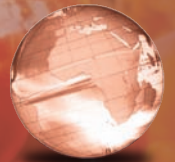




GLOBAL  
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# Entrepreneurship and Small Business Management

SECOND EDITION

Steve Mariotti • Caroline Glackin



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# ENTREPRENEURSHIP & SMALL BUSINESS MANAGEMENT

**Second Edition  
Global Edition**

**Steve Mariotti • Caroline Glackin**

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—*Steve Mariotti*

To my children, Elise and Spencer, whose support and love  
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To my parents, Howard and Maria Wiedenman,  
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of education. My love and gratitude.

—*Caroline Glackin*

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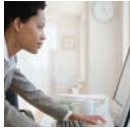
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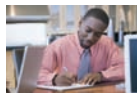
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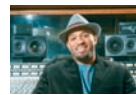
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## Preface

# Helping Students Own Their Future

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*Entrepreneurship and Small Business Management (ESBM), Second Edition*, is the newest textbook in a line of entrepreneurship textbooks written by Steve Mariotti, founder of the Network for Teaching Entrepreneurship (NFTE). This is the second written with professor and entrepreneur Caroline Glackin, and it promotes entrepreneurship as a career option for college students. It is built on the success of *Entrepreneurship: Starting and Operating a Small Business*, Third Edition, with greatly expanded coverage of the details of managing and growing a small business.

Business students, as well as those from other disciplines, can benefit from *ESBM*. For business students, it recasts their prior learning from a typical corporate context and focuses it on small and entrepreneurial enterprises. For students in such fields as hospitality, the arts, engineering, and fashion merchandising, the text introduces key business concepts and provides examples from a broad range of careers. Cases from hospitality, technology, retail, manufacturing, distribution, real estate, finance, and not-for-profit organizations bring a wealth of learning opportunities. Most importantly, *ESBM 2e* is a balanced mix of the academic and applied components of entrepreneurship education. Students are introduced to the theories, methods, and requisite knowledge and skills required of entrepreneurs and are immediately given practical examples and discussion opportunities. Using the Application Exercises and Exploring Online features at the end of each chapter, they are encouraged to take this new knowledge and apply it in their own lives, so that the course materials are reinforced and internalized.

## Highlights of New Content and Changes

---

*Entrepreneurship and Small Business Management, Second Edition*, contains new content and some changes, including the following:

- **Eight new Chapter Openers.** These feature more small and entrepreneurial enterprises. New cases are: Bridgecreek Development, Mercedes, Virgin Group Ltd., University Parent, Aravind Eye Care System, Chilly Dilly, inDinero, and Paula Jagemann.
- **Eleven new short End-of-Chapter Case Studies.** Urban Decay, SarahCare of Snellville, Happy Belly Curbside Kitchen, BNI, MooBella, Gentle Rest Slumber, Holterholm Farms, Gelato Fiasco, The Bun Company, Khan Academy, and Anago Cleaning Systems.
- **Seven new longer End-of-Chapter Case Studies.** Foursquare, Wahoo's Fish Tacos, Rosi and Brian Amador, Chilly Dilly's Ice Cream, Airbnb, AYZH, and iContact.

- **All New Unit Cases.** These are more current and relatable for students and include: Spanx, Kitchen Arts & Letters, Inc., Empact, Lee's Ice Cream, ONLC Training Centers, and Honest Tea.
- **Step into the Shoes, Entrepreneurial Wisdom, BizFacts, and Global Impact Features.** These have been updated and expanded with 29 new featured items, including 22 Step into the Shoes, 1 Entrepreneurial Wisdom, 2 BizFacts, and 4 Global Impact Features. These features connect chapter content to business facts and examples to reinforce learning.
- **New Honest Tea Featured Business Plan.** From its early stage funding search, this example provides students with an interesting start-up plan for a company that is also featured in the Unit 6 case.
- **BizBuilder Business Plan Questions.** These have been added to chapters to connect the content to student work using the business plan templates.

## Combining Street Smarts and Academic Smarts

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*Entrepreneurship and Small Business Management, Second Edition*, is an extension of the academic programs developed by Steve Mariotti under the auspices of NFTE. Since 1987, NFTE has reached over 500,000 graduates and trained more than 5,000 teachers in 15 countries to impart its innovative entrepreneurship curriculum through its 18 U.S. and 11 international program sites. NFTE is widely viewed as a world leader in promoting entrepreneurial literacy and has a proven track record of helping young people start a great variety of successful ventures.

This textbook unites Steve Mariotti's experience as an entrepreneur with relevant academic theory and practice, supported by a rich variety of examples and stories that include experiences from NFTE program graduates who have started their own businesses. Caroline Glackin brings years of experience in the university classroom, as a lender to small and microbusinesses, and as an entrepreneur and small business owner. Together, these two authors have produced a text that is practical, useful, and academically solid.

## Organization

---

*Entrepreneurship and Small Business Management, Second Edition*, is organized to follow the life cycle of an entrepreneurial venture from concept through implementation into harvesting or replication. It is a comprehensive text written in light of the reality that college students often take only one course in entrepreneurship and the topic is covered in a multitude of ways. For instructors who will teach the course as a "business plan," *ESBM 2e* offers step-by-step content to build a plan over a semester or a quarter. For those who focus on the management of small and entrepreneurial ventures, there is an abundance of high-quality material on the critical topics of management, human resources, marketing, and operations for such ventures. For those charged with teaching a comprehensive introductory course, all of the components are provided.

# Chapter Learning System

## Chapter Openers Set the Stage

Each chapter starts with an inspirational quote, Learning Objectives that provide a “road map” so readers know where they are headed, and then an opening case study. The reader connects with a story of a real business in the opening vignette that sets the stage for upcoming material.

### Chapter 3

## FINDING OPPORTUNITY IN AN EXISTING BUSINESS

### Learning Objectives

1. Understand the potential benefits of buying a going concern.
2. Identify potential drawbacks of purchasing a business.
3. Learn how to identify and evaluate purchasing opportunities.
4. Learn how to determine the value of a business.
5. Learn how to negotiate and close the deal.
6. Recognize joining a family business as an entrepreneurial pathway.



**“I have found no greater satisfaction than achieving success through honest dealing and strict adherence to the view that, for you to gain, those you deal with should gain as well.”**

—Alan Crossman, Former Chairman of the Federal Reserve Bank

Many businesses succeed through the entrepreneurial effort of owners who were not the founders. Charles R. Walgreen, Sr. became a store owner in 1901 when he purchased a pharmacy from Isaac Blood in Chicago for \$6,000. Walgreen had worked at the store as a pharmacist and was not satisfied with the quality of customer service there or at pharmacies in general. He had worked in drugstores since he was a teenager! However, he saw value in taking over a business that was already in existence, and started with one that he knew well. Walgreen saw that the neighborhood was thriving, but the store was struggling. It did not take long for Walgreen's innovative approach to store layout and merchandising to reap rewards. He opened a second store in 1909 and by 1919, he had incorporated 20 stores as Walgreen's Inc.

Not content to rest on his success, Walgreen's “steak and” the soda fountain portion of the pharmacy business in 1922 with the invention of the malted milk shake by his “Pop” Cousins, which was a revolutionary product and boosted sales phenomenally. By 1926, Walgreen had opened his 100th store in Chicago, and the company went public the following year. In 1938, upon its founder's death, Walgreen transferred the presidency to his son, Charles Walgreen, Jr., illustrating business growth through acquisition, a public stock offering, and generational transfer. This leadership change was followed by continued expansion that resulted in Walgreen's becoming the nation's largest self-service retailer by 1953.

Walgreen's continued to grow and successfully transferred the presidency to the third generation in 1968. The company reached the \$1 billion sales mark in 1975 and opened its 1,000th store in 1984. Charles Walgreen III retired in 1999 but remained on the board of directors. Walgreen's continued its rapid growth trajectory through acquisition, including the acquisition of New York's Duane Reade chain and Take Care Health Systems, adding clinics to its business mix.

Walgreen's is a classic example of entrepreneurial success through acquisition and internal growth.

Many entrepreneurs, like Charles Walgreen, Sr. elect to purchase a going concern rather than starting a business “from scratch.” Others decide to apply their entrepreneurial talents to existing family-owned businesses they buy.



Lightworks Media/Getty

Source: Walgreen's. “Annual Report 2011 and 2012.” <http://www.walgreen.com/content/dam/walgreen>

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## “Step into the Shoes” of the Experts

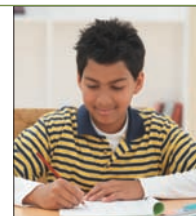
Step into the Shoes appears in each chapter and gives insight into the business practices of entrepreneurs and an opportunity to discuss the brief example. It brings the content to life with real-world application.

### Step into the Shoes . . .

#### Maritza Gonzalez and Noel Cruz—Kumon Math and Reading Center

Kumon Math and Reading Centers, a successful franchisor, had been providing supplemental academic support to students in Newark (New Jersey) Public Schools for four years, through the No Child Left Behind program, when Maritza Gonzalez and Noel Cruz opened a new center there. Maritza is a Kumon parent (that is, a parent of a child in the Kumon system), a product of Newark Public Schools, and a graduate of Montclair State University. For her, the opportunity to direct a Kumon Math and Reading Center is a chance to give back

to the community. Noel Cruz headed up the No Child Left Behind program with Kumon and was an assistant principal at a charter school in Newark. Kumon is a 54-year-old after-school math and reading program with 26,000 centers in 47 countries (more than 1,500 in the United States) that totals more than four million students globally.<sup>5</sup>



Stockbyte/Thinkstock

<sup>5</sup>Kumon, accessed June 23, 2009, and July 1, 2013, <http://www.kumon.com/AboutUs>.

## BizFacts

BizFacts impart useful information regarding entrepreneurship statistics, company practices, or business applications.

### BizFacts

Entrepreneurship has proven to be an effective way for minorities and women to enter the business world.

- More than 6.1 million businesses were minority-owned in 2007, and they generated \$871 billion in revenues.
- There were more than 12.4 million non-farm businesses owned by women (or co-owned equally with men), accounting for 45.4 percent of all U.S. companies.

Source: U.S. Small Business Administration, accessed June 29, 2013, <http://www.sba.gov>.

## Entrepreneurial Wisdom

Entrepreneurial Wisdom contains insights or advice that will help students in the preparation of a business plan or management of an enterprise.

### Entrepreneurial Wisdom . . .

A new business usually will require time before it can turn a profit. Federal Express, in fact, suffered initial losses of a million dollars a month! But if you are not making enough money to stay in business, that is the market speaking. It is telling you that your business is not satisfying consumer needs well enough. Do not take it personally. Many famous entrepreneurs opened and closed a number of businesses during their lifetime.

Henry Ford failed in business twice before the Ford Motor Company was a success. If you want to be a successful entrepreneur, start growing a thick skin and decide right now that you intend to learn from failures and disappointments. Do not let them get you down. Learn, so that you do not make the same mistakes again.

## Global Impact

Global Impact, featured in each chapter, provides examples of entrepreneurial ventures around the world or information that can be applied in global trade.

### Global Impact . . .

#### Raw Material Prices Challenge Manufacturers

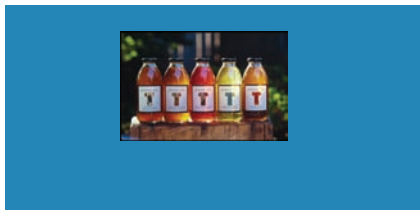
When the price of crude oil rises, much of the world feels the pain. Manufacturers using crude oil in their production are affected. When copper prices rise, the effects are also felt worldwide. Volatile raw-material costs in one area can have huge ripple effects on prices around the world. Whereas labor costs frequently are perceived to be a primary driver of manufacturing costs, the impact of changing raw materials prices may also be quite significant, particularly when they are volatile. Manufacturers must control raw material costs to create sustainable profits.

Manufacturers have to buy smarter, explore alternate materials, and evaluate their ability to increase prices to their customers. Manufacturers source potential materials for purchase globally to attain the most favorable pricing, making any changes an international issue. Thus, a price increase in crude oil in Saudi Arabia has ripple effects on Main Street U.S.A.

Source: Jill Jusko, "Rethinking Raw Materials," *IndustryWeek.com*, August 1, 2006, accessed March 29, 2009, <http://www.industryweek.com>.

## New! Honest Tea Business Plan

This is the plan developed by founders Seth Goldman and Barry Nalebuff during Honest Tea's first year of operations. It appears following Chapter 4 and includes a comprehensive market analysis and detailed historical financials. The business raised over \$1 million at a time when sales were less than \$250,000 and the company had operating losses. The Honest Tea plan is an excellent example for students and one that many of them will intuitively understand as customers of bottled tea.



Business Plan for 1999  
December 1998  
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BUSINESS PLAN

Our tea lines are produced by internationally known companies that specialize in tea blending and importation. Our primary source is Hilsen & Lyon of Germany, the largest specialty tea company in the world. Another, Assam Tea Traders, has direct ties to tea estates in the Assam District of Northern India. The other ingredients are commodities which are in plentiful supply.

As the Company grows in size, we anticipate dealing more directly with the tea growers. We intend to visit the tea estates so that we can verify that the labor conditions of the tea workers meet international standards and International Labor Organization conventions. We also expect to ensure that the tea is grown organically.

**Market Opportunity**

**Keynote Snapshot—The Emerging Market for Quality Bottled Tea**

We have identified four market trends that are fueling demand for Honest Tea within the \$72 billion non-alcoholic liquid refreshment beverage market.

**1. Explosive growth in Ready-to-Drink (RTD) tea and bottled water markets**—Although carbonated soft drinks still dominate the beverage market, in the past ten years Ready-to-Drink tea and bottled water have emerged as alternatives. Since 1992 the RTD tea market has enjoyed 69% annual growth, reaching sales of \$2 billion in 1998. The bottled water market has grown to \$2.4 billion, with more of the growth fueled by sales of single-serving bottles.

\*Water and soft drink figures come from Beverage Marketing, Inc. The RTD Tea figure is based on 1997 sales volume of \$2.4 billion, which equates to roughly one billion gallons.

**2. Beyond the tea bag**—The emergence of tea culture—Single and smaller format bottled teas are accessible to broader populations. Not only in the same way that gourmet coffees have become popular, consumers are beginning to develop an appreciation for their tea. Over the last ten years U.S. home and gift sales have more than doubled, from \$1 billion

# End-of-Chapter Learning Portfolio

End-of-chapter materials help students demonstrate a working understanding of key concepts and develop critical-thinking skills.

All chapters include the following:

- **Key Terms** list.
- **Critical Thinking Exercises** that require students to consider important issues and support thoughtful responses.
- **Key Concept Questions** that review core topics.
- **Application Exercises** that give students a structured opportunity to reinforce chapter topics through experience.
- **Exploring Your Community and Exploring Online** assignments that invite students to go into their business communities or search online for information.
- **BizBuilder Business Plan Questions** guide students through the development of business plan components as they learn new information throughout the book.
- **Cases for Analysis** include one short case and one longer case with analytical questions. Cases cover a variety of issues and draw on real business scenarios. Examples of businesses that may be familiar to students include eHarmony, Krispy Kreme, and Khan Academy. Other organizations that may be less familiar include Happy Belly Curbside Kitchen, 23andme, MIDA Trade Ventures, iContact, and Enablemart. These cases reflect a diverse set of entrepreneurs, industries, and geographic locations.

### Entrepreneurship Portfolio

**Critical Thinking Exercises**

- 2-1. What are four positive aspects of franchising for a business start-up? Why are they important?
- 2-2. What are some challenges faced by franchisees?
- 2-3. Describe the type of franchise you might want to open.
- 2-4. Franchisees agree to pay a variety of fees to franchisors, initially and ongoing. Describe these fees, and discuss why understanding their impact on profitability and cash flow is important to franchisees.

**Key Concept Questions**

- 2-5. Compare and contrast product and trade-name franchising with business-format franchising.
- 2-6. Explain why the FDD is critical to analyzing a franchise opportunity.
- 2-7. What, if any, trends in franchising suggest continued expansion of the industry? Contraction? Cite your sources.

**Application Exercise**

- 2-8. Identify an industry or type of business that interests you. Select a community where you would like to locate such an organization (select a business that would have a physical presence). Find two competitors already in that market space and one franchisor that is not. Would it or would it not make sense to open a franchise in the community?

