Growing Concerns

Topics of particular interest to owners and managers of smaller businesses

Realistic criteria for judging new ventures

New ventures are extremely prone to failure in their early years. What can entrepreneurs do to reduce this likelihood? Perhaps the most important thing they can do is be more hard-nosed in evaluating their ideas than they are prone to be. Doing that effectively involves using objective criteria to assess the advantages and disadvantages of proposed businesses. In this Growing Concerns article, the author describes a number of criteria in the areas of marketing, new product viability, and projected profitability that entrepreneurs can use to evaluate a new venture.

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The notion of starting a business can be quite alluring, conjuring up images of independence, glory, fame, and riches. Such emotionally uplifting images make it quite easy to be overly optimistic or even totally unrealistic in assessing markets, products, profits, and other aspects of a new venture.

This article is not meant to discourage budding entrepreneurs, but rather to identify the factors necessary for new business success that need objective assessment the most. These factors, in my experience, tend to get short shrift from would-be and even experienced entrepreneurs. Potential owners can evaluate these factors by considering certain basic questions:

1. What kind of business, in an economic sense, will be created?
2. What will be the size of the business’s market?
3. How marketable is the product that will be sold?
4. Are the start-up costs commensurate with the long-term prospects of the business?
5. What will be the relationship between profitability and price in the new business?
6. Can the business be easily explained to potential investors?
7. What mechanism exists for investors to cash in their chips and get out of the business?

The ‘Mom and Pop’ business

A new business can evolve into one of two essential types: the “Mom and Pop” variety or the “other” type, which has functional management. This distinction is particularly important in screening an idea for a new business because you devote all your time and energy to that business, irrespective of whether it is the first or second type.

A Mom and Pop type of business does not have to be the familiar example of a hardware store or gas station; it could be any type of business in which, as the bankers say, “When the president goes home, the business goes home.”

Such a business frequently starts as an effort by the entrepreneur to “buy” a job. More often than not, the entrepreneur uses his or her own money to start the venture. How rational is this approach? It depends on the size of the salary from the job that is bought. If all the future owner gets out of the business is a salary comparable to what he or she could earn in an alternative situation, then an “opportunity cost” may be involved in terms of what the investment could return if placed in another business or investment medium.

For instance, an entrepreneur might invest $300,000 in a start-up business permitting a salary of $80,000 a year. A salary of $80,000 for the president of a manufacturing company with $1 million to $3 million in annual sales—which is what one might

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In one instance, an individual wanted to start a company to distribute a product made overseas that would have particular interest to "one telephone" businesses. When I asked how many such businesses there were in the United States, he enthusiastically reported that there were about 300,000. When we started talking about the percentage of companies that might buy this wonderful invention, the numbers shrank in a hurry.

The real clincher came when we multiplied the selling price (to the new company) by this aggregate market. We were now talking about total potential sales of about $4 million to $5 million. These were not just sales for the first year, but total sales of the product. The entrepreneur's bubbling enthusiasm quickly turned to dismay. Clearly the market size was insufficient to warrant starting a new venture.

At the other extreme is what I will call the "1% syndrome." In this situation, a prospective business owner starts a venture on the
premise that, "If we sell only 1% of the potential market, we'll be a big success." How inviting this sounds! Why waste time doing fundamental market research when, to be a success, all the business has to do is sell to this tiny percentage of possible buyers? But what if even this 1% of potential customers won't buy the product or service?

Take the case of a person who wanted to start a magazine to be sold at professional sports arenas. He pleaded earnestly, "Surely at least 1% of the people going to the games would buy this magazine." But that depended on how the magazine was sold (or perhaps not sold) at the stadium. The point is that it is unreasonable to assume any percentage the potential market will buy without doing some research first.

Potential market size can also be too big. In this situation, if an entrepreneur starts a venture and thus leads the way into a substantial new market, much larger competitors can then quickly move in and swamp the upstart business.

