a condition of the loan.</li> </ol>

**8. Describe the most common sources of equity funding.**

The three most common forms are :

1. **Business angels :**  
Business angels are individuals who invest their personal capital directly in start-ups. Business angels are valuable because of their willingness to make relatively small investments.
2. **Venture Capital :**  
Venture capital is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential. Venture capital firms are limited partnerships of money managers who raise money in "funds" to invest in start-ups and growing firms.  
[A distinct difference between angel investors and venture capital firms is that angels tend to invest earlier in the life of a company, whereas venture capitalists come in later.]
3. **Initial public offering (IPO).**

An IPO is the first sale of stock by a firm to the public. When a company goes public, its stock is typically traded on one of the major stock exchanges.

### **9. Describe the most common sources of debt financing.**

The three common sources or categories of debt financing available to entrepreneurs are

1. Commercial Banks
2. SBA Guaranteed Loans

This program accounts for 90 percent of the SBA's loan activity. The program operates through private-sector lenders who provide loans that are guaranteed by the SBA. The loans are for small businesses that are unable to secure financing on reasonable terms through normal lending channels. The SBA does not currently have funding for direct loans, other than a program to fund direct loans for businesses in geographic areas that are hit by natural disasters.

Almost all small businesses are eligible to apply for an SBA guaranteed loan.

#### 3. Other Sources of Debt Financing

- **Vendor credit (also known as trade credit)** is when a vendor extends credit to a business in order to allow the business to buy its products and/or services up front but defer payment until later.
- **Factoring** is a hybrid method for obtaining cash. Not really debt financing per se, factoring is a financial transaction whereby a business sells its accounts receivable to a third party, called a factor, at a discount in exchange for cash.
- **Peer-to-peer lending** is a financial transaction that occurs directly between individuals or "peers." Prosper, which is the best known peer-to-peer lending network, is a Web site where individuals can buy loans and request to borrow money.

### **10. What is the purpose of an elevator speech?**

#### **Why is preparing an elevator speech one of the first things an entrepreneur should do in the process of raising money?**

The elevator speech is a very brief description of your opportunity, product idea, qualifications, and market. Imagine that you step into an elevator in a tall building and a potential investor is already there; you have about 60 seconds to explain your business idea.

There are many occasions when a carefully constructed elevator speech might come in handy. For example, many university-sponsored centers for entrepreneurship hold events that bring investors and entrepreneurs together. Often, these events include social hours and refreshment breaks designed specifically for the purpose of allowing entrepreneurs looking for funding to mingle with potential investors.

#### **11. Why is it so important to get a personal introduction before approaching a potential investor or banker?**

A cardinal rule for approaching a banker or an investor is to get a personal introduction. Bankers and investors receive many business plans, and most of them end up in what often becomes an unread stack of paper in a corner in their offices. To have your business plan noticed, find someone who knows the banker or the investor and ask for an introduction.

#### **12. Describe the three steps required to effectively engage potential investors or bankers.**

1. First, the lead entrepreneurs in a new venture should prepare an elevator speech (or pitch)
2. The second step, the new venture should carefully assess the type of financing or funding it is likely to qualify for

3. The third step in engaging potential investors or bankers is to be prepared to provide the investor or banker a completed business plan and make a presentation of the plan if requested.

**13. Identify the three most common forms of equity funding.**

The three most common forms are :

1) Business angels :

Business angels are individuals who invest their personal capital directly in start-ups. Business angels are valuable because of their willingness to make relatively small investments.

2) Venture Capital :

Venture capital is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential. Venture capital firms are limited partnerships of money managers who raise money in “funds” to invest in start-ups and growing firms.

[A distinct difference between angel investors and venture capital firms is that angels tend to invest earlier in the life of a company, whereas venture capitalists come in later.]

3) Initial public offering (IPO).

An IPO is the first sale of stock by a firm to the public. When a company goes public, its stock is typically traded on one of the major stock exchanges.

**14. Describe the nature of business angel funding. What types of people typically become business angels, and what is the unique role that business angels play in the process of funding entrepreneurial firms?**

**Business angels are individuals who invest their personal capital directly in start-ups.**

The prototypical business angel, who invests in entrepreneurial start-ups, is about 50 years old, has high income and wealth, is well educated, has succeeded as an entrepreneur, and invests in companies that are in the region where he or she lives. These investors generally invest between \$10,000 and \$500,000 in a single company and are looking for companies that have the potential to grow 30 to 40 percent per year before they are acquired or go public.