**Exploring Online**

- 2-9. Visit the Wahoo Fish Taco Web site at <http://www.wahoos.com>. What are the advantages of a Wahoo Fish Taco franchise according to the site? What franchise opportunities are available?
- 2-10. Visit the International Franchise Association Web site at <http://www.franchise.org>. Find a franchise organization that is unfamiliar to you. Find the following information about the franchisor:
  - a. When did it begin offering franchisees?
  - b. How many company-owned units does it have?
  - c. What are its initial financial requirements (start-up fee, net worth, liquid resources)?
  - d. What type of franchisor is it (product or trade-name or business-format)?

If the information is not available on the International Franchise Association (IFA) Web site, try others from the list in **Exhibit 2-3**.

### Entrepreneurship Portfolio

**Critical Thinking Exercises**

5-1. Use the following charts to define a business you would like to start, and analyze your competitive advantage.

Business Definition Question	Response
<b>The Offer.</b> What products and services will be sold by the business?	
<b>Target Market.</b> Which consumer segments will the business focus on?	
<b>Production Capability.</b> How will that offer be produced and delivered to those customers?	
<b>Problem Solving.</b> What problem does the business solve for its customers?	
Competitive Advantage Question	Competitive Difference (USP)
<b>The Offer.</b> What will be better and different about the products and services that will be sold?	
<b>Target Market.</b> Which segments of consumers should be the focus of the business to make it as successful as possible?	
<b>Production and Delivery Capability.</b> What will be better or different about the way the offer is produced and delivered to those customers?	

Attributes Important to Customers	Your Company				Competitor Number 1		Competitor Number 2		Competitor Number 3	
	Weight (a)	Rating (b)	Weighted Rating (c = a × b)	Rating (d)	Weighted Rating (e = a × d)	Rating (f)	Weighted Rating (g = a × f)	Rating (h)	Weighted Rating (i = a × h)	
Quality										
Price										
Location										
Selection										
Service										
Speed/Turnaround										
Specialization										
Personalization										
Total	1.00									

# Additional Resources

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## Instructor Resources

At the Instructor Resource Center, [www.pearsonglobaleditions.com/mariotti](http://www.pearsonglobaleditions.com/mariotti), instructors can access a variety of print, digital, and presentation resources available with this text in downloadable format. Registration is simple and gives instructors immediate access to new titles and new editions. As a registered faculty member, you can download resource files and receive immediate access to and instructions for installing course management content on your campus server. In case you ever need assistance, our dedicated technical support team is ready to help with the media supplements that accompany this text. Visit <http://247.pearsoned.com> for answers to frequently asked questions and toll-free user support phone numbers.

The following supplements are available for download to adopting instructors:

- Instructor's Resource Manual
- Test Bank
- TestGen® Computerized Test Bank
- PowerPoint Presentations

## Student Resources

### **BizBuilder Business Plan Worksheets and Templates Online**

Go to [www.pearsonglobaleditions.com/mariotti](http://www.pearsonglobaleditions.com/mariotti) to download business plan and presentation templates that will help students write a plan and present it.

- ***BizBuilder Business Plan Worksheets*** provide step-by-step instructions on building a business plan. The MS Word document contains a comprehensive set of questions and tables organized by business plan section. The Excel document includes Start-Up Costs, Sales Projections, Income Statement, Balance Sheet, Cash Flow, and Ratio Analysis worksheets.
- ***BizBuilder Business Plan Template*** provides a professional-looking format for a business plan that ties in with assignments in the text.
- ***BizBuilder Business Plan Presentation Template*** guides the student through the process of creating a PowerPoint presentation deck for a business plan.

Students can build their business plans using the BizBuilder worksheets. Appendix 2 provides students with instructions on how to use the worksheets that mirror the planning process in the book and contains more questions in some areas than are found in commercially available planning software. Once they have created a plan using the worksheets, students can generate a professional-looking document using the BizBuilder Business Plan Template.

## CourseSmart eTextbook

CourseSmart eTextbooks were developed for students looking to save on required or recommended textbooks. Students simply select their eText by title or author and purchase immediate access to the content for the duration of the course using any major credit card. With a CourseSmart eText, students can search for specific keywords or page numbers, take notes online, print out reading assignments that incorporate lecture notes, and bookmark important passages for later review.

# About the Authors



**STEVE MARIOTTI**, founder of the Network for Teaching Entrepreneurship (NFTE), is considered one of today's leading experts in education for at-risk youth. He has been helping young people develop marketable skills through learning about entrepreneurship for 30 years.

Starting his career as a treasury analyst for the Ford Motor Company, Mariotti changed career paths in 1982 when he gave up operating his own import-export firm to become a special education teacher in the New York City school system, where he remained for five and a half years. His first assignments were in the East New York and Bedford-Stuyvesant neighborhoods of Brooklyn; he also taught in what was, at the time, the notorious "Fort Apache" neighborhood of the South Bronx.

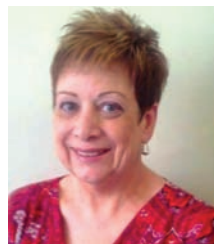
While teaching in these demanding environments, Mariotti gained a breakthrough insight for successfully motivating his economically at-risk students—it was showing them that entrepreneurship, learning how to start and operate their own small businesses, was a way to financial independence. This perception, combined with his solid business background, inspired Mariotti to create a program to bring entrepreneurial education to at-risk young people.

In 1987, the Network for Teaching Entrepreneurship was formed and received nonprofit 501(c)(3) status from the IRS the following year. Now, 25 years later, NFTE continues its mission of bringing entrepreneurship-education programs to youth from low-income communities on a global basis. The organization has reached over half a million young people since its founding and currently has programs and licensees in 18 states, as well as in Belgium, Chile, China, Colombia, Germany, India, Ireland, Israel, and New Zealand.

Steve Mariotti received a B.B.A. and M.B.A. from the University of Michigan, Ann Arbor. He also studied at Harvard University, Stanford University, and Brooklyn College. He has been the subject of many national media profiles, including *ABC Evening News* and *20/20+*. In addition, he is the coauthor of some 20 books and manuals on entrepreneurship that together have sold over one million copies. Mariotti is an active member of the Council on Foreign Relations and has presented papers at the World Economic Forum in Davos.

Among the many honors awarded to Steve Mariotti are Best Teacher of the Year, National Federation of Independent Businesses, 1988; Honorary Doctorate

in Business and Entrepreneurship, Johnson and Wales University, 1990; Social Entrepreneur of the Year, the Chief Executive Officer's Club; *Inc.* Magazine's Social Entrepreneur of the Year Award; Ernst & Young Entrepreneur of the Year Award, 1992; Award from the Minority Business Development Agency of the U.S. Department of Commerce; University of Michigan Business School Entrepreneur of the Year Award; Association of Educational Publishers' Award for Best Math Curriculum, 2010; the Bernard A. Goldhirsh Social Entrepreneur of the Year Award; the New York Enterprise Report's 2012 Founder's Award for Social Entrepreneurship; and 2012 inductee into the Entrepreneurship Hall of Fame.



**CAROLINE GLACKIN, Ph.D.**, is a "pracademic" who has succeeded as a microenterprise and small business owner and manager, as an executive director of a community-development financial institution, and as an academic in areas of community-development

finance, entrepreneurship, and management. She is the Edward L. Snyder Endowed Chair for Business Administration at Shepherd University in West Virginia. She has been assisting entrepreneurs in achieving their dreams for over 30 years.

Glackin earned a doctorate from the University of Delaware, where her research emphasis was on microfinance. She received an M.B.A. from The Wharton School at the University of Pennsylvania and a B.A. from Bryn Mawr College. Her professional career began with the DuPont Company, American Bell, Bell Atlantic, and American Management Systems. She has consulted for businesses and not-for-profit agencies in turnaround and high-growth situations. After exiting a family business, she became the executive director of a Community-Development Financial Institution serving businesses and not-for-profits.

Dr. Glackin has succeeded in leading change in the practical fields of her research and has received numerous honors and awards. These include the first Gloeckner Business Plan Award at The Wharton School, the Minority Business Advocate of the Year for Delaware from the U.S. Small Business Administration, and the She Knows Where She's Going Award from Girls Inc. Dr. Glackin co-chaired the Delaware Governor's Task Force for Financial Independence. She has participated in the Cornell University Emerging Markets Think Tank Series and has presented her research and pedagogy at numerous professional conferences.

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---

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# ENTREPRENEURIAL PATHWAYS

## Chapter 1

ENTREPRENEURS RECOGNIZE OPPORTUNITIES

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FRANCHISING

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# Chapter 1

# ENTREPRENEURS RECOGNIZE OPPORTUNITIES

## Learning Objectives

1. Explain what entrepreneurs do.
2. Describe how free-enterprise economies work and how entrepreneurs fit into them.
3. Find and evaluate opportunities to start your own business.
4. Explain how profit works as a signal to the entrepreneur.



Tom Szaky of Terracycle, Inc.  
(Paul Zimmerman/Getty Images)

“Everyone lives by selling something.”

—Robert Louis Stevenson,  
Scottish author

Tom Szaky was a 19-year-old college student in need of inspiration for a business plan competition, when he happened to visit friends who were using red worms to compost waste that they then used as plant fertilizer. The idea captured his imagination, and he created a business plan for an environmentally friendly company that would convert trash into fertilizer. Although he finished in fifth place in the competition, Szaky moved ahead to make the company a viable venture.<sup>1</sup>

TerraCycle Inc. has expanded its product lines to encompass a wide range of recycling and upcycling, including branded products for Target and Kraft Foods. The company is the producer of the world’s first product made from and packed in recycled waste: fertilizer generated from waste. Szaky sells to some of the world’s largest retailers, including Wal-Mart, Target, and Home Depot, and oversees programs that involve entire communities in recycling projects. Sales exceed \$20 million per year, and the company has collected literally billions of discarded items. TerraCycle plant food was twice named the most eco-friendly product in Home Depot. Tom Szaky and TerraCycle have turned trash into treasure.

## Entrepreneurship Defined

Have you ever eaten a Subway sandwich? Used an Apple device? Listened to music with Skullcandy headphones? The entrepreneurs that founded these companies brought these products into your world. Entrepreneurship is all around us.

### What Is an Entrepreneur?

Most Americans earn money by working in *business*. They are somehow engaged in the buying and selling of products or services in order to make money.

**product** something tangible that exists in nature or is made by people.

**service** intangible work that provides time, skills, or expertise in exchange for money.

**entrepreneur** a person who recognizes an opportunity and organizes and manages a business, assuming the risk for the sake of potential return.

- A **product** is something that exists in nature or is made by human beings. It is *tangible*, meaning that it can be physically touched.
- A **service** is labor or expertise (rather than a tangible commodity) exchanged for money. It is *intangible*. It cannot actually be touched.

Someone who earns a living by working directly for someone else’s business is an *employee* of that business. There are many roles for employees. At Ford Motor Company, for instance, some employees build the cars, some sell the cars, and some manage the company. But employees have one thing in common—they do not *own* the business; they work for others who do. They know how much money they can earn, and that amount is limited to salary or wages, plus bonuses and any stock options they may receive.

People who have their own businesses work for themselves and are called small business owners, or **entrepreneurs**. Entrepreneurs are often both owners and employees. For an entrepreneur, the sky is the limit as far as earnings are concerned. Unlike an employee, an entrepreneur owns the profit that his or her business earns, and may choose to reinvest it in the business or take it as payment.

An entrepreneur is someone who recognizes an opportunity to start a business that other people may not have noticed, and jumps on it. As economist Jeffrey A. Timmons writes in the preface of *New Venture*

**Learning Objective 1** ➤  
Explain what entrepreneurs do.

<sup>1</sup>TerraCycle Inc., accessed June 23, 2013, <http://www.terracycle.net>.

*Creation: Entrepreneurship for the 21st Century*, “A skillful entrepreneur can shape and create an opportunity where others see little or nothing—or see it too early or too late.”

The French word *entrepreneur* began to take on its present-day meaning in the seventeenth century. It was used to describe someone who undertook any project that entailed risk—military, legal, or political, as well as economic. Eventually, it came to mean someone who started a new business venture—often of a new kind or a new (or improved) way of doing business. French economist Jean-Baptiste Say wrote at the turn of the nineteenth century:

An entrepreneur is an economic agent who unites all means of production—the land of one, the labor of another and the capital of yet another, and thus produces a product. By selling the product in the market he pays rent on land, wages to labor, interest on capital and what remains is his profit. He shifts economic resources out of an area of lower and into an area of higher productivity and greater yield.<sup>2</sup>

Say argued that entrepreneurs “added value to scarce resources.” Coal is a resource because it is used as fuel. Wood is a resource because it can be used to build a house or a table, to make paper, or to burn as fuel. Economists consider *scarce* all resources that are worth money, regardless of their relative availability.

Debbi Fields, founder of Mrs. Fields Cookies, took resources—eggs, butter, flour, sugar, chocolate chips—and turned them into cookies. People liked what she did with those resources so much that they were willing to pay her more for the cookies than it cost her to buy the resources to make them. She *added value* to the resources she purchased by what she did with them and created a multimillion-dollar business in the process.

Entrepreneurs may have different reasons to start and continue their businesses, but they share the common focus of creating sustained value. Entrepreneurs seek opportunities that they envision as generators of incremental income, or *wealth*. Whether the business is intended to meet short-term household cash needs or to grow into a publicly traded company, viability is critical. Each activity of the firm should be driven by this need.

## The Economic Questions

Since the beginnings of human society, people have had to answer the same basic questions:

- What should be produced?
- When will it be produced?
- How will it be produced?
- Who will produce it?
- Who gets to have what is produced?

Families and individuals, as well as businesspeople, charitable organizations, corporations, and governments, all have had to answer these questions. The system created by making these decisions is called an *economy*. The study of how different groups answer the questions is called *economics*.

An economy is the wealth and resources of a country or region, including its financial structure. The economy of the United States is a **free-enterprise system** because it is characterized by private (rather than governmental) ownership of capital assets and goods; anyone is free to start

**free-enterprise system**  
economic system in which businesses are privately owned and operate relatively free of government interference.

<sup>2</sup>Jean-Baptiste Say, *A treatise on political economy; or the production distribution and consumption of wealth (Traité d'économie politique ou simple exposition de la manière dont se forment, se distribuent et se composent les richesses)*, C. R. Prinsep, trans. [slightly modified] and Clement C. Biddle., ed. (Philadelphia: Lippincott, Grambo & Co., 1855). Library of Economics and Liberty, accessed June 26, 2013, <http://www.econlib.org/library/Say/sayT.html>.

a business. Americans do not have to get permission from the government to go into business, although they are expected to obey laws and regulations.

The free-market system, which is also called **capitalism**, typifies the following attributes:

- Individuals and companies may compete for their own economic gains.
- Private wealth and property ownership are permissible.
- Free-market forces primarily determine prices.

Cash or goods invested to generate income and wealth is called **capital**; in a free-enterprise system anyone who can raise the necessary capital may start a business.

## Voluntary Exchange

The free-enterprise system is also sometimes referred to as a private enterprise free-trade system because it is based on **voluntary exchange**. Voluntary exchange is a transaction between two parties who agree to trade money for a product or service. Each wishes to take advantage of what the trade offers. The parties agree to the exchange because each will benefit.

For example, José has a construction business, and his neighbors hire him to renovate their kitchen. He wants to earn money and is willing to use his skills and time to do so. The neighbors are willing to give him money to get the renovation done. They each have something the other wants, so they are willing to trade. A satisfactory exchange only takes place when both parties believe they will benefit. Robbery, in contrast, is an *involuntary* exchange.

## Benefits and Challenges of Free Enterprise

The public benefits from living in a free-enterprise system, because it discourages entrepreneurs who waste resources by driving them out of business. It encourages entrepreneurs who use resources to satisfy consumer needs efficiently by rewarding them with profit.

### Learning Objective 2

Describe how free-enterprise economies work and how entrepreneurs fit into them.

**capitalism** the free-market system, characterized by individuals and companies competing for economic gains, ownership of private property and wealth, and price determination through free-market forces.

**capital** money or property owned or used in business.

**voluntary exchange** a transaction between two parties who agree to trade money for a product or service.

## Global Impact . . .

### Free Trade

For much of recorded history, international trade was difficult and hazardous. To sell products in another country often required long and dangerous journeys overland or by ship. Many countries were closed to outside trade. Governments also used their power to give their own businesspeople a competitive advantage over those from other countries by establishing trade barriers, such as imposing taxes (tariffs) on foreign goods that made them very expensive. Governments could also enforce restrictions on how many imports or exports could cross their borders.

Today, trade barriers have fallen in many parts of the world. The North American Free Trade Agreement (NAFTA) of 1994 eliminated trade barriers between the United States, Mexico, and Canada. This turned the entire continent into a free-trade zone. The General Agreement on Tariffs and Trade (GATT) cut or eliminated tariffs between 117 countries. This evolved into the World Trade Organization, which now has 159 members.