For example, an inventor wanted to start his own company, producing a device that would allow a typewriter to transmit data over telephone lines. The product, as discussed, did not seem to have any special patent protection. When I asked the inventor about the market, he replied that it was "huge." When I asked about current or future competition, he named the corporate giants in the business equipment industry. But if this were the case, what chance would this little company have?

Before the reader takes me to task on this point, I am quite aware of the success that Digital Equipment Corporation and Amdahl Corporation have had competing head to head with IBM. But in each case, the companies had done sound research to clearly delineate the market niche or were aware of a managerial "lag" that permitted the new venture to obtain a special place in the market.

Thus the aspiring entrepreneur should not brush aside market size; he or she should do some market research for any new business before making a major investment.

Is one product enough?

Along with attempting to determine potential market size, entrepreneurs must carefully evaluate the product or products that they propose to sell.

First and foremost, future business owners should give consideration to the number of products they intend to sell. One-product businesses usually get started to produce some invention and, possibly, to show the world how clever the inventor is. But one-product ventures tend to encounter technological problems—namely, they can be quickly rendered obsolete by competitors. Of course, if the product that represents a new company's entire line is of low technology, technological obsolescence is usually less likely than if the product is of high technology.

Preferable to trying to base a business on only one product is to sell several products. By multiple products I do not mean mere variations of the basic product. Instead, I mean products that can possibly be produced in the same manufacturing facility and probably by the same manufacturing process, but which are perceived as different products.

For example, a business that manufactures a novel line of lamps might have the facilities to make either a completely different type of lamp, in order to guard against both technological obsolescence and a shift in market taste, or a different product altogether that might fit in with the company's overall marketing strategy.

The would-be entrepreneur should consider the following three questions: First, what would happen to the new company if there were a technological breakthrough by the competition? Second, if being a one-product business seems to limit the potential sales and profits, what additional products could the venture produce to provide the hoped-for growth? Third, what sort of second-generation products would result from the first set of products?
Avoiding single-sale products

I recall one venture that was founded to sell tapes and books to hospitals. Experts in both audiovisual materials and technological science produced the materials that were to be used to train hospital staffs in specific subjects. The product was first rate in every sense. The potential market included every hospital in the country and, perhaps, in the world.

The new company started amidst much fanfare and excitement. Unfortunately, the owners didn’t realize that they had to make a substantial sales effort to sell each unit, and the price did not warrant the onerous effort involved.

As if this problem were not enough, another more devastating factor was at work: there were no repeat sales. It was not that the customers did not like the product, because they did; but each hospital needed only one item. If the product had been a computer or a sizable machine with a hefty selling price, then the lack of repeat orders would not have been a problem. But the total selling price—with all the frills and add-ons—was only several hundred dollars.

Much superior to a single sale product is one that produces add-on or repeat sales. If the customer is a manufacturer, then repeat orders for hundreds or thousands of units could develop in the years to come. If the potential customer is a major retailer (a Sears or Penney’s), distributor, or wholesaler, then one convincing sales talk might persuade it to take on the line of products and place endless future orders. (Be careful of this oneucer problem. Aside from possible marketing problems, a “concentration factor” in a company’s accounts receivable might convince banks to avoid financing such receivables.)

The future owner should view the business as a distributive network for products, so that the branches of the network not only remain after the sale but also grow stronger as the number of customers grows. This outlook entails a different philosophical conceptualization of the business than that held by the typical ambitious inventor, who is most likely thinking of (1) the product, and (2) how this marvelous product will make him or her rich.

Once a venture has a repeat customer, then it can sell additional products during the same sales call or broaden the catalog that the customer uses to make repeat orders. One of the most precious and valuable assets any business possesses is its customer list. A company that can keep the names on that list happy and even expand the list will itself grow. The more products that can be pumped through that customer pipeline, the more the company will grow.

Too simple a product

How can a product or service be too elementary? Looking at the countless examples of product ideas, one frequently wonders, “Gee, that’s so simple, why didn’t I think of it?”