Angels tend to invest earlier in the life of a company, whereas venture capitalists come in later.

**15. Describe what is meant by the term *venture capital*. Where do venture capital firms get their money? What types of firms do venture capitalists commonly want to fund? Why?**

Venture capital is money that is invested by venture capital firms in start-ups and small businesses with exceptional growth potential.

Venture capital firms are limited partnerships of money managers who raise money in “funds” to invest in start-ups and growing firms. The funds, or pools of money, are raised from high net worth individuals, pension plans, university endowments, foreign investors, and similar sources. The investors who invest in venture capital funds are called limited partners . The venture

capitalists, who manage the fund, are called general partners .

Venture capitalists fund very few entrepreneurial ventures in comparison to business angels and relative to the number of firms seeking funding because Venture capitalists know that they are making risky investments and that some of them will not be successful.

**16. Describe the purpose of an initial public offering (IPO). Why is an initial public offering considered to be an important milestone for an entrepreneurial firm?**

An initial public offering (IPO) is an important milestone for a firm for four reasons:

1. It is a way to raise equity capital,
2. it raises a firm's public profile
3. it is a liquidity event
4. it creates another form of currency (company stock) that can be used to grow the company.

**17. What is the purpose of the investment bank in the initial public offering process?**

The first step in initiating a public offering is for a firm to hire an investment bank. An investment bank is an institution that acts as an underwriter or agent for a firm issuing securities.<sup>36</sup> The investment bank acts as the firm's advocate and adviser and walks it through the process of going public. The most important issues the firm and its investment bank must agree on are the amount of capital needed by the firm, the type of stock to be issued, the price of the stock when it goes public (e.g., \$20 per share), and the cost to the firm to issue the securities.

**18. In general, why are commercial banks reluctant to loan money to start-ups?**

There are two reasons that banks have historically been reluctant to lend money to start-ups.

1. First, as mentioned previously, banks are risk averse. In addition, banks frequently have internal controls and regulatory restrictions prohibiting them from making high-risk loans. So when an entrepreneur approaches a banker with a request for a \$250,000 loan and the only collateral he or she has to offer is the recognition of a problem that needs to be solved, a plan to solve it, and perhaps some intellectual property, there is usually no practical way for the bank to help. Banks typically have standards that guide their lending, such as minimum debt-to-equity ratios that work against start-up entrepreneurs.
2. The second reason banks have historically been reluctant to lend money to start-ups is that lending to small firms is not as profitable as lending to large firms, which have historically been the staple clients of commercial banks. If an entrepreneur approaches a banker with a request for a \$50,000 loan, it may simply not be worth the banker's time to complete the due diligence necessary to determine the entrepreneur's risk profile.

**19. Briefly describe the SBA's 7(A) Loan Guaranty Program. Do most start-up firms qualify for an SBA guaranteed loan? Why or why not?**

Definition : 7(A) loan guaranty program. The main Small Business Administration (SBA) program available to small businesses operating through private sector lenders providing loans that are guaranteed by the SBA. The loan guarantees reserved for small businesses that are unable to secure financing through normal lending channels.

**Almost all small businesses are eligible to apply for an SBA guaranteed loan.** The SBA can guarantee as much as 75 percent (debt to equity) on loans up to \$5 million. For loans of \$150,000 or under, the guaranteed amount is 85 percent. Guaranteed loan funds can be used for almost any legitimate business purpose. The maximum length of the loans are 10 years for working capital, 10 years for equipment (or useful life of equipment), and 25 years for real estate purchase. To obtain an SBA guaranteed loan, an application must meet the requirements of both the SBA and the lender.<sup>41</sup> Typically, individuals must pledge all of their assets to secure the loan.

**20. What is a Small Business Innovation Research (SBIR) grant? Why would a firm want to apply for such a grant if it so qualified?**

The SBIR Program is a competitive grant program that provides over \$1 billion per year to small businesses for early stage and development projects. Each year, 11 federal

departments and agencies are required by the SBIR to reserve a portion of their research and development funds for awards to small businesses.

The money is essentially free. It is a grant, meaning that it doesn't have to be paid back and no equity in the firm is at stake. The recipient of the grant also retains the rights to the intellectual property developed while working with the support provided by the grant.