Where entrepreneurs are free to trade voluntarily, to as large a market as possible, their ability to find customers to buy

their goods or services increases, as well as their overall ability to meet consumer needs. Meanwhile, the Internet has made it much easier for businesses to sell to clients all over the world. Shipping, too, has become much faster and less expensive.

Society in general benefits because free enterprise encourages competition between entrepreneurs. Someone who could make cookies that taste as good as Mrs. Fields Original Cookies and sell them at a lower price would eventually attract Mrs. Fields's customers. This would force Mrs. Fields to lower prices to stay competitive or the company would go out of business. Consumers would benefit because they would get to buy the same-quality cookie at a lower price.

On the flip side, free enterprise has some disadvantages. If a company fails, the employees are out of work. Owners who have invested their financial resources in the business lose money. Other companies or individuals that depended on the products and services of the failed business themselves lose customers or suppliers.

## What Is a Small Business?

The public often thinks of business only in terms of “big” business—companies such as Apple, Wal-Mart, Microsoft, McDonald’s, and Berkshire Hathaway. However, the vast majority of the world’s businesses are small businesses. A small business is defined by the U.S. Small Business Administration’s Office of Advocacy as having fewer than 500 employees and selling less than \$5 million worth of products or services annually. A neighborhood restaurant, a mattress manufacturer, and a clothing boutique are examples of a small business; even a leading local employer may be classified as “small” under this definition.

Surprisingly, the principles involved in running a large company—like Microsoft—and a corner deli are the same. However, the operations of a small business are not the same as those of a large one. Most multimillion-dollar businesses in this country started out as small, entrepreneurial ventures. This is why entrepreneurship is often called the engine of our economy. It drives our economic creativity, giving rise to wealth and jobs and improving our standard of living.

## Why Become an Entrepreneur?

Entrepreneurs put a great deal of time and effort into launching their own businesses. While establishing a business, an entrepreneur may also pour all of his or her money into it. An entrepreneur may not be able to buy new clothes or a fancy car, go on vacation, or spend much time with family—until the business becomes profitable and starts generating cash.

If so much work and sacrifice are involved, why become an entrepreneur? The entrepreneur is working for the following rewards:

1. **Control over time.** Do you work better at midnight than at 8 A.M.? If you start your own business, you will have control over how you spend your time by the type of business it is. Are you the kind of person who would rather work really hard for two weeks, nonstop, and then take a break? If you are an entrepreneur, you can structure your schedule to make this possible. You can also choose to hire others to perform tasks that you do not like to do or are not good at, so you can stay focused on what you do best. Bill Gates liked to spend his time designing software. He hired people to manage Microsoft’s operations and to market and sell its products. Many eBay entrepreneurs have carved out flexible schedules for responding to orders, packaging, and shipping. Bricks-and-mortar retail stores, on the other hand, do not often afford such flexibility.
2. **Fulfillment.** Successful entrepreneurs are passionate about their businesses. They are excited and fulfilled by their work. Entrepreneurs who are working to reach their full potential are rarely bored, because there is always plenty to do. If one facet of running the business is uninteresting, and they have the income to support it, they can hire someone else for that task.

Social entrepreneurs who want to contribute to societal improvement find ways to do this while also earning profits. Founders of not-for-profit organizations create enterprises to address public issues that are personally important. Other entrepreneurs start lifestyle businesses that allow them to earn money while following a passion. For example, avid pilots may operate aviation-oriented businesses in which they can fly often, such as specialty delivery companies or flight instruction. Art lovers may open galleries, create art-rental firms, or operate art tours.

## BizFacts

- There are 27.3 million businesses in the United States; approximately 99.9 percent of them are small companies with fewer than 500 employees.
- Small businesses in America employed 49.2 percent of the country's private (nongovernment) workforce, hired 43 percent of high-tech workers, and created 64 percent of net new jobs annually over the last decade.
- Home-based businesses make up 52 percent and franchises 2 percent of all small firms.
- Small businesses represent 99.7 percent of all companies with employees.
- Small firms constituted 98 percent of all identified exporters and produced 33 percent of the country's known export value in fiscal year 2010.

Source: U.S. Small Business Administration, accessed June 29, 2013, <http://www.sba.gov>.

3. **Creation/ownership.** Entrepreneurship is a creative endeavor. Entrepreneurs put time and effort into creating a venture that they expect will survive and become profitable. Entrepreneurs own the businesses they create and the profits those businesses earn. *Ownership* is the key to wealth. Your goal is to find a business that will create a continuing stream of earnings. Eventually, you may be able to sell that company for a multiple of those earnings. That is how entrepreneurs create wealth. Many entrepreneurs, such as Bill Gore, the inventor of GORE-TEX fabric, start their own business after becoming frustrated or disillusioned in other roles or having ideas rejected by an employer.
4. **Control over compensation.** Entrepreneurs choose how and when they are paid. As owner of your company, when funds permit, you can decide to:
  - Pay yourself a **salary**—a fixed payment made at regular intervals, such as every week or every month. Salaries are not applicable to sole proprietorships, where owners may take a “draw” on revenues, or partnerships, where they may “draw down” profits.
  - Pay yourself a **wage**—a fixed rate per hour. This is not a common choice, but it is available.
  - Take a share of the company's profit. As the owner, you can pay yourself a portion of the business's profits. In a corporation this kind of payment is called a **dividend** and must be paid to all shareholders.
  - Take a **commission** on every sale you make. A commission is a percentage of the value of a sale. If you decide to pay yourself 10 percent commission, and sell an item for \$120, your commission on the sale would be \$12.
5. **Control over working conditions.** As an entrepreneur, you can create a work environment that reflects your values. If you support recycling, you can make sure your company recycles. You will also evaluate your own performance. As long as you have control of the company, no one else has the power to fire you. If equality is essential, you may have an office with equal working spaces, no special privileges for managers, and few management layers.

**salary** fixed amount of money paid to an employee at regular intervals.

**wage** fixed payment per hour for work performed.

**dividend** each stockholder's portion of the profit-per-share paid out by a corporation.

**commission** a percentage of a sale paid to a salesperson.

Some of the greatest entrepreneurs in the world dealt with problems as they were growing up, such as extreme poverty, abuse, or learning disabilities. Sir Richard Branson, for example, had such severe dyslexia



Jeff Greenberg/Alamy

O'Lakes, Florida, with hundreds of independent contractors who are balloon artists. Alexander, who started the company in 2003, secures contracts with restaurants to provide balloon artists to amuse customers while they wait to be seated or while they are seated and waiting for their food to be served.

## Step into the Shoes . . .

### *Balloon Distractions Inc.: Putting a New Twist on Entertainment*

When Ben Alexander was a student at Rowan University in Glassboro, New Jersey, he earned spending money by working as a balloon artist. Today, he operates Balloon Distractions in Land

Balloon Distractions provides its artists with a four-hour DVD training kit to teach them 25 shapes. The artists can recruit other artists, generally college students, and thereby become trainers. Artists book their restaurant locations online through the company's interactive Web site. These independent contractors work to earn tips plus bonuses. Balloon Distractions uses entertainment skills Alexander developed during college, as well as selling skills learned in over 10 years as an automobile salesman and natural gas marketer. Alexander seized an opportunity and grew a business.

*Source:* Balloon Distractions Inc., accessed June 26, 2013, <http://www.balloondistractions.com>.

that he dropped out of high school. He became a successful entrepreneur, however, creating more than 200 companies—including Virgin Airlines, Virgin Galactic, and Virgin Records. The Virgin Group employs about 50,000 people in 34 countries and has revenues of approximately \$21 billion.<sup>3</sup> Branson has a personal net worth of about \$4.6 billion, making him number 272 on the Forbes list of billionaires.<sup>4</sup> As an entrepreneur, he was able to create an environment in which he could succeed.

## The Desire to Make Money Is Not the Only Reason to Start a Business

Starting a business is an opportunity and, like any opportunity, it should be evaluated by taking a careful look at the costs and benefits it offers. One thing is for certain, though: *The desire to make money, alone, is not a good enough reason to start one's own business.*

The financial rewards of owning your own business may not occur until you have put in years of hard work. The desire to make money may not be enough to keep you going through the difficult early period. Most successful companies have been founded by an entrepreneur with a powerful and motivating vision and passion, balanced by a strong work ethic and dedication.

Entrepreneurs have declared that they are “not in business for the money” so often that it has become a cliché, but, like most clichés, it is based on a degree of truth.

## Definitions of Success—Monetary and Other

The Millennial Generation (born between 1977 and 1995) has redefined success. It is more individualized than the traditional concept and based on factors beyond those of income and wealth. Business owners may start an enterprise to create a more environmentally friendly approach to a product or process, to provide jobs for a disadvantaged population, or to improve the mental or physical health of themselves or others. For these entrepreneurs, success might be measured by the ability to have an impact on the population they serve. Or, success may mean working to provide a

<sup>3</sup>Virgin Group, accessed June 26, 2013, <http://www.virgin.com>.

<sup>4</sup>“The World's Billionaires,” *Forbes*, March 2013, accessed June 26, 2013, <http://www.forbes.com>.

lifestyle that permits a shortened work week or telecommuting. Recognition from peers and others could also be a goal. Financial success may be just one of many measures of achievement for an entrepreneur.

## Taking the Long View

Successful entrepreneurs know that it is important to begin with the end in mind, so that they can have an idea of where they want the organization to be at their personal exit point, even before they make the first sale. Because the daily tactical decisions they make will be affected by what they hope to create in the short *and* long term, a clear vision is vital. As you consider an entrepreneurial path, consider these questions:

- Are you planning to be active in the business until retirement? At what age will you retire? Who will take over then? A family member? A new owner?
- Do you plan to grow the business to a certain size or level of maturity and then sell it? If so, what is the target level? Are you looking at an initial public offering or a small private sale? Would you stay with the business after it was sold?
- Would you want to stay active for a given number of years? Then what would you do?

Taking the long view also means considering personal satisfaction, including conformance with individual values and ethics. Entrepreneurs make hundreds of choices and decisions every day. These decisions may conform to their values and ethics or violate them to meet a customer need, provide an expedient or cost-effective solution to an immediate problem, or the like. If you find yourself facing such a decision, for your long-term wellness and the benefit of those around you, it will be critical to keep your core values in the forefront. Consider the legacy you want to leave behind for your successors.

## Benefits and Costs of Becoming an Entrepreneur

Even if you have a clear vision that you believe will motivate you through the ups and downs of running a business, look closely at the costs and benefits of being an entrepreneur before you decide whether this is the life for you. The scope of this examination will vary considerably from person to person and is essential in the decision to become an entrepreneur.

Benefits include:

- **Independence/autonomy.** Because they are not reporting to managers or supervisors, business owners do not have to follow orders or observe working hours set by someone else. They have control over their decisions.
- **Satisfaction.** Doing what they love to do or turning a skill, hobby, or other interest into a business can be highly satisfying. The words of Confucius, “Choose a job that you love, and you will never have to work a day in your life” are often cited with respect to entrepreneurship.
- **Financial reward.** Entrepreneurs can build income and wealth through their endeavors. Although income potential is generally capped for employees, entrepreneurs are limited only by their own imagination and tenacity. Entrepreneurs built most of our country’s

great fortunes. At the same time, many part-time, seasonal, and lifestyle entrepreneurs find ways to fund gaps in household income, pay for college, or support extraordinary expenses through their business endeavors.

- **Self-esteem.** Knowing that they created something valuable can give business owners a strong sense of accomplishment. It can help them feel good about themselves and increase their self-confidence.
- **Contribution to society.** Business owners decide how they can add value to their communities and the wider world. The issues they care about can be “designed-in” when they form their companies.

Costs include:

- **Business failure.** About one in five new businesses fails in the first eight years, although this is sometimes attributed to entrepreneurs not getting proper training. Another third close because the entrepreneurs become discouraged and give up. Entrepreneurs risk losing not only their own money but also the financial investments of others.
- **Obstacles.** Entrepreneurs run into problems that they will have to solve, primarily by themselves. In addition, their families and friends may not support their visions and may actively discourage them.
- **Loneliness.** It can be lonely and even a little scary to be completely responsible for the success or failure of a business. While owners have control, they also have responsibility and cannot defer to someone else for decisions.
- **Financial insecurity.** Owners are not guaranteed a set salary or benefits. They may not always have enough money to pay themselves, particularly in the first 18 months or so of a new enterprise. They also have to set up and fund their own retirement funds.
- **Long hours/hard work.** Entrepreneurs have to work long hours to get their businesses off the ground. Many entrepreneurs work six or even seven days a week, often for 12 hours or more per day. While they decide when to work, they often end up working or thinking about their businesses many more hours as entrepreneurs than they would as employees.
- **Strain on personal relationships.** Even with the strong support of family and friends, the inherent challenges of a small business can strain relationships to the breaking point.

Not everyone is cut out to be an entrepreneur. Entrepreneurs have to be able to tolerate a higher degree of risk and uncertainty than people who work steady jobs for established employers. With higher risk, however, comes the potential of higher rewards.

## Cost/Benefit Analysis

Using a comparison of benefits and costs to make a decision is called **cost/benefit analysis**. It is a helpful tool because people often make decisions based on emotions, not intellect, to evaluate pros and cons. Strong emotions may take over to the point where they see only the benefits and not the costs of an action (or vice versa).

For example, Xavier plans to buy a car. He might be overwhelmed by the idea of making such a large purchase, even if the benefits are greater than the costs. On the other hand, he might decide to buy a car at a cost that outweighs the benefits it will bring, simply because he is temporarily blinded by a desire to own a really impressive vehicle. Making a list that includes the dollars and cents of the costs and benefits of a purchase is a

**cost/benefit analysis** a decision-making process in which the costs of taking an action are compared to the benefits.

concrete way to take the emotion out of the decision, while also considering nonfinancial factors.

To turn an opportunity into a business, entrepreneurs invest both time and money. Before making this kind of investment, think carefully about:

**Costs.** The money, energy, and time you will have to invest, as well as the opportunities you will be giving up, to operate the business.

**Benefits.** The wealth you will accrue and the knowledge, skills, self-esteem, and experience you will gain.

## Opportunity Cost

Cost/benefit analysis is incomplete without considering **opportunity cost**. This is the cost of your “next-best investment.” Perhaps your goal is to become a composer who writes scores for movies. You get a full-time job at a local music store for \$400 a week to support yourself, so you can write and record music in the evenings that you hope to sell to producers, agents, or film companies.

You find, however, that whenever a producer or agent wants to meet with you, you cannot get out of work to go. You realize that, even though you are making \$400 a week, you are missing some important opportunities. Perhaps it would be smarter to take a part-time job for \$300 a week that would leave your mornings free for meetings. The opportunity cost of the \$100 a week you will lose is offset by the potential income from film-scoring jobs you are missing by not being free to see people in the business. If your first film-scoring job pays \$5,000, for example, you definitely would have made the right decision to earn \$100 a week less for a few months.

People often make decisions without considering the opportunity cost and then wonder why they are not happy with the outcome. Each time you make a decision about what to do with your time, energy, or money, think about the cost of the opportunities you are giving up. **Exhibit 1-1** presents a simple quiz that can help you decide whether you have what it takes to be an entrepreneur.

## Seeking Advice and Information to Succeed

While experience is an excellent teacher, using knowledge, skills, and abilities to avoid errors, problems, and delays is much healthier. A savvy entrepreneur learns from the mistakes of others and appreciates the wisdom and experience of trusted advisors and mentors.

Preparation and planning are key to avoid making mistakes. Thoughtful consideration of the entrepreneurship option is an excellent starting point. Thorough research and taking advantage of training and/or technical assistance to bridge gaps in your preparation can make a world of difference.

Two of the best resources for keeping on track are mentors and advisors. A **mentor** is a trusted advisor with whom a person forms a developmental partnership through which information, insight, skills, and knowledge are shared to promote personal and/or professional growth. Finding a committed business mentor with industry-specific knowledge and experience, broad general business experience, or both, is a worthwhile endeavor. A successful entrepreneur in your field, perhaps outside of your geographic area, may prove invaluable if she will mentor you. Many successful entrepreneurs will carve out time for promising newcomers. Unfortunately, becoming a mentor may be more of a commitment than your identified entrepreneur is willing or able to make. Perhaps she will become an advisor instead.

**opportunity cost** the value of what must be given up in order to obtain something else.

**mentor** a trusted advisor with whom a person forms a developmental partnership through which information, insight, skills, and knowledge are shared to promote personal and/or professional growth.