Simplicity becomes a negative only if a business idea is so basic that little management or marketing expertise is required for success. After all, what is to prevent every Tom, Dick, and Harriet from duplicating your business if your venture looks successful?

An illustration of this problem is a recently proposed business that would sell a computer program of a file-and-retrieve system to help car dealers find needed cars in dealerships throughout a particular state. While the idea made sense as a product, it was the kind of thing almost any programmer could have written in a day or so.

If the entrepreneur got going with this program as a product, what was to prevent another business, or the regional representative of the car manufacturer, from duplicating the service and underselling the initial venture? “Oh, we’ll have such a head start, the others will never be able to catch us!” is the typical reply. This usually is a gross overstatement or an error. Even if the head start lets the new business get a beachhead, what happens when the competition comes charging—or flooding—in?

In & out of vogue

Finally, no product is less marketable than last year’s red hot idea. The list of once voguish ideas is long: athletic gyms, handheld calculators, certain computer software, recreational vehicles, and mobile home parks, to name a few. What matters, then, is that the current product idea is not out of vogue.

As simple as this principle seems to be, someone invariably comes along trying to sell last year’s pet rock and then wonders why it seems so difficult. If the entrepreneur is going to attempt business’s version of surfing, then he or she had better be up on the wave and not a little behind it.

Evaluating capital intensity

New businesses can vary widely in the amount of “sunk” costs that they might require. Starting certain businesses entails raising enormous sums of money to build a plant (such as John Z. de Lorean’s sports car factory in Northern Ireland), or to launch a satellite (COMSAT), or to buy a fleet of jet airplanes (Federal Express). For many individuals with considerably shorter track records than the entrepreneurs who started those companies, large initial capital outlays might greatly increase the potential losses.

Once a product is proven in the market and in other ways, investing large amounts of capital can make sense. But if a new business requires a sizable investment before finding out if the product will sell and, in turn, make for a profitable venture, I think that the potential owner and his or her financial backers ought to reconsider whether the reward is worth the gamble.

Entrepreneurs might also ask themselves if some way exists to reduce sunk costs. For instance, can production be subcontracted to someone who already has the facilities to

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make the product? In this way, they can reasonably prove the market demand before the expensive facilities are added.

The point is not that a start-up should involve only small amounts of money—this might guarantee failure. Rather, entrepreneurs should screen out ideas that require sizable “sunk” investments before they can be justified by sales performance.

Setting prices

The issue of basic profitability sinks many new ventures, either because the future owner failed to consider the issue or because he or she exaggerated potential profits to appear more attractive to venture capitalists. The most important aspect of basic profitability is gross profit, i.e., sales minus the cost of goods sold.

If a business is entering a new field, the profit expectations are likely to be quite different from the profit expectations of a business entering an established industry. The rule of thumb that some successful managers use for a venture making an innovative new product is a selling price of at least four to five times the cost of goods sold—in other words, a gross profit of 75% to 80% of sales.

The logic of pricing a product to attain this level of gross profits is rather clear. In the early going, the new venture will presumably not be able to supply the same quantity of product or service as later when capacity is larger. Therefore, a “skimming” pricing policy may be in order early on, while “penetration” pricing can be used when much larger sales are desired. After all, if a pricing structure results in a skinny gross profit before competition jumps in, what will happen to the gross profit after competing businesses invade the marketplace?

But how do you set the price of the product so as to return a minimum of 75% to 80% gross profits? Theoretically, both the price and production volume are based on market research. But with many start-up businesses, little or no money is usually available for market research to determine the optimal pricing structure.

Typically, a great amount of pure guesswork goes into the pricing strategy, which can lead to a fatal mistake—misleading yourself or others. When you make the pro-forma financial projections and the gross profits from the predetermined price-quantity expectations look a “little skinny,” the temptation is to say, “Oh, I’m sure we can sell just as many at a higher price.”

Selling price should have little or nothing to do with the cost of the product. Price should be the result of potential buyers’ perception that the product’s intrinsic value is equal to or greater than the asking price. It simply does not matter how much something costs to make (or, if a service, to deliver); the question is, how much will a customer pay, in the quantities specified? (Government contracts might be an exception.)

Many examples exist of products that are truly creative—but for which buyers are unwilling to pay the price that would make the product (and venture) an economic success. A superb stereo system for cars was so good that the quality actually went beyond the range of normal hearing. “Sure it costs more,” the management of the struggling stereo manufacturer said, “but it’s worth so much more!” Worth so much more to whom? The buyers didn’t perceive the product as worth “so much more”; in fact, they were unaware just how superior the product really was.

Another pricing pitfall to avoid is the “Cadillac syndrome.” Some aspiring entrepreneurs brush aside the vital price-volume problem and its relation to gross profit with the explanation that, “We’re the Cadillac of the field.” Building a business on a profitability structure that implies unreasonably high pricing may imply a market so small that the total dollar gross profit—even if a good percentage—sinks the business.

For many inventors who fall in love with their inventions, financial failure is often of secondary importance to artistic success (unless it is their money at stake). The fact that their product is on the market is, in itself, sufficient success.

Of profits squeezed

A venture need not be a producer of a new or innovative product to be a successful start-up. Many entrepreneurs start businesses to produce products or deliver services in established markets. But what about the profit structure existing in that market before the entry of the new venture?

In economics we speak of a “normal profit” as being the price-quantity structure that allows for sufficient profits to prevent companies in an industry from leaving but not high enough to induce businesses to enter the field. How many entrepreneurs are bright enough to know the difference, privy to the actual economic facts about this, or, frankly, even concerned enough to care?

The problems of trying to enter certain established markets are illustrated by a new business started several years ago in a specialty branch of the pump industry. The successful manager who started the venture unfortunately chose an industrial segment so competitive that typical gross profits in the industry were 18% to 20%. It’s hard enough to have a profitable manufacturing business with a skinny gross profit, but consider what would happen to the gross profit of the established companies when an additional venture squeezed into the marketplace. But hope springs eternal.

“Our company will be different,” the manager said.

The restaurant business in Southern California further illustrates this situation. Restaurant owners lament that the marketplace is so competitive that menus cannot be priced high enough to provide realistic profit levels. If someone has an idea for a new restaurant, the romance of the new idea is all too likely to overcome objectivity about future profitability.

Role of future profitability

Profitability is also important as it relates to the percentage of the venture that the future owner will
have to give to investors who will supply the start-up capital. How much of the new business should investors get if they put up all the money and the entrepreneur contributes his or her time and talents and the basic idea (product) for the venture? This is an age-old question for which there is no perfect answer.

Professional venture capitalists typically seek five to ten times their investment in five years. The following procedure might be used to divide the new company's stock ownership:

First, agree on some sort of multiple (price-earnings ratio) of the company's earnings for five years hence. This might seem questionable to some, but the way it is done in practice is to use the current price-earnings ratio for a comparable business. (For example, both businesses make dental equipment and related products.) If this multiple is, say, 15 times earnings and the fifth year earnings are projected at $500,000 after tax, then the firm should be worth $7.5 million.

Now, if it takes $400,000 from the investors to start the business, then five to ten times this investment would be $2 million to $4 million. Now if we compare the $2 million to the $7.5 million, then about 27% of the stock would be given to the investors so that they can realize their five times investment profit. But if the investors demand ten times their money, then about 53% of the stock would have to be given.

(I would discourage anything over 49%, but the potential owner should not delude himself or herself into thinking that 53% guarantees control. It does not. If things go wrong, professional venture capitalists have ways of taking control even if they own less than a majority of stock.)

Thus, the more profitable the projected business, the smaller the percentage of ownership that will have to be given up to investors. When the aspiring entrepreneur analyzes the future profitability of a start-up proposal, he or she ought to ask these questions, "Will this idea result in higher future profits than all my other new venture ideas? Do I really want to spend years of my life developing a company with anemic profitability—especially if it means giving the lion's share to the financial backers?"