**Exhibit 1 - 1** *“Do You Have What It Takes?” Quiz*

Take the following quiz to learn more about yourself and whether you may have what it takes to be an entrepreneur. Circle the answer that best represents how you feel.

1. You are at a party and a friend tells you that the guy in the expensive-looking suit recently invested in another friend’s business. What do you do?
  - a. Race over to him, introduce yourself, and tell him every detail of your business idea while asking if he would be interested in investing in it.
  - b. Ask your friend to introduce you. Once introduced, you hand the potential investor your business card and politely ask whether you might be able to call on him sometime to present your business plan.
  - c. Decide that it is probably not a good idea to bother the man at a party. After all, he is here to relax. Maybe you will run into him again somewhere else.
2. Your boss asks you to take charge of researching office supply stores and choosing the one that you think would be best for the company to use. What is your response?
  - a. Yes! Finally, a chance to show the boss what you are made of—plus, you will be able to spirit a few of the supplies away for your own business.
  - b. You are terrified; this is more responsibility than you really want. What if you make a mistake and cost the company money? You do not want to look bad.
  - c. You are excited. This is a good opportunity to impress your boss and also learn how to compare and negotiate with suppliers . . . something you will need to do for your own business.
3. You are already going to school full time when you are offered a part-time job that is in the same field as the business you want to start when you graduate next year. What do you do?
  - a. Take the job, after talking with your student advisor about how to juggle your schedule so it will fit, because you believe the experience and the contacts you will develop will be invaluable when you start your business.
  - b. Take the job. In fact, you ask for extra hours so you can finally start making some real money. Who needs sleep?
  - c. Turn down the job. School is hard enough without working, too. You do not want your grades to suffer.
4. You are offered a job as a survey-taker for a marketing firm. The job pays really well but will require you to talk to a great many people. What do you do?
  - a. Take the job. You like people and this job will be a good way to practice getting to know what consumers want.
  - b. Turn down the job. Just the thought of approaching strangers makes you queasy.
  - c. Take the job so you can conduct some market research of your own by also asking the people you survey what they think about your business idea.
5. Your last job paid well and was interesting, but it required you to put in long hours and sometimes work on the weekends. What was your response?
  - a. You put in the extra hours without complaint, but mainly because you felt that the rewards were worth it.
  - b. You went a little overboard and worked yourself into a state of exhaustion; moderation is not your strong suit.
  - c. You quit. You are strictly a nine-to-five person. Work is definitely not your life!
6. You are such a good guitar player that friends keep offering to pay for you to give them lessons. What is your response?
  - a. You spend some money to run a six-week advertisement in the local paper, announcing that you are now available to teach at the same rate that established teachers in the area charge.
  - b. You start teaching a few friends to see how it goes. You ask them what they are willing to pay and what they want to learn.
  - c. You give a few friends some lessons but refuse to take any money.
7. Your best friend has started a business designing Web sites. He needs help because the business is really growing. He offers to make you a partner in the business even though you are computer-illiterate. What is your response?
  - a. You jump in, figuring that you will learn the ropes soon enough.
  - b. You ask your friend to keep the partnership offer open but first to recommend a class you can take to get your skills up to speed.
  - c. You pass. You do not see how you can work in a business you know nothing about.

**Analysis of the “Do You Have What It Takes?” Quiz****Scoring**

- |          |       |       |
|----------|-------|-------|
| 1. a = 2 | b = 1 | c = 0 |
| 2. a = 2 | b = 0 | c = 1 |
| 3. a = 1 | b = 2 | c = 0 |
| 4. a = 1 | b = 0 | c = 2 |
| 5. a = 1 | b = 2 | c = 0 |
| 6. a = 2 | b = 1 | c = 0 |
| 7. a = 2 | b = 1 | c = 0 |

**Exhibit 1-1** *“Do You Have What It Takes?” Quiz*

**12 Points or More:** You are a natural risk-taker and can handle a lot of stress. These are important characteristics for an entrepreneur to have to be successful. You are willing to work hard but have a tendency to throw caution to the wind a little too easily. Save yourself from that tendency by using cost/benefit analysis to carefully evaluate your business (and personal!) decisions. In your enthusiasm, do not forget to look at the opportunity costs of any decision you make.

**6 to 12 Points:** You strike an excellent balance between being a risk-taker and someone who carefully evaluates decisions. An entrepreneur needs to be both. You are also not overly motivated by the desire to make money. You understand that a successful business requires hard work and sacrifice before you can reap the rewards. To make sure that you are applying your natural drive and discipline to the best possible business opportunity, use the cost/benefit analysis to evaluate the different businesses you are interested in starting.

**6 Points or Fewer:** You are a little too cautious for an entrepreneur, but that will probably change as you learn more about how to run a business. You are concerned with financial security and may not be eager to put in the long hours required to get a business off the ground. This does not mean that you cannot succeed as an entrepreneur; just make sure that whatever business you decide to start is the business of your dreams, so that you will be motivated to make it a success. Use cost/benefit analysis to evaluate your business opportunities. Choose a business that you believe has the best shot at providing you with both the financial security and the motivation you require.

In addition to your paid professional advisors, such as attorneys and accountants, individual advisors or an advisory board can be the difference between success and failure. Even if you are forming a venture with a full slate of experienced technical and managerial professionals, the guidance of a carefully composed advisory board can provide valuable counsel and connections. Such a board might meet only once or twice a year to listen to your problems, share experiences, and help you avoid mistakes. During the times between meetings, advisors may also be able to offer substantial assistance.

Of course, taking advantage of available courses in entrepreneurship, whether brief workshops, individual college courses, an entrepreneurial certificate program, or a degree program, can offer considerable benefits. The opportunity to learn from the experiences of others and to systematically explore entrepreneurial options and build skills will be important. There are numerous Internet resources for nascent entrepreneurs, too.

A well-prepared entrepreneur is more likely to stay on the path to success.

## Entrepreneurial Options

Entrepreneurship extends beyond the fast-growing technology enterprises that are most commonly associated with it. There are many variations on entrepreneurship, and the opportunities are innumerable. Entrepreneurship may include for-profit enterprises that support the missions of not-for-profit organizations, businesses designed for social impact, and ventures that are environmentally oriented.

**Social entrepreneurship** has multiple definitions and forms, but in general it is commonly thought of as a for-profit enterprise that has the dual goals of achieving profitability and attaining beneficial returns for society. Another view is that of taking an entrepreneurial perspective toward social problems.<sup>5</sup> Gregory Dees has created the following definition:

Social entrepreneurs play the role of change agents in the social sector by:

- adopting a mission to create and sustain social value (not just private value),
- recognizing and relentlessly pursuing new opportunities to serve that mission,
- engaging in a process of continuous innovation, adaptation, and learning,

**social entrepreneurship** a for-profit enterprise with the dual goals of achieving profitability and attaining social returns.

<sup>5</sup>Gregory Dees, “The Meaning of ‘Social Entrepreneurship,’” May 30, 2001, accessed July 9, 2013, [http://www.fuqua.duke.edu/centers/case/documents/dees\\_SE.pdf](http://www.fuqua.duke.edu/centers/case/documents/dees_SE.pdf).

**social business** a company created to achieve a social objective while generating a modest profit to expand its reach, improve the product or service, and subsidize the social mission.

**venture philanthropy** a subset or segment of social entrepreneurship wherein financial and human capital is invested in not-for-profits by individuals and for-profit enterprises, with the intention of generating social rather than financial returns on their investments.

**green entrepreneurship** business activities that avoid harm to the environment or help to protect it in some way.



*Organically grown produce*  
(Ulrich Willmunder/Shutterstock)

- acting boldly without being limited by resources currently in hand, and
- exhibiting heightened accountability to the constituencies served and for the outcomes created.

In this view, social entrepreneurship is less about profit than it is about social impact.

In addition to the broadly defined “social entrepreneurship,” there is the more recent concept of the **social business**, “a non-loss, non-dividend company designed to address a social objective within the highly regulated marketplace of today. It is distinct from a non-profit because the business should seek to generate a modest profit but this will be used to expand the company’s reach, improve the product or service or in other ways to subsidize the social mission.”<sup>6</sup> In his book *Creating a World without Poverty—Social Business and the Future of Capitalism*, Muhammad Yunus suggests two kinds of social business:

- Type I provides a product and/or service with a particular environmental, social, or ethical purpose. Grameen Danone does this by providing food for the poor in Bangladesh.
- Type II is profit-oriented business with ownership consisting of underprivileged people who have the opportunity to benefit directly or indirectly.

In addition, **venture philanthropy** is a subset or segment of social entrepreneurship. Financial and human capital is invested in not-for-profits by individuals and for-profit enterprises with the intention of generating social rather than financial returns. In some cases, venture philanthropy may involve the investment of capital in the for-profit, commercial part of a not-for-profit. In others, it may mean investing in not-for-profits directly, to encourage entrepreneurial approaches to achieve social impact.

**Green entrepreneurship** is another form of social entrepreneurship and can be defined as: “Enterprise activities that avoid harm to the environment or help to protect the environment in some way.”<sup>7</sup> TerraCycle is an excellent example of green entrepreneurship. According to the Corporation for Enterprise Development (CFED), green entrepreneurship can:

- create jobs and offer entrepreneurship opportunities,
- increase energy efficiency, thus conserving natural resources and saving money,
- decrease harm to workers’ health,
- enable businesses to tap into new sources of local, state, and federal funding,
- take advantage of consumer preference for environmentally friendly goods, and
- preserve limited natural assets on which businesses and communities depend for business and quality of life.

Each of these alternative approaches offers opportunities for innovation and growth for the right entrepreneur.

<sup>6</sup>Muhammad Yunus, *Creating a World without Poverty: Social Business and the Future of Capitalism*, New York: PublicAffairs, 2009, p. 320.

<sup>7</sup>“Green Entrepreneurship,” *Corporation for Enterprise Development: Effective State Policy and Practice*, Volume 5, Number 2, April 2004, <http://www.cfed.org>.

## How Do Entrepreneurs Find Opportunities to Start New Businesses?

In the twentieth century, Joseph Schumpeter expanded on Say's definition of entrepreneurship by adding that entrepreneurs create value “by exploiting an invention or, more generally, an untried technological possibility for producing a new commodity or producing an old one in a new way, by opening up a new source of supply of materials or a new outlet for products, by reorganizing an industry and so on.”<sup>8</sup> This view emphasizes innovation as the key to entrepreneurship. Management expert Peter Drucker simplified this view to the essential core of creating a new business, taking on risk, and persevering in light of uncertainty.<sup>9</sup>

Schumpeter's definition describes five basic ways that entrepreneurs find opportunities to create new businesses:

1. Using a new technology to produce a new product
2. Using an existing technology to produce a new product
3. Using an existing technology to produce an old product in a new way
4. Finding a new supply of resources (that might enable the entrepreneur to produce a product more economically)
5. Developing a new market for an existing product

## Entrepreneurs Creatively Exploit Changes in Our World

Today's economists and business experts have defined entrepreneurship even more specifically. Drucker pointed out that, for a business to be considered entrepreneurial, it should exploit changes in the world. This is in alignment with Schumpeter's definition of entrepreneurship but explicitly takes it a step further—to take advantage of circumstances. These changes can be technological, like the explosion in computer technology that led Bill Gates and Paul Allen to start Microsoft, or cultural, like the collapse of Communism, which led to a great many new business opportunities in Eastern Europe. Babson professor Daniel Isenberg narrows the definition of entrepreneurship to “the contrarian creation and capture of extraordinary value.”<sup>10</sup>

Nothing changes faster than technology. Not so many years ago, there were no bar codes and no electronic scanners, hardly anyone used e-mail, and “smart phones” didn't exist. Today, even the smallest of organizations needs to use current technologies to be competitive. Sharp entrepreneurs increase their efficiency by taking advantage of the latest breakthroughs in business equipment. To learn about what's new in technology, read current business and trade magazines and visit such Web sites as:

- TechCrunch, <http://www.techcrunch.com>.
- Start-up Digest, <http://www.start-updigest.com>.

Peter Drucker defined an entrepreneur as someone who “always searches for change, responds to it, and exploits it as an opportunity.” Entrepreneurs are always on the lookout for ways to create businesses from the opportunity of change.

<sup>8</sup>Joseph A. Schumpeter, *Capitalism, Socialism and Democracy*, New York: Harper & Row, 1942.

<sup>9</sup>Peter Drucker, *Innovation and Entrepreneurship: Practice and Principles*, New York: Harper Collins, 1985.

<sup>10</sup>Daniel Isenberg, *Worthless, Impossible and Stupid: How Contrarian Entrepreneurs Create and Capture Extraordinary Value*, Cambridge, Massachusetts: Harvard Business Press, 2013.

### Learning Objective 3

Find and evaluate opportunities to start your own business.

### How Do Entrepreneurs Create Business Ideas?

1. **They listen.** By listening to others, entrepreneurs get ideas about improving a business or creating a new one. Create one business idea by listening. Describe how you got the idea.
2. **They observe.** By constantly keeping their eyes and ears open, entrepreneurs get ideas about how to help society, about what kind of businesses they could start, and about what consumers need. Create a business idea by observing. Describe how you got the idea.
3. **They analyze.** When entrepreneurs analyze a problem, they think about what product or service could solve it. Create a business idea by thinking up a solution to a problem. Describe how you arrived at the idea.

### Where Others See Problems, Entrepreneurs Recognize Opportunities

Here is a simple working description of an entrepreneur that captures the essentials: An entrepreneur recognizes opportunities where other people see only problems or the status quo.

Many famous companies were started because an entrepreneur turned a problem into a successful business. An entrepreneur recognized that the problem was actually an opportunity. Where there are dissatisfied consumers, there are likely opportunities for entrepreneurs.

Anita Roddick was an excellent example of an entrepreneur who started off as a dissatisfied consumer. She started The Body Shop International because she was tired of paying for unnecessary perfume and fancy packaging when she bought makeup, and she thought other women might feel the same way.

### Train Your Mind to Recognize Business Opportunities

An important step in becoming an entrepreneur is to train your mind to recognize business opportunities. A further step is to let your creativity fly. Consider developing your entrepreneurial instincts by asking yourself:

- What frustrates me the most when I try to buy something?
- What product or service would really make my life better?
- What makes me annoyed or angry?
- What product or service would take away my aggravation?

### BizFacts

Entrepreneurship has proven to be an effective way for minorities and women to enter the business world.

- More than 6.1 million businesses were minority-owned in 2007, and they generated \$871 billion in revenues.
- There were more than 12.4 million non-farm businesses owned by women (or co-owned equally with men), accounting for 45.4 percent of all U.S. companies.

Source: U.S. Small Business Administration, accessed June 29, 2013, <http://www.sba.gov>.

## Entrepreneurs Use Their Imaginations

Businesses are also formed when entrepreneurs not only fume about products or services that annoy them but fantasize about products or services they would like to have in their lives. Jump-start your imagination by asking yourself such questions as:

- What is the one thing I would like to have more than anything else?
- What would it look like? What would it taste like?
- What would it do?
- What innovative product or service idea have I been mulling over in my mind?
- What problem have I encountered in everyday life and thought: “There has to be a better way to do this?”

Consider posing these questions to friends and family members as well. You might hear about an opportunity you had not yet recognized.

## An Idea Is Not Necessarily an Opportunity

Not every business idea you may have or invention you may explore is an opportunity. In fact, most ideas are not viable business possibilities. An *opportunity* has a unique characteristic that distinguishes it from an ordinary idea. An opportunity is *an idea that is based on what consumers need or want and are willing to buy sufficiently often at a high enough price to sustain a business*. A successful business sells products or services that customers need, at prices they are willing to pay. Many a small business has failed because the entrepreneur did not understand this. It is critical that an idea has “legs” for it to succeed.

In addition, according to Jeffrey Timmons, “An opportunity has the qualities of being attractive, durable, and timely and is anchored in a product or service which creates or adds value for its buyer or end user.”<sup>11</sup>

Timmons’s definition of a business opportunity includes these four characteristics:

1. It is attractive to customers because it creates or adds value for its customers.
2. It will work in the business environment.
3. It can be executed in a defined window of opportunity.
4. It can be implemented with the right team to make it durable.

The window of opportunity is the length of time available to get the business idea to market before the market either diminishes due to lessening demand or is dominated by a competitor. You might have a great idea, but if other entrepreneurs have it too, and have already brought it to the marketplace, that window of opportunity is probably closed.

Remember, not every idea is an opportunity. For an idea to be a genuine opportunity, it must lead to the development of a product or service that is of value to the consumer and is profitable for the business.