Making the deal understandable

Failing to make an idea for a new venture comprehensible to potential investors, creditors, and customers can doom the venture before it begins.

I recall trying to assist two friends, who had impressive educational and work backgrounds, in a real estate deal. But their idea entailed an extraordinarily complicated financial scheme. We took the proposal to another friend who was quite knowledgeable about real estate. After nearly three hours of explanation, we finally said, "Well, what do you think?" "Brilliant," he said, "but it will never fly. How are you going to raise the money from a group of unsophisticated people when it took me several hours to figure out what you are doing?"

In another instance, a man in his late twenties came to see me about starting a specialized type of garage for repairing cars. The idea seemed all right for a Mom and Pop type of business, but he was proposing a limited partnership with a corporation as the general partner.

While there's nothing intrinsically wrong with his approach, it's probably not appropriate for a small garage. Not surprisingly, he had been trying to put together his new company for well over a year. I suggested he get a relative to borrow about $40,000 on his or her home and loan it to him on a subordinated basis and, for the balance, apply for a Small Business Administration loan.

Giving investors an out

Finally, entrepreneurs forming a new venture must deal with the issue of how investors are going to realize their profits from the company.

From the mid-1950s through mid-1971, public stock offerings provided a frequent solution. In the typical case, the company would make a "combination" initial public offering that included some stock sold by the business (the "primary" portion) and some stock sold by the existing shareholders (the "secondary" portion). It was through this secondary portion that the initial investors could recover their original investment plus some of their profit.

During the ten-year period from 1971 to 1980 when the market for initial public stock offerings was nearly nonexistent, giving investors an "out" became quite difficult. Some received convertible notes or notes with warrants, so that the investments could be repaid via the notes with the profits coming at some undetermined time in the future, when the company went public or after it was acquired by some large corporation.

Not only was this rather roundabout way of rewarding the initial investors annoying, but the profits yielded to investors were considerably less than in the prior decade.

The 1980s have certainly started differently. Now we have a rather active new issues market in which all manner of ventures are going public. The price-earnings ratios of these ventures vary considerably from industry to industry. Therefore, the aspiring entrepreneur ought to seriously consider the future prospects for his or her venture's price-earnings relationship. What kind of P-E ratio might the new business have in the future? Obviously, the higher the P-E ratio, the better off the owner will be.

Of course, the present new issues market may not exist three to five years hence. Nonetheless, the very existence of such a market when funding is being sought may help greatly in raising venture capital. The psychology of the situation seems to be that if there is a hot new issues market today, there will still be one three to five years from now. Conversely, if no such market exists today, the assumption is that there will not be one three to five years from now. As logical or illogical as this psychology might seem, the future owner should keep it in mind when timing the start of a new company.

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Is entrepreneurship the best way?

At this point in the screening process, the aspiring entrepreneur might consider an alternative approach: not starting a business at all. Instead, how about placing the great new idea with an established company and letting it manufacture and market the idea and pay a royalty? If pushed too far, this notion would preclude the start-up of just about all businesses.

Surely, this is not what I mean. If an inventor has a good product, but does not have all the requisite skills to successfully garner the venture capital and then manage a start-up venture, putting the product with another company—assuming he or she can negotiate adequate and minimum royalties—might spare much frustration and possible failure. Besides, if the product is economically successful, this success might very well constitute the track record that venture capitalists look for in a potential business owner. Then the inventor or entrepreneur can point with pride and say, “Look how much money I have made for other people. Now I want to do that for myself and my backers.” This is an argument that professional and other venture capital sources love to hear.

Still, I don’t expect this argument to have a great deal of impact on potential entrepreneurs. A man once came to me with a pill counter he had invented—similar to ones that are in rather widespread use today. I went down the list of criteria previously discussed and found the product lacking on a number of points.

While the logic of putting this device with a major corporation that had the necessary marketing resources to sell to pharmacies seemed convincing, the inventor had it in his mind that he was going to have his own business with his name on it. And that was that. And when you come down to essentials, perhaps this is what makes the entrepreneurial world go around.

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