Larry Lilac/Alamy

<sup>11</sup>Jeffrey Timmons, *New Venture Creation: Entrepreneurship for the 21st Century*, 5th ed., New York: Irwin/McGraw-Hill, 1999, p. 7.

## Entrepreneurial Wisdom . . .

A useful way to evaluate a business idea is to look at its strengths, weaknesses, opportunities, and threats (SWOT). This is called **SWOT analysis**.

- **Strengths**—All the capabilities and positive points the entrepreneur has, from experience to contacts. These are internal to the organization.
- **Weaknesses**—All of the negatives the entrepreneur faces, such as lack of capital or training or failure to

set up a workable accounting system. These are internal to the organization.

- **Opportunities**—Any positive external event or circumstance (including lucky breaks) that can help the entrepreneur get ahead of the competition.
- **Threats**—Any external factor, event, or circumstance that can harm the business, such as competitors, legal issues, or declining economies.

**SWOT analysis** consideration of the internal strengths and weaknesses of an organization and the external opportunities and threats which it may face.

### Opportunity Is Situational

A problem is one example of an opportunity that entrepreneurs need to be able to recognize. A changing situation or a trend is another. Opportunity is *situational*, meaning it is dependent on variable circumstances. There are no rules about when or where an opportunity might appear. Change and flux create opportunities.

Think about recent changes in computer technology. In the early 1990s, the conventional wisdom was that only the biggest telecommunications companies were in a position to exploit the Internet and all the opportunities it had to offer. How could entrepreneurs compete with established, resource-laden companies? The opposite has been true, however. Entrepreneurs penetrated and, indeed, have dominated the market for Internet-based services. Think of Facebook, Google, and Foursquare. Each was an entrepreneurial venture that left industry giants scrambling to catch up.

It can take a huge corporation (think dinosaur) multiple years to develop and implement a new business strategy, while entrepreneurs can be nimble and enter and exit the market like roadrunners. Successful entrepreneurs can “turn on a dime rather than a dollar bill.”

### The Five Roots of Opportunity in the Marketplace

Entrepreneurs can exploit “five roots of opportunity.”<sup>12</sup> Notice how similar these are to Schumpeter’s definition of entrepreneurship.

1. **Problems** your business can solve
2. **Changes** in laws, situations, or trends
3. **Inventions** of new products or services
4. **Competitive advantage** in price, location, quality, reputation, reliability, speed, or other attributes of importance to customers
5. **Technological advances** that entrepreneurs take from the laboratory to the marketplace

### Integrating Internal and External Opportunities

It is helpful not only to be aware of the five roots of opportunity in the marketplace but to think also about how we perceive opportunities ourselves. Opportunities fall into two classes: internal and external. An internal opportunity is one that comes from inside you—from a personal hobby,

<sup>12</sup> Adapted from John Clow (ed.), *Master Curriculum Guide: Economics and Entrepreneurship*, New York: Joint Council on Economic Education, 1991.



Russell Simmons  
(© Everett Collection  
Inc./Alamy)

## Step into the Shoes . . .

### *Russell Simmons Makes Rap Happen*

In the late 1970s, Russell Simmons was promoting rap concerts at the City University of New York. At the time, rap was considered a passing fad, but Simmons really loved it. Even though most record executives thought rap would be over in a year or two, Simmons truly believed it was a business opportunity. He formed Def Jam Records with fellow student Rick Rubin for \$5,000. Within a year, they produced hit records by Run DMC and LL Cool J, and Simmons went on to become a multimedia mogul.

Simmons took a chance on this opportunity because he felt that, if you personally know 10 people who are eager to buy your product or service, 10 *million* would be willing to buy it if they knew about it. Luckily, he was right about rap's popular potential, but he could have been wrong. That can be a problem with perceived opportunities: You may be passionate about something, but there may not be enough consumer interest to sustain an actual business venture.

Simmons loved rap and hoped that other people would, too. That was the internal factor—he had the passion to sustain himself as he worked 24/7 to make his dream come true. As it turned out, music fans were a little bored with rock at that time and looking for a fresh sound. Rap filled the bill. This was an external opportunity that happened to coincide with Simmons's internal commitment.

interest, or even a passion—or inside your organization. These can come in the form of the resolution of a problem, such as creating a viable product from scrap material, or the potential for a new product line.

An external opportunity, in contrast, is generated by an outside circumstance. External opportunities are conditions you notice that make you say to yourself, “Hey! I could start a great business from that!” For example, you see that people in your neighborhood are complaining about the lack of available day care, so you start a day care center after confirming the market need. But what if you find out very quickly that two-year-olds get on your nerves? That can be a major drawback for external opportunities. Your idea may fill a market need, but you may not have the skills or interest to make it a successful business.

The best business opportunities usually combine both internal and external factors. Ideally, a business that you are passionate about will fill a sustainable need in the marketplace.

## Establishing Strategies

Business success hinges on the creation and application of profitable strategies to the work at hand. A **strategy** is a plan for how a business intends to go about its own performance and outdo that of its competition. Michael Porter created a “strategy framework” that delineates cost leadership and differentiation as low-cost and product-uniqueness strategies.<sup>13</sup> It also layers in the concept of focus strategies, which work in narrow market segments rather than broad ones. The illustration in Figure 1-1 shows how each of Porter's Generic Strategies relates to the other.

A firm using a product-uniqueness strategy bases its competitive advantage on its ability to differentiate the firm's products and/or services from others in its competitive market space. Such factors as quality, availability, customer service, and the like are critical to differentiation, as will be discussed in greater detail in the marketing chapters of this text.

If you choose to emphasize a low-cost approach, you will be using a “cost-leadership” strategy. This means that you are finding ways to reduce

**strategy** a plan for how an organization or individual plans to proceed with business operations and outperform that of its competitors.

<sup>13</sup>Michael Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, New York: Free Press, 1998.

**Figure 1-1** Porter's Generic Strategies

Scope of Target Market	Strategic Advantage	
	Product Uniqueness	Low Cost
Industry-Wide (Broad)	Differentiation Strategy	Cost Leadership Strategy
Market Segment (Narrow)	Focus Strategy (Differentiation)	Focus Strategy (Low Cost)

Source: Adapted from Michael Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (Free Press, 1998).

the costs of operations and management sufficiently to be able to undercut the pricing of your competition and to sustain that price advantage.

Another component of the Porter framework is that of a focus strategy. This line of attack narrows in and creates a laserlike focus on a particular market segment or group. Rather than strategically targeting an entire industry, you locate a niche or subset of the customer base and focus your marketing efforts on it. If you can find a sufficiently large niche to sustain your business, you can set the company apart from the competition and maintain the advantage. A focus strategy can work with differentiation and cost leadership.

## Paths to Small Business Ownership

Not all business owners start their ventures from the ground up. Although the emphasis of this book is on starting and growing your own enterprise, the paths to business ownership are varied. You could buy an existing company, secure franchise rights, license or purchase critical technology or methods, inherit a company, or be hired as a manager.<sup>14</sup> There are pros and cons to each approach, and it will be worthwhile to give thought to each option. Note the possibilities in **Exhibit 1-2**.

### Securing Franchise Rights

“A **franchise** is a legal and commercial relationship between the owner of a trademark, service mark, trade name or advertising symbol and an individual or group seeking to use that identification in a business.”<sup>15</sup> For many people who want to own and operate a business, it is worthwhile to consider franchising as a path to business ownership. (See Chapter 2 for a discussion of franchising as an entrepreneurial opportunity.)

### Buying an Existing Business

The purchase of a business, or **acquisition**, can be a good way to jumpstart entry into small business ownership. There is both an art and a science to buying an existing business.

The challenge is to do a complete, in-depth analysis of the opportunity, just as you would for a start-up, with the added dimension of taking into account an existing history, whether for better or worse. Be wary of owners whose businesses seem to be too good to be true or who are overly eager to sell. Be thorough, whether you are buying an entire firm, a customer list, or some or all assets and especially if you are taking on some or all debt. Done well, buying a business can be the starting point for success.

**franchise** is a legal and commercial relationship between the owner of a trademark, service mark, trade name or advertising symbol and an individual or group seeking to use that identification in a business.

**acquisition** a business purchase.

<sup>14</sup>Jerome A. Katz and Richard P. Green, *Entrepreneurial Small Business*, New York: McGraw-Hill/Irwin, 2008.

<sup>15</sup>U.S. Small Business Administration Workshop, “Is Franchising for Me?” accessed December 2007, [http://www.sba.gov/idc/groups/public/documents/sba\\_homepage/serv\\_sbp\\_isfforme.pdf](http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sbp_isfforme.pdf).

**Exhibit 1-2** Selected Business Entry Options

Business Aspects	Start a Business	Buy an Existing Business	Secure a Franchise or License	License Technology
Customers	None	Established	None—but may have name recognition	None
Location	Needed	In place	Assistance possible	Needed
Management Control	Owner	Owner	Owner within terms of license	Owner within terms of license
Operational Control	Owner	Owner	Owner within terms of license	Owner
Marketing	Needed	In place (+/–)	Assistance possible. Rules absolutely.	Needed
Reputation	None	In place (+/–)	Should be. If not, why license?	Possible
Royalties/Fees	Not usual	Maybe	Ongoing	Likely
Financing	Needed	Prior owner may provide	Assistance possible	Needed
Disclosures	None	Buyer beware	UFOC and contracts	Agreement

Done poorly, buying a business can be more challenging and problematic than starting a new venture. (See Chapter 3 for a more in-depth discussion.)

## Licensing Technology

One way to potentially shorten the product-development cycle and to access innovative technology is to identify and *license* that technology—that is, to enter into a contract to use it without purchasing the rights to own it. Whether you acquire such rights through a university, state economic development office, federal agency such as NASA, or an individual scientist/inventor, you can create a business based on technology transfer. Or, you may find that it makes more sense to purchase the rights outright, or over time.

The MBA team of Bruce Black and Matt Ferris, from the University of Georgia, developed a business plan that garnered numerous competitive awards for the KidSmart Vocal Smoke Detector, someone else's creation that they arranged to bring to market. The product is now available in major retail stores and on the Internet, through Signal One, the successor company.

Before securing franchise rights, purchasing a business, or licensing technology, be certain to do your research thoroughly to understand what you are and are not buying, and what your ongoing obligations—financial, operational, legal, and reporting—will be. Because these transactions are complex and can have significant financial and personal implications, it is important to invest in qualified legal and financial counsel before signing any agreements of this kind.

## Do Not Take Unfair Advantage of Someone Else's Creativity

You would be upset if someone made money from your invention or artistic creation, so resist the urge to base your business on someone else's creative work. Be sure that any business you start respects the intellectual property of others.

- Do not sell counterfeit knockoffs of popular brands.
- Do not take graphics, music, or content from the Web without permission and/or payment.
- Always know the source of the goods you buy from suppliers to avoid the risk of receiving stolen property.

## The Many Faces of Entrepreneurship

Entrepreneurs are as diverse as the composition of the economy. They are of all ethnicities, races, and religions and come from every socioeconomic status. They enter into self-employment for a wide range of reasons and choose to continue as entrepreneurs or return to outside employment for just as many. There are women and minority entrepreneurs and young entrepreneurs in record numbers. Continuing an American tradition, there are also refugee and immigrant entrepreneurs.

This diverse and ever-changing pool of entrepreneurs does not produce a single path to entrepreneurial success. Rather, the types of businesses formed reflect the diversity of the founders. In addition to full-time ventures founded to maximize growth and wealth, some are started as part-time and microenterprises, “gazelles,” artisanal and opportunistic businesses, and others.

### Gazelles

A classic entrepreneurial story is that of a pair of inventors who develop a new, innovative technology or product in a garage, basement, or dormitory; lift themselves up by their bootstraps into a wildly successful business venture in virtually no time; take the company public; and become incredibly wealthy in the process. This stereotype describes the founders of a high-potential venture with the potential to become a **gazelle**, a company that achieves an annual growth rate of 20 percent or greater, typically measured by the growth of sales revenue.

Gazelles tend to be the exception rather than the rule for entrepreneurial enterprises but are a significant type of firm. Gazelles are financed by a combination of found resources with significant outside assistance. They rely heavily on external financial support and counsel.

### Microenterprises

Most businesses are founded as **microenterprises**, which are defined as businesses with five or fewer employees, initial capitalization requirements of less than \$50,000, and the habitual operational involvement of the owner. In fact, more than 60 percent of all U.S. firms have four or fewer employees, according to the U.S. Small Business Administration.<sup>16</sup> The Association for Enterprise Opportunity (AEO) estimates that the more than 25.1 million microenterprises in the United States account for 88.2 percent of all businesses and 22 percent of all private employment.<sup>17</sup>

Microenterprises are founded for a variety of reasons and are often more fluid than other types of businesses. These firms may be founded to provide only part-time employment for their owners. They may not be intended as long-term enterprises and may not have the goal of growing larger. They may be planned as only temporary ventures to provide income during periods of unemployment or to supplement household finances for a particular purpose. **Lifestyle businesses** are microenterprises that permit their owners to follow a desired pattern of living, such as supporting college costs or taking vacations. On the other hand, a microenterprise could make the difference between a family living in poverty and achieving economic stability.

### Mainstream Small Firms

These constitute the bulk of the small businesses in the public perception, in the press, and in community visibility. They provide, or have the

**gazelle** a company that achieves an annual growth rate of 20 percent or greater, typically measured by the increase of sales revenue.

**microenterprise** a firm with five or fewer employees, initial capitalization requirements of under \$50,000, and the regular operational involvement of the owner.

**lifestyle business** a microenterprise that permits its owners to follow a desired pattern of living, such as supporting college costs or taking vacations.

<sup>16</sup>U.S. Small Business Administration, Office of Advocacy, 2013.

<sup>17</sup>Association for Enterprise Opportunity, accessed June 30, 2013, <http://www.microenterpriseworks.org>.

potential to provide, substantial profits to their owners. Mainstream small firms can be operated by founder-entrepreneurs, subsequent generations of family members, successor owners, or franchisees. They create many of the jobs included in statistics from the U.S. Small Business Administration and employ the majority of American workers. Unlike many micro-enterprises, they are established with continuity and permanent wealth building in mind and are more often registered with local, state, and federal agencies.

## Making the Business Work Personally and Professionally

What makes a business work is not only profitability and cash flow, although they are necessary. Each entrepreneur has his own goals and objectives for the business. As an entrepreneur, it will be up to you to determine how you want your business to be and to make it happen.

### A Business Must Make a Profit to Stay in Business

No matter how big or small, a business must make a **profit**—that is, show a positive gain from operations after all expenses are subtracted. Most businesses lose money initially because entrepreneurs have to spend money to set up operations and advertise to attract customers. If the business cannot make a profit and generate cash, eventually the entrepreneur will be unable to pay the bills and will have to close.

Closing a business is nothing to be ashamed of, if you operate ethically and learn from the experience. In fact, many successful entrepreneurs open and close more than one business during their lives. If your venture is not making a profit after you have gotten it up and running, that is a signal you may be in the wrong business. Closing it may be the best decision.

An entrepreneur may change businesses many times over a lifetime in response to changing competition and consumer needs.

### Profit Is the Sign That the Entrepreneur Is Adding Value

Profit is the sign that an entrepreneur has added value to the resources he or she is using. Debbi Fields added value to scarce resources by creating something that people were willing to buy for a price that gave her a profit. In contrast, not making a profit is a sign that the entrepreneur is not using resources well and is not adding value to them.

### Profit Results from the Entrepreneur's Choices

An entrepreneur's choices directly affect how much profit the business makes. For example, suppose, like Debbi Fields, you have a business selling homemade cookies. You might decide one week to buy margarine instead of butter because it is cheaper, even though the cookies may not taste as good made with margarine. This type of choice is called a **trade-off**. You are giving up one thing (taste) for another (money).

If your customers do not notice the change and continue to buy your cookies, you have made a good choice. You have conserved a resource (money) and increased your profit by lowering your costs. The increase in profit confirms that you have made the right choice.

If your customers notice the change and stop buying your cookies, your profit will decrease. The decrease in profit signals that you have made a bad choice. Next week you should probably go back to butter. The profit

**profit** amount of money remaining after all costs are deducted from the income of a business.

#### ◀ Learning Objective 4

Explain how profit works as a signal to the entrepreneur.

**trade-off** the act of giving up one thing for another.

signal taught you that your customers were dissatisfied and the trade-off was not worth it. Every choice an entrepreneur makes is a trade-off.

## Seven Rules for Building a Successful Business

Russell Simmons and Rick Rubin were successful in creating Def Jam because they instinctively applied the seven basic rules of building a successful business:

1. **Recognize an opportunity.** Simmons believed that rap music was an untapped business opportunity.
2. **Evaluate it with critical thinking.** He tested his idea by promoting concerts and observing consumer reaction.
3. **Build a team.** Simmons formed a partnership with Rubin.
4. **Write.** Simmons and Rubin created a realistic business plan.
5. **Gather resources.** Simmons and Rubin pooled their \$5,000.
6. **Decide ownership.** Simmons and Rubin formed a legal partnership.
7. **Create wealth.**

## The Team Approach

While most businesses do not hire employees, successful entrepreneurial ventures grow well beyond their initial founder. Some have multiple co-founders while others grow their teams along with their businesses. The team approach can make or break a business. For example, alone, neither Simmons nor Rubin had enough skills or money to launch a record label, but together they were able to do it. Their business was also helped by the fact that each knew different artists and had different contacts in the recording industry.

Potential team members are all around you. Some might be in your immediate circles of friends and family members who have skills, equipment, or contacts that would make them valuable business partners. At the same time, you may reach across the globe to find other team members. Perhaps you very much want to start a Web site design business, because you know of companies in your community that want to put up Web sites.

# Entrepreneurial Wisdom . . .

## Build Your Brain

Becoming a successful entrepreneur is all about making connections, those “Aha!” moments when you realize what your business opportunity is or when you figure out how to do something better than the competition. Research indicates that mental exercise will help your brain become better at making such connections. Even the most erudite scientists recognize the value of activities that encourage brain cells to make new connections. Robotics engineer Hugo de Garis, who has worked on such projects as building an artificial brain for an artificial cat, plays classical piano every day before he sits down at the computer. “This helps to build my own brain,” he told *The New*

*York Times*.<sup>18</sup> Arnold Scheibel, head of the University of California–Los Angeles Brain Research Institute, suggests the following brain-builders:

- Solving puzzles
- Playing a musical instrument
- Fixing something; learn to repair cars or electrical equipment
- Creating art, writing poetry, painting, or sculpting
- Dancing
- Making friends with people who like to have interesting conversations

<sup>18</sup>Nicholas D. Kristof, “Robokitty,” *The New York Times*, August 1, 1999.

You are a graphic artist, but you do not know how to use Web site development programs. If you have a friend who has that knowledge, you might start a business together. Or maybe you would like to start a DJ venture, but you only have one turntable or laptop computer. If you form the business with a friend, you can pool equipment. (When forming a business team, organize the enterprise so that everyone involved shares in the ownership and profits. People work better when they are working for themselves.) Just be careful of jumping into business relationships with undue haste.

Now carry this idea a step further. Everyone you meet is a potential contact for your business, just as you may be a valuable contact for theirs. Thinking this way will encourage you to *network*, or exchange valuable information and contacts with other businesspeople. Keep your business cards with you at all times and truly view every individual you encounter as an opportunity for your business. Remember, though, that networking is a two-way street. See how you can help those that you meet rather than always focusing on how they can help you. The results can be nothing short of amazing.

## Chapter Summary

Now that you have studied this chapter, you can do the following:

1. Explain what entrepreneurs do.
  - Entrepreneurs start their own businesses and work for themselves.
  - Entrepreneurs recognize opportunities to start businesses that other people may not have noticed.
  - Entrepreneurs shift economic resources from an area of lower productivity into an area of higher productivity and greater yield. By doing this, they add value to scarce resources.
2. Describe how free-enterprise economies work and how entrepreneurs fit into them.
  - The free-enterprise system is based on voluntary exchange. Voluntary exchange is a trade between two parties who agree to trade money for a product or service. Both parties agree to the trade because each benefits from the exchange.
  - The free-enterprise system encourages entrepreneurs who use resources efficiently to satisfy consumer needs by rewarding them with profit.
3. Find and evaluate opportunities to start your own business.
  - The five roots of opportunity are:
    - i. problems that your business can solve;
    - ii. changes in laws, situations, or trends;
    - iii. inventions of totally new products or services;
    - iv. competition (if you can find a way to beat the competition on price, location, quality, reputation, reliability, or speed, you can create a very successful business with an existing product or service); and
    - v. technological advances (scientists may invent new technology, but entrepreneurs figure out how to sell it).
4. Explain how profit works as a signal to the entrepreneur.
  - Profit is the sign that an entrepreneur has added value to the scarce resources he or she is using.
  - Not making a profit is a sign that the entrepreneur is not using resources well and is not adding value to them.

5. A business opportunity is an idea plus these three characteristics:
  - It is attractive to customers.
  - It will work in your business environment.
  - It can be executed in the defined window of opportunity.
6. Use cost/benefit analysis to make decisions.
  - Cost/benefit analysis is the process of comparing costs and benefits in order to make a good decision.
  - Cost/benefit analysis can be inaccurate without including opportunity cost. This is the cost of missing your next-best investment.
7. Use SWOT analysis to evaluate a business opportunity.
  - Strengths: all of the capabilities and positive points that the entrepreneur has, from experience to contacts. These are internal to the organization.
  - Weaknesses: all of the negatives the entrepreneur faces, such as lack of capital or training or failure to set up a workable accounting system. These are internal to the organization.
  - Opportunities: any positive external events or circumstances (including lucky breaks) that can help the entrepreneur get ahead of the competition.
  - Threats: any external factors, events, or circumstances that can harm the business, such as competitors, legal issues, or declining economies.

## Key Terms

acquisition, 42	opportunity cost, 33
capital, 27	product, 25
capitalism, 27	profit, 45
commission, 29	salary, 29
cost/benefit analysis, 32	service, 25
dividend, 29	social business, 36
entrepreneur, 25	social entrepreneurship, 35
franchise, 42	strategy, 41
free-enterprise system, 26	SWOT analysis, 40
gazelle, 44	trade-off, 45
green entrepreneurship, 36	venture philanthropy, 36
lifestyle business, 44	voluntary exchange, 27
mentor, 33	wage, 29
microenterprise, 44	

# Entrepreneurship Portfolio

## Critical Thinking Exercises

- 1-1. Are creativity and entrepreneurship two sides of the same coin? Illustrate the argument with an example.
- 1-2. Is being able to make a profit important for the success of a business? If yes, how does profit indicate the worth of a business?
- 1-3. If you were to start a business, what would be your opportunity cost? In other words, what is the next-best use of your time? How much money could you make working at a job, instead? The answer to this last question will give you a rough idea of how to value your time when you start a business and figure out how much to pay yourself.
- 1-4. Describe an idea that you have for a business. Explain how it could satisfy a consumer need.
- 1-5. What are the steps to convert a business idea into a successful business? Illustrate with an example from your country.
- 1-6. Is money the only motivator for a person to become an entrepreneur? Substantiate your response with suitable reasons.
- 1-7. List five business opportunities in your environment and the need(s) each would satisfy. Note whether the opportunity you describe is internal, external, or a mix.

## Key Concepts Questions

- 1-8. Define small business.
- 1-9. Does everyone live by selling something? If yes, illustrate with examples.
- 1-10. What are the unethical or unfair practices to watch out for when venturing into a new business?
- 1-11. How important is cost/benefit analysis in entrepreneurship?
- 1-12. Identify a few successful small or medium business enterprises in your country. Visit their Web sites and write a summary of how the business started (200 words or fewer). Remember to create a proper citation for the article.

## Application Exercises

- 1-13. Have a conversation with a friend or relative. Ask this person to tell you about which things he or she finds frustrating in the area/neighborhood. Write down these comments.

**Step 1:** Generate at least three business opportunities from this conversation.

**Step 2:** Use the checklists below to evaluate your three business ideas as opportunities.

**Step 3:** Choose the best of the business opportunities and write a SWOT analysis for it.

**Step 4:** Create a cost/benefit analysis for starting this business. Use the analysis to explain why you would or would not actually start it.

Business Idea 1 _____	Critical Evaluation	
Would it be attractive to potential customers?	Yes _____	No _____
Would it work in your business environment?	Yes _____	No _____
Is there a sufficient window of opportunity?	Yes _____	No _____
Do you have the skills and resources to create this business?	Yes _____	No _____
If you do not have the skills and resources to create this business, do you know someone who does and might want to create the business with you? (Consider how you might determine this.)	Yes _____	No _____
Business Idea 2 _____	Critical Evaluation	
Would it be attractive to potential customers?	Yes _____	No _____
Would it work in your business environment?	Yes _____	No _____
Is there a sufficient window of opportunity?	Yes _____	No _____
Do you have the skills and resources to create this business?	Yes _____	No _____
If you do not have the skills and resources to create this business, do you know someone who does and might want to create the business with you?	Yes _____	No _____
Business Idea 3 _____	Critical Evaluation	
Would it be attractive to potential customers?	Yes _____	No _____
Would it work in your business environment?	Yes _____	No _____
Is there a sufficient window of opportunity?	Yes _____	No _____
Do you have the skills and resources to create this business?	Yes _____	No _____
If you do not have the skills and resources to create this business, do you know someone who does and might want to create the business with you?	Yes _____	No _____

### Exploring Your Community

- 1-14. Interview an entrepreneur, preferably in person. Entrepreneurs are busy people, but many are willing to spend time speaking with someone who is interested in what they are doing. Meeting over a light meal might be the most efficient use of the entrepreneur's time. Before the interview, brainstorm 10 questions in the following four categories. After the interview, be sure to write a thank-you note.
- Information gathering.** Open the interview with questions about the entrepreneur's family (any other entrepreneurs in it?) and educational and work background.
  - About the business.** Next, ask questions about how the business was started. How did the entrepreneur recognize an opportunity and develop it?
  - Running the business.** Ask about which challenges arose as the business got underway and how they were solved.
  - Reflection.** Ask the entrepreneur to reflect. What advice would he or she give to an aspiring entrepreneur? Has running a business been rewarding?

### Exploring Online

Visit an Internet search engine such as Google, Yahoo, or Bing. Search for one of the following terms: *entrepreneurship ideas*, *businesses for sale*, *franchise opportunities*. For the search that you selected, answer:

- 1-15. Which search engine and term was used and
- 1-16. What were the number of matches (“hits”).

Next, find a site that looks promising and answer these questions:

- 1-17. What is the Web site (URL and name)?
  - 1-18. Who is sponsoring the Web site?
  - 1-19. Is the Web site selling a product or information (as a primary function, not through banner ads)? If so, what products or information?
  - 1-20. Identify three businesses/ideas/opportunities from the site, and state why they might or might not be viable opportunities for you.
-

# Urban Decay: Finding an Entrepreneurial Opportunity



Alamy

Sandy Lerner cofounded Cisco Systems in 1984 with her former husband, Leonard Bosack. It became a world leader in sales of computer routers. When she was ousted from the company in 1990, Lerner had the time and financial resources to focus on charitable activities and other business possibilities. By 1995, she was ready to start another company that would fill a market void.

Lerner believed that there was an opportunity in the beauty market for quality, nontraditional products. According to the Urban Decay Web site, “Our story opens 15 years ago, when pink, red and beige enslaved the prestige beauty market. Heaven forbid you wanted purple or green nails, because you’d either have to whip out a marker, or risk life and limb with that back alley drugstore junk.” She had seen a Chanel polish that was a deep red color, nearly black, but found little else in high-end products that met the need she identified.

Lerner’s business manager introduced her to a creative businesswoman and self-described makeup addict, Wende Zomnir, and the business began to take shape. “Over high tea, the two forged a pact that led to renegade nail polish mixing sessions in Wende’s Laguna Beach bungalow.” Urban Decay launched in

1996 with 12 nail enamels and 10 lipsticks. “Inspired by seedier facets of the urban landscape, they bore groundbreaking names like Roach, Smog, Rust, Oil Slick and Acid Rain. The first magazine ad queried ‘Does Pink Make You Puke?’ fueling the revolution as cosmetics industry executives scrambled to keep up.” Today, the company describes itself as, “Urban Decay is beauty with an edge. It is feminine, dangerous and fun . . . appealing to anyone who relishes her individuality and dares to express it.”

Even after the ’90s grunge style faded, Urban Decay thrived. The company became a global organization; it is a popular full cosmetic line at major retailers such as Sephora, Macy’s, and Ulta and is found on the Internet through Beauty.com. Urban Decay is sold by retailers in the Middle East, the United Kingdom, Italy, Canada, France, Singapore, and Spain. After several transitions, it is currently owned by L’Oreal Cosmetics, and Zomnir continues to work at the company.

Urban Decay notes factors contributing to its success: “And although UD fans around the world might approach our products in wildly different ways, we’ve noticed they share an independent spirit that unites them. Maybe this hunger for something unique explains the passionate support we’ve received over the years.”

Clearly, Lerner and her cofounders saw opportunity in beauty.

## Case Study Analysis

- 1-21. What unmet needs of the consumer contributed to the success of Urban Decay?
- 1-22. Was founding Urban Decay an expected next step after leaving Cisco Systems for Sandy Lerner? Why or why not?
- 1-23. What characteristics made Urban Decay an opportunity rather than simply an idea? Which of the five roots of opportunity apply here?
- 1-24. Is there a future for Urban Decay? What might that future look like?

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Foursquare is the ubiquitous location-based social network that creatively incorporates gaming elements and marketing. It is the brainchild of Dennis Crowley and Naveen Selvadurai.

### The Founders

Crowley and Selvadurai met in New York City in 2007. They worked for different technology companies (AreaCode and Socialight, respectively), but in the same office space. Crowley is a graduate of Syracuse University. He has a degree in advertising and holds a master's from New York University's Interactive Telecommunications Program. Selvadurai, a software engineer, holds computer science degrees from King's College (London) and Worcester Polytechnic Institute (Worcester, Massachusetts).



*Dennis Crowley and Naveen Selvadurai*  
(Scott McDermott/Getty Images)

Both founders had prior experience in the technology field. Crowley worked at Jupiter Communications directly out of college, and Vindego after that. He cofounded Dodgeball in 2003 and sold it to Google in 2005; he worked for Google after the acquisition. Then, he joined AreaCode as its director of product development. Selvadurai worked at Sun Microsystems, Lucent, RunTunes, and Sony Music. He later joined Socialight as its Vice President of Engineering.

The companies where the founders worked were related to the business that Foursquare is today. Vindego created mobile applications, including city guides. Dodgeball was based on Crowley's graduate thesis, which he partnered with Alex Rainert (currently head of product at Foursquare) in order to commercialize the concept. Dodgeball was a location-based social

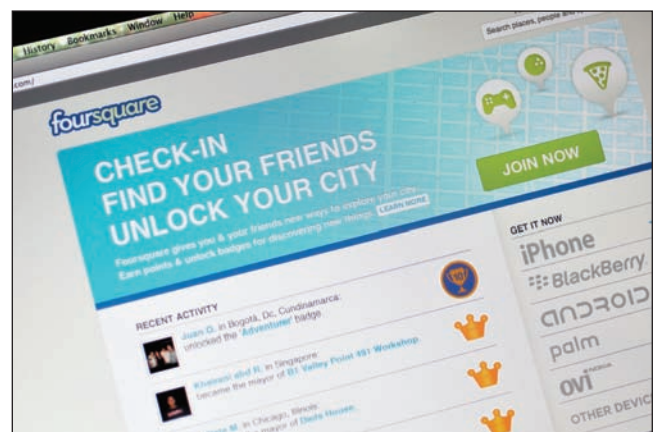
networking option for mobile devices that was available in a number of U.S. cities. Google acquired and operated Dodgeball until 2009, when Dodgeball was shut down and replaced with Google Latitude. AreaCode was a software start-up in the area of game play when Crowley worked there.

RunTunes was a company, started by some friends of Selvadurai, that aimed to bring music to phones. It was bought by Sony Music. Finally, Socialight is a company that creates and promotes local content with social interaction and user-content contributions.

According to Christopher Nomes, "Partnership between Naveen and Dennis was a perfect match. Both young and brilliant, both with already hefty working experience from working in cool and innovative companies, and both with ability to take everything they learned and forge it into something new and special that will overshadow everything they did before."

### Creating at the Kitchen Table

About a year after they met, Crowley and Selvadurai began building the first version of Foursquare at Crowley's kitchen table in the East Village. In March 2009, Foursquare launched at South by Southwest Interactive. Most recent numbers suggest that Foursquare has over 30 million users and is growing at a rate of 25,000 new users per day. Daily check-ins exceed 3 billion.



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### The App

Foursquare is widely popular and becomes an even more useful mobile app with its increasing numbers of users. As users check in on their mobile devices at various locations, such as restaurants, retail stores, and museums, they can



zeljkodan/Shutterstock

add recommendations/reviews. This serves three purposes: (1) They can tell friends where they are. (2) They construct a set of places visited to serve as reminders. (3) The recommendations provide additional data for other Foursquare users and thus add value to the app.

To increase usage and improve user experience, Crowley and Selvadurai built incentives into the app. For example, users become the “mayor” of a particular location based on the number of visits. Users earn virtual badges for the number or variety of check-ins. They also can receive discounts and incentives from advertisers when they check in. A restaurant might provide a 10 percent discount or a free dessert.

Foursquare was designed to generate frequent use. Selvadurai says, “Your app has to have a primary-use case. That brings people back. I think simplicity has a lot to do with it. Simplicity is probably high on that list.” In the case of Foursquare, the “check-in” is the primary use case. The app is designed to make the process quick and easy.

### Financing

A start-up like Foursquare required resources beyond what Crowley and Selvadurai could contribute. They sought venture capital in multiple offerings. The Series A round totaled \$1.35 million, which they raised in 2009. The primary investors were Union Square Ventures with O’Reilly AlphaTech Ventures, and the funding was an equity investment. At the time of the investment, Foursquare was valued at \$6 million.

The Series B, or second round, totaled \$20 million, with Foursquare valued at \$95 million in 2010. The group of venture capitalists was led by Andreessen Horowitz with participation by Union Square Ventures and O’Reilly AlphaTech Ventures. The funds were needed to continue

the expansion of the company, including the addition of critical team members and a new office space.

The next round of financing was raised on June 24, 2011, at \$50 million in equity from Andreessen Horowitz, with Union Square Ventures, O’Reilly AlphaTech Ventures, and Spark Capital. Interestingly, Sarah Lacy notes, “Some firms said they shied away from the deal, because they felt monetization was only more unclear now. With the local space on fire, Foursquare’s target advertisers are already beset with salespeople from Yelp, Living Social, Groupon, Google, and others calling on them. There’s going to be a level of retailer fatigue, and business-wise Foursquare is late to the party.” For this round, the company was valued at \$600 million; again, the funds were needed for expansion.

In the spring of 2013, Foursquare raised an additional \$41 million in a loan and convertible debt, rather than equity. The lead on this round was Silver Lake, a private equity firm, which provided a multi-year loan. Both Andreessen Horowitz and Union Square ventures participated in this round, but with convertible debt. According to Tomio Geron, “The mobile location app was a social media darling after championing the check-in and surviving as others in the space faded away. But it has been struggling to revamp itself as a local search and commerce tool as the check-in becomes more of a commodity available on other apps such as Facebook.”



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In total, through these four rounds of financing, Foursquare raised \$112.35 million in five years to fuel its start-up and growth.

### Cofounder Perspective

During a presentation in October 2001, Selvadurai shared his seven formulas for creating and building a successful venture:

1. Keep good company.
2. Make something people want.
3. Build around an “atomic action” (i.e., check-in).
4. Seek mentors early.
5. At first, hunch; then, data.
6. Balance unknowns with knowns.
7. Always be recruiting.

Foursquare is a reflection of the opportunity its founders identified, the team they created, and the resources they garnered.

### Case Study Analysis

- 1-25. Looking at Schumpeter’s definition and the five basic ways entrepreneurs find opportunities to create new businesses, how does Foursquare fit?
- 1-26. How do Selvadurai’s seven formulas compare with the seven rules for building a successful business?
- 1-27. Apply Porter’s generic strategies to the industry in which Foursquare competes, using case information and your own knowledge. Describe your analysis. Based on this work, what did you find?
- 1-28. What prepared the founders to create Foursquare?
- 1-29. What gaps in the founders’ team and resources needed to be filled by outside sources? Name four specific resources they acquired.
- 1-30. What features and benefits did the founders include in the app to ensure its popularity? Why were these selected?
- 1-31. Is Foursquare the only app of its kind? If not, what other apps are similar?
- 1-32. What future do you envision for Foursquare?

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## Chapter 2

# FRANCHISING

### Learning Objectives

1. Define and describe franchising.
2. Identify the positive and negative aspects of franchising.
3. Understand the structure of the franchise industry.
4. Recognize the legal aspects of franchising.
5. Learn how to research franchise opportunities.
6. Explore international franchising.



E. J. Baumeister Jr./Alamy

**“The two most important requirements for major success are: first, being in the right place at the right time, and second, doing something about it.”**

—Ray Kroc,  
McDonald’s Restaurants

### Learning Objective 1

Define and describe franchising.

**franchise** a business that markets a product or service developed by a franchisor, typically in the manner specified by the franchisor.

**franchising** the system of operating a franchise governed by a legal agreement between a franchisor and franchisee.

**franchisor** the person who develops a franchise or a company that sells franchises and specifies the terms and particulars of the franchise agreement.

**franchisee** the second party to the franchise agreement, the owner of the unit or territory rights.

In 1965, Fred de Luca was a 17-year-old high school graduate looking for a way to earn money for college, when a family friend, Dr. Peter Buck, provided him with \$1,000 of start-up capital for a submarine sandwich shop.<sup>1</sup> With the opening of Pete’s Super Submarines came the start of what has grown into a franchise operation, with 39,618 franchised units in 102 countries.<sup>2</sup> The SUBWAY restaurant chain continues to be a privately held company with the original franchisor, Doctor’s Associates Inc., and de Luca as president. The company is a consistent leader in *Entrepreneur* magazine’s annual listing of top franchises.

SUBWAY franchisees operate in traditional stand-alone units or in such nontraditional locations as convenience stores, shopping malls, and military bases. Franchisee candidates receive two weeks of classroom and on-site training and must pass a comprehensive examination before being accepted. With the initial franchise fee of \$15,000, the costs of start-up range from just under \$100,000 to over \$250,000. The company offers equipment leasing and a franchise fee assistance program for minorities. It also offers loans to existing franchisees for relocation, expansion, and remodeling. Franchisees pay a percentage of weekly sales (approximately 4.5 percent) into an advertising fund and an additional 8 percent royalty on all sales, regardless of profitability. The company provides national and regional advertising. Franchises are being added continually.

## Defining Franchising

Whereas many individuals want to start their businesses from the ground up, others are happy to begin with a tested formula. Although there is no guarantee of success, for many, franchising is the best business start-up option.

A **franchise** is a business that markets a product or service developed by a franchisor, typically in the manner specified by the franchisor. It is also a commercial and legal relationship between the owner of a trademark, service mark, trade name, or advertising symbol and an individual or group wishing to use that identification in a business.<sup>3</sup> The franchise agreement determines the specific parameters of the relationship between the parties.

**Franchising** is the system of operating a franchise governed by a legal agreement between a franchisor and franchisee. The **franchisor** is the person who develops a franchise or a company that sells franchises and specifies the terms and particulars of the franchise agreement. The **franchisee** is the second party to the franchise agreement and is the owner of the unit or territory rights. For example, Liberty Tax Service (the franchisor) franchises tax-preparation businesses to local/territory owners (franchisees).

## What Are the Types of Franchises?

All franchises involve legal agreements between the parties, and these are as varied as they are numerous. The types of franchises are defined by the Federal Trade Commission (FTC). Two main categories are

- Product and trade-name franchising, and
- Business-format franchising.

<sup>1</sup>Subway, accessed July 1, 2013, <http://www.subway.com>.

<sup>2</sup>As of July 2013.

<sup>3</sup>“Franchise Businesses,” U.S. Small Business Administration, accessed July 1, 2013, <http://www.sba.gov/content/franchise-businesses/>.



© Planetpix/Alamy

**product and trade-name franchising** the licensing of the product or the production of the product and the use of the trademark, logo, or other identity of the franchise.

**business-format franchising** a form of franchising in which the franchisee secures the product and trade-name benefits but also the operating, quality assurance, accounting, marketing methods, and support of the franchisor.

**master franchise** a specific type of franchise that allows individuals and organizations to buy the right to subfranchise within a delineated geographic territory.

**area franchise or multiple-unit franchise** a type of franchise that gives the exclusive rights to open franchisee-operated units within specified areas.

**Product and trade-name franchising** is the licensing of the product, or the production of the product, and the use of the trademark, logo, or other identity of the franchise. The franchisee usually sells products that are manufactured by the franchisor. It is essentially a supplier-dealer relationship with some level of exclusivity. In other cases, the franchisee sells products or services that are expected to meet the quality standards established by the franchisor. The operations of the business itself are at the discretion of the franchisee within the constraints of the agreement. Automobile dealerships are generally trade-name franchises, for example.

**Business-format franchising** is a much broader and more extensive form of undertaking. The franchisee secures the product and trade-name benefits, along with the operating, quality assurance, accounting, and marketing methods and support of the franchisor. Typically, this is the purchase of an entire business model and system, including access to management expertise. Some well-recognized business-format franchise systems include Krispy Kreme, Circle K, Pizza Hut, and Jani-King. Some unethical product and trade-name franchises will attempt to sell themselves as being business-format operations, making it particularly important for the prospective franchisee to understand exactly what is being provided. To get a better idea of the range of legitimate franchises available, you may want to explore the Franchise Registry at <http://www.franchiseregistry.com>.

In addition to the two primary models described previously, other variations on licensing and ownership structures are offered. For example, **master franchises** allow individuals and organizations to buy the right to subfranchise within a delineated geographic territory. Such franchises generally require the franchisee or area developer to take on additional franchisor responsibilities, such as providing training and support and recruiting subfranchisees. Master franchises have higher initial franchise fees than those charged for a unit franchise with the same franchisor. It is typical for the master franchisee to form two companies, one for the operation of a primary, single franchise and another for expansion through subfranchisees.

Also, rather than purchasing a single unit, a franchisee may elect to own multiple units, effectively blanketing one or more territories with the franchise brand. Such an **area franchise** or **multiple-unit franchise** gives the purchaser exclusive rights to open franchisee-operated units within specified areas.

## BizFacts

### Facts to Know Before Investing in a Franchise

Even though investing in a franchise seems like a sure bet, it isn't. Several key issues must be considered before making the decision:

1. *Pick a franchise you're familiar with*—it has a more recognized brand with the public.
2. *Know the upfront costs*—which vary significantly and are distributed differently.
3. *Know your restrictions*—what the rules are and how they will affect your bottom line.
4. *If you want to get rich, plan to expand*—permission to grow protects you.
5. *Read the fine print*—know what is required so you know what to expect.

Source: Patricia Laya, "Five Franchise Facts You Need to Know Before You Buy," *American Express Open Forum*, June 15, 2011, accessed May 7, 2013, <http://www.openforum.com/articles/5-franchise-facts-you-need-to-know-before-you-buy/>.

## Positive Aspects of Franchises

Entrepreneurs who want to start up with a formula for success—and you may be among them—may find numerous advantages in franchising. The most significant advantage is the increased probability of success, given that franchise brands have positive track records and instant recognition in most communities. Some other advantages include training and financing assistance, purchasing power, advertising and promotional support, and operating guidelines and management assistance. Some factors to consider are presented in **Exhibit 2-1**.

### ◀ Learning Objective 2

Identify the positive and negative aspects of franchising.

## Start-Up Assistance

Sound franchisors provide a significant quantity and excellent quality of start-up assistance to new franchisees, as well as ongoing education and support for established ones. In many cases, there is mandatory training and technical assistance before a franchise is granted. Some franchisors require examinations on the training content. Others require work experience with established franchisees. These forms of support are intended to foster franchisee success.

The FTC has specific requirements with respect to support that franchisors must provide, including:

- one week of training to the franchisee and a manager,
- an operating manual for the franchise,
- ongoing support and assistance, and
- guidelines on audits.

Beyond the obligatory training and information, franchisors can provide other valuable start-up assistance. They may provide site-selection help to ensure that the location selected is likely to be successful. With business-format franchising, franchisees may have access to the entire package of components, making the start-up essentially a turn-key operation (a business that is ready to start immediately). In some

### Exhibit 2-1 *Factors to Consider before Becoming a Franchisee*

1. **Franchisor success**—How many similar franchises are nearby? In total? How are they performing? What name recognition exists? What's its reputation? Ask franchisees and consumer protection agencies.
2. **Franchisor durability**—Determine the length of experience. Is this a long-term opportunity or a fad? Does the franchisor own any intellectual property?
3. **Franchisor financial health**—How healthy is the company? Financial statements should be in the disclosure documents. Be certain you understand them.
4. **Start-up investment**—What is the amount and what does it buy? Ask about all potential franchise costs. Be certain that ongoing costs and start-up costs are clear.
5. **Financing support**—Does the franchisor offer competitive financing? How much do you need until you reach positive cash flow? Do the financial projections under various conditions and know your options.
6. **Purchasing requirements**—Do you have to buy from the franchisor or its list of suppliers? Are there minimum purchases? Can you purchase from others? How does the pricing from the required suppliers compare?
7. **Term of the agreement**—What is it? What, if any, are the terms for selling the franchise rights to another operator? What are your renewal rights?
8. **Competition**—Are there any restrictions on how you can compete within your territory? Is there assistance to help you compete? What kind? What is the level of competition?
9. **Management fit**—Does the management style and level of control exerted by the franchisor fit for you? Is the loss of independence worth the potential gains?

cases, franchisors provide financing support, whether in the form of application assistance, agreements with third-party lenders, or direct financing. Hundreds of franchisors are certified through the U.S. Small Business Administration's FranData Franchise Registry program (<http://www.franchiseregistry.com>), thereby streamlining the loan application process you and other prospective franchisees would encounter. Some franchises listed on the registry include AlphaGraphics, Cici's Pizza, Snap Fitness 24-7, and Jenny Craig.

The particular combination of start-up assistance and ongoing support provided by franchisors is a vital reason for opting to pursue a franchise rather than starting a venture from the ground up.

## Instant Recognition

A strong advantage of purchasing a franchise is the instant name and brand recognition that a well-known and reputable franchisor has to offer. A new McDonald's franchise has the instant recognition that a unique, stand-alone business, such as Bubba's Bountiful Burgers, would not. With a franchise, the name and image are well established and widely understood. You purchase the use of the company's logo, trademark, and advertising, as well as the physical design, layout, and décor that ensure this recognition.

## Purchasing Power

As a franchisee you will benefit from the purchasing power of the franchisor to get lower costs and favorable vendor service. Because franchisees are part of a potentially large group of customers for any one vendor, they have more clout with respect to pricing, delivery terms, and product quality. In addition, where custom-designed products or components are used, the costs of research, prototype creation, and testing are distributed among a far greater number of parties than for a stand-alone business. Any cost savings you realize will assist in offsetting ongoing franchise fees and may support greater profitability.

## Advertising and Promotional Support

Advertising and promotional support is frequently included as part of the franchise opportunity and is crucial to brand identity and name recognition. Franchisees may pay a fee that is separate from the royalty fee, often called a **cooperative advertising fee**, to contribute to a shared advertising fund. Franchisors engage advertising and public relations firms to create strong, memorable, and effective national and regional advertising campaigns. They handle the national and regional media purchasing. Franchisors also provide you with templates and promotional materials for local use. The quality and quantity of advertising support is one of the most valuable aspects of franchising.

Many franchises have professional associations, which take an active role in determinations with respect to the cooperative advertising fund. They provide insight and feedback to the franchisor. Ideas may travel back and forth between franchisors and franchisees. For example, Ronald McDonald was created by a McDonald's franchisee and became one of the most recognized characters in the world.<sup>4</sup> At the same time,

**cooperative advertising fee** a fee paid by franchisees to contribute to a shared advertising fund that is separate from royalty fees.

<sup>4</sup>"Top 10 Advertising Icons of the Century," *Advertising Age*, March 29, 1999, accessed August 18, 2010, [http://www.adage.com/century/ad\\_icons.html](http://www.adage.com/century/ad_icons.html).

franchisors may decide to create promotions to boost their flagging revenues that will have the effect of causing problems for franchisees. For example, a franchisor could promote a discounted price that succeeds in generating revenues, but insufficient profits. You may appreciate revenue generation but not at such a low price, because you will actually lose money after royalties are paid. Royalties are paid on top-line sales (gross revenues), not profits.

## Operating Guidelines and Assistance

Franchisors are required to provide operating manuals and training to their franchisees, which are valuable factors in success. In addition, ongoing operating training and assistance also increase the probability of positive franchisee performance. Further assistance with regulatory compliance, site selection and development, product research and development, and utilization of technology can all prove invaluable.

Some of the greatest challenges facing entrepreneurs are establishing and maintaining solid operations while maintaining structured quality assurance, sound financial record keeping, and sound human resources policies. Franchisees have the distinct advantage of benefiting from the years of experience and success of their franchisor, so that the learning curve is considerably less daunting. However, the start-up and ongoing assistance provided will not in any way guarantee your success.

Operating guidelines vary considerably in their breadth and depth. They may be as precise as the dimensions (with allowable tolerances) for food production, dress codes, and component specifications. They may reach across all functions of the business. Or, they may be relatively broad and nonspecific. The nature and quality of operating guidelines as provided by the franchisor is essential to understanding the value of the franchise and the flexibility afforded the individual franchisee. What is needed and desired will vary by franchisee and is based on individual experience, desire for operating specifics and flexibility, and the cost of participation; however, most franchisors do not individualize franchise packages. Franchisors have their manuals and methods, and that is what is presented to new franchisees.



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## Step into the Shoes . . .

### *Maritza Gonzalez and Noel Cruz—Kumon Math and Reading Center*

Kumon Math and Reading Centers, a successful franchisor, had been providing supplemental academic support to students in Newark (New Jersey) Public Schools for four years, through the No Child Left Behind program, when Maritza Gonzalez and Noel Cruz opened a new center there. Maritza is a Kumon parent (that is, a parent of a child in the Kumon system), a product of Newark Public Schools, and a graduate of Montclair State University. For her, the opportunity to direct a Kumon Math and Reading Center is a chance to give back

to the community. Noel Cruz headed up the No Child Left Behind program with Kumon and was an assistant principal at a charter school in Newark. Kumon is a 54-year-old after-school math and reading program with 26,000 centers in 47 countries (more than 1,500 in the United States) that totals more than four million students globally.<sup>5</sup>



Stockbyte/Thinkstock

<sup>5</sup>Kumon, accessed June 23, 2009, and July 1, 2013, <http://www.kumon.com/AboutUs>.

## Record of Success

Any reputable franchisor can demonstrate a record of success that would provide a significant advantage for your business start-up. In essence, the business formula has been tested and the product or service established. In addition to the name recognition afforded by the franchisor and the disclosure information the franchisor must provide, you can and should explore the record of success of the franchisor and existing franchisees. An investment of time in online and other research on your part will identify the genuine track record of the franchisor. Strong franchisors have established multiple franchises, positive relationships with their franchisees, and years of experience. They also have few, if any, legal disputes with franchisees and have garnered positive press reports. Such a record of success will bode well for a prospective franchisee, which will become a new component of the success equation.

## Drawbacks of Buying a Franchise

Whereas purchasing a franchise has quite a few advantages, it is not without its drawbacks. Franchising is an excellent choice for many business start-ups, but it is not a good choice for many others. Franchising provides a higher probability of business success, but success is not guaranteed and is not without costs. Constraints on the creativity and freedom of the owner, high start-up and ongoing costs for franchise participation, and potential for termination of the agreement are all factors to be weighed. The quality and strength of the franchise brand and its program also matter.

## Constraints on Creativity and Freedom

For the individual who wants to start a business to break away from the corporate mold and the rigors of a management and supervisory structure that restrict creativity and flexibility, franchising is unlikely to be the best option. Franchisees are required to comply with franchise rules and processes, and autonomy is not a consideration. Products and services may not be altered, added, or dropped without franchisor agreement. In many instances, products or ingredients must be purchased from the franchisor or designated suppliers. Whereas the franchisor cannot require the individual franchisee to adhere to a pricing structure, purchasing requirements can lock in costs at higher than desired levels. Also, the layout and design of the franchise outlet are often defined by the franchisor.

While the formula provided by the franchise guarantees brand recognition, eases the issues of start-up development, and ensures ongoing

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## Global Impact . . .

### *Franchising Worldwide*

Want to be an international mogul? Check out these Web sites:

International Franchising Opportunities—  
<http://www.internationalfranchisedirectory.net/>  
World Franchising—<http://www.worldfranchising.com>

International Franchising's directory lists more than 1,000 North American franchises that train and support franchisees overseas.

It also provides contact information for consultants and attorneys specializing in international franchising. World Franchising lists the top 100 franchises worldwide, as well as the top 50 franchises that have fewer than 50 operating units.

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support, it removes the creativity and freedom that many entrepreneurs crave. You will have to decide whether the trade-off is worthwhile.

## Costs

The costs of franchises vary significantly, depending upon the type of franchise, its brand recognition, popularity, and capacity to secure franchisees. Franchise costs are divided into initial franchise fees and ongoing fees. The typical franchisee can expect to pay start-up fees that range from about \$3,000 for Jazzercise, \$1.0 million to \$2.2 million for a McDonald's outlet, or \$3.7 million to \$13.5 million for a Hampton Hotel.<sup>6</sup> Ongoing costs generally include royalties of 1–12 percent (most are between 3 and 7 percent) of top-line revenues payable weekly or monthly, regardless of profitability or cash flow. In addition, cooperative advertising fees of 1 to 5 percent (or a flat fee) are payable periodically. Some franchisors require franchisees to spend a minimum amount on local advertising as well. Additional start-up cost considerations are the legal costs required for franchise agreement review and any required plant, property, equipment, inventory, or marketing requirements. **Exhibit 2-2** includes some of the items that may be included as fees associated with franchises.

It is important that you understand and fully identify all costs, so that you completely understand the legal obligations and the financial projections that reflect them. This is particularly true for the fees that are payable regardless of profitability or cash flow. Franchisors are focused on creating wealth for themselves. Good faith franchisors are also focused

### Exhibit 2-2 Selected Franchise Fees and Costs\*

Initial costs (categories will vary considerably)
Right to use the company name, trademark, or service mark (licensing fees)
Royalty fees
Training
Management assistance
Use of operations manuals
Signage
Insurance coverage (general liability, fire, inventory, burglary, worker's compensation, accident and health, use and occupancy, and possibly vehicle)
Advertising and promotion
Equipment
Furniture
Fixtures
Site selection assistance
Site purchase and preparation
Land lease, if not purchased
Construction or renovation
Initial inventory
Financing (initial costs plus interest)
Renewal of franchise
Transfer

\*Must be disclosed in the Franchise Disclosure Document.

<sup>6</sup>"Franchise 500," *Entrepreneur*, accessed July 1, 2013, <http://www.entrepreneur.com/franchises>.

on the success of their franchisees, but a word to the wise is to be wary of franchisors that have a track record of high turnover among franchises and a reputation for “churning” their franchises for the upfront fees. A quick search on the Internet will disclose such companies. Current required disclosures will reveal some of the legal issues as well.

## Standards and Termination

Franchisors have standards and obligations that franchisees and prospective franchisees must comply with, initially and on a long-term basis. The start-up standards may include specific types of experience and skills, as well as net worth and liquidity requirements. The ongoing constraints typically are financial and performance-based.

Each franchisor establishes specific experience requirements for new franchisees. Typically, these are based upon the type of franchise and experience with success and failure among franchisees. Some of the more established and successful franchisors require less education and experience prior to becoming a franchisee, because of their highly developed and effective training programs. For example, Circle K, Jani-King, and Liberty Tax do not require specific industry experience but do want general business experience.

The financial requirements for becoming a franchisee depend upon the nature of the franchise and the type of franchise agreement. For example, home-based franchises have far lower net worth and liquidity requirements than retail establishments. Jan-Pro requires a net worth of \$1,000 to \$14,000-plus, and liquid assets of greater than \$1,000 for franchisees who will expect to make a total investment of \$3,100 to \$50,405.<sup>7</sup>

At the other end, Panera Bread requires a net worth of \$7.5 million and liquid assets of \$3 million, and it requires a potential franchisee to commit to opening multiple units, generally 15 of them over 6 years.<sup>8</sup> Master franchisees and area franchisees, such as those associated with Panera Bread, must pay larger upfront fees and must have substantially greater net worth and liquidity than single-unit franchisees.

The ongoing compliance and performance standards and requirements of franchises also come with penalties and termination options for noncompliance. Franchisors may conduct periodic inspections, announced or unannounced, to evaluate compliance and conditions of the unit. Franchisees that stray from the company formula, fail to comply with quality standards, or do not pay their fees are subject to termination and repurchase. Franchisors cannot afford to tarnish their brands with underperforming or noncompliant franchises. Also, they must produce revenue and earnings, manage their finances successfully, and be dependent upon the financial returns from their franchises for success.

## The Structure of the Franchise Industry

### Learning Objective 3

Understand the structure of the franchise industry.



Various forms of franchising have existed in the United States since the mid-1800s (beginning with the Singer Sewing Machine), with the industry evolving and growing over time. Most of the growth has occurred since 1960. A study for the International Franchising Association reported 747,359 franchise establishments in the United States in 2012, with revenues of \$769 billion and providing a total of more than 8.1 million jobs.<sup>9</sup>

<sup>7</sup>Jan-Pro Franchising Int'l. Inc., *Entrepreneur* magazine. Accessed July 1, 2013, <http://www.entrepreneur.com/franchises/janprofranchisingintlinc/282471-0.html#>

<sup>8</sup>*Panera Bread*, accessed July 1, 2013, <http://www.panerabread.com/about/franchise>.

<sup>9</sup>*Franchise Business Economic Outlook*, HIS Global Insight for the International Franchise Association, May 2013. Accessed July 1, 2013, <http://www.franchise.org>.

The same study projects economic contributions of a significant multiple of this base.

The industry is led by several mammoth franchisors, accounting for thousands of franchisees worldwide. At the same time, there are numerous smaller franchisors with local and regional franchisees. *Entrepreneur* magazine publishes an annual issue devoted to franchising that provides insight into the industry. It is informative to compare the *Entrepreneur* rankings from year to year to understand the trends affecting industries and specific companies.

In addition to the types of franchises described earlier, several other kinds have emerged and are growing in popularity. **Internet franchises**, such as We Simplify the Internet (WSI; <http://www.wsimarketing.com>) have taken hold as the World Wide Web has become ubiquitous. Internet franchises are franchise companies that do not depend upon physical location for the delivery of their products or services; rather, they are virtual businesses. Also, **conversion franchising** has gained popularity, wherein an existing stand-alone business or local chain becomes part of a franchise operation. Another trend is **piggybacking**, or **co-branding**, in which two franchises share locations and resources. Examples of this include Baskin-Robbins and Dunkin' Donuts. The franchising industry continues to expand and reach new entrepreneurs.

## Franchising and the Law

Franchises are governed by state and federal laws and regulations. The Federal Trade Commission (FTC) is the primary government agency involved in oversight. The FTC primarily serves to protect the interests of franchisees by directing the disclosure rules for franchisors. The process and specific requirements have evolved significantly over the past century, with the most recent changes occurring in 2008.

**Internet franchise** a type of franchise company that does not depend on physical location for the delivery of its products or services; rather, it is a “virtual” business.

**conversion franchising** a stand-alone business or local chain becoming part of a franchise operation.

**piggybacking** or **co-branding** occurs when two franchises share locations and resources.

### ◀ Learning Objective 4

Recognize the legal aspects of franchising.

## Step into the Shoes . . .

### Buying a Franchise: College Hunks Hauling Junk—Miami

Ronald Rick III and Christopher Poore, students in an entrepreneurial consulting class at the University of Miami, were assigned to assist a company in finding a U of M franchisee. They chose a junk-removal company called College Hunks Hauling Junk, a company cofounded by an U of M alumnus nearly a decade earlier.

Rick and Poore investigated the College Hunks system and ultimately saw the potential of the company for themselves. The business duo met cofounder Omar Soliman when he spoke about entrepreneurship at U of M. Meeting with Soliman gave them the confidence—both in themselves and in the system—to apply for a franchise.

Less than a year later, Rick and Poore launched their College Hunks location in Miami. Now, these two twenty-somethings appear to be retracing the steps of CEO Soliman and his cofounder, President Nick Friedman, who were in their early twenties when they started the company.

Soliman and Friedman launched College Hunks Hauling Junk in 2005 and by 2007 had become the youngest franchisors in America. They later added College Hunks Moving to increase

revenue through synergy and the dual brand has since grown exponentially. Now, their franchise system includes 46 locations covering 25 states and counting.

The HUNKS (Honest, Uninformed, Nice, Knowledgeable Students) for the most part still are students from local colleges and universities.

Soliman and Friedman seek franchise owners from all walks of life. The company is adamant that the most important attribute for a potential franchisee to possess is the passion to grow a business through a client-focused approach.

Source: *College Hunks Hauling Junk*, accessed July 1, 2013, <http://www.collegehunkshaulingjunk.com>. Alexandra Leon, “From students to start-ups: Local college grads open businesses,” *Miami Herald*, January 7, 2013, accessed May 7, 2013, <http://www.miamiherald.com/2013/01/07/3171513/from-students-to-start-ups-local.html#storylink=cpy>.



Christopher Poore and Ron Rick  
(Chris Poore, College Hunks Hauling  
Junks Inc.)

**Franchise Disclosure Document (FDD)** the primary source of information for prospective franchisees regarding franchisors.

The **Franchise Disclosure Document (FDD)** has replaced the Uniform Franchise Offering Circular (UFOC) as the primary source of information for prospective franchisees regarding franchisors. It is registered with the FTC and must be organized into a common format so that prospective franchisees may more readily compare franchise opportunities. The FDD which discloses the terms of the franchise relationship and any pertinent financial and legal issues affecting the franchisor, must be provided by the franchisor a minimum of 14 days before the signing of a franchise agreement. As a practical matter, as a prospective franchisee, you should secure this document as early in the exploration and negotiation process as possible. The FDD includes such information as:

- **Overview and background.** Company review and offer, background information on key personnel and directors, and disclosures of current and past litigation or bankruptcy.
- **Fees and costs.** All initial fees, all anticipated operating fees, and a table of the potential cost ranges for every part of the initial investment.
- **Contractual obligations.** Table of franchisee responsibilities with specific reference to the franchise agreement and the FDD, and an extensive list of franchisor obligations, from pre-opening through ongoing operations. Also included are details about training programs and any required point of sale, advertising, or other required franchise systems, along with a list of personal obligations of the franchisee.
- **Territory.** Terms regarding the limits of the protected territory that the franchisee will receive. This could be a very large or very small area. Or, there could be no protected territory. This has huge significance for the franchisee because franchisors have often put franchisees so close together that they compete with one another for business.
- **Financial performance.** Franchisor discloses the performance of franchisee units by providing statistical information with clearly stated assumptions and explanations of limitations. Prospective franchisees are best served by taking this data and carefully analyzing it to secure a better understanding of what is and is not stated and to use it as a launching point for further research.
- **Data regarding existing units.** Table data regarding the existing units in the franchise system and the units that have closed or transferred ownership can assist in understanding both the franchisor's success rates and "churn."
- **Financial statements and contracts.** Past three years of the franchisor's audited financial statements and all contracts the franchisee is required to execute. Contracts include the franchise agreement and those for advertising co-op rules and conditions, real estate, personal guarantees, and territory development. Prospective franchisees should acquire legal and accounting review for these.
- **Termination, renewal, transfer, and dispute resolution procedures.** Policies regarding exit strategies, including fees and restrictions, as well as rules regarding mediation and/or negotiation versus legal action are the best ways to understand the reality of costs, fees, requirements, and other conditions set by the franchisor. The refusal of a prospective franchisor to provide this information should be a red flag for any franchisee. Regardless of what a salesperson or franchise broker says to you, the FDD conveys the pertinent information.

In addition to the FDD, each franchisor and franchisee must enter into a **franchise agreement**, which is the legal document governing the specific franchise. Included in the franchise agreement are the following:

- the term of the agreement—length of time the franchisor and franchisee agree to work together;
- standards of quality and performance;
- an agreement on royalties—usually a percentage of the franchisee’s sales paid to the franchisor;
- a noncompete clause stating that, for instance, if you are licensing a McDonald’s franchise, you cannot also own a Blimpie’s;
- a “hold harmless” clause that may release the franchisor from specific actions or violations of state laws;
- integration clauses that may block the franchisee from suing the franchisor for misrepresentation or deception that occurred prior to the signing of the agreement;
- choice of venue or other provisions that require the franchisee to settle disputes with the franchisor in the franchisor’s state;
- clauses regarding termination, renewal, and transfer of the franchise;
- territories—franchisors usually assign a territory in which an individual franchisee can do business; within the assigned area, no other franchisee from that company will be allowed to compete.

As with any legal agreement, professional legal counsel skilled in this type of contract should be hired and engaged to explore fully the contents prior to signing it, or paying any money to the franchisor. In addition, prospective franchisees may want to hire an accounting professional to provide a review of the franchise agreement and proposed business plan.

## Steps for Franchise Selection

Deciding to purchase a unit franchise, or a master or area franchise, is a major decision that is best undertaken after complete due diligence. Numerous steps are involved in becoming a franchisee and it is important to pursue each. Skipping any one step, or not fully completing it, may create short-term and/or long-term barriers to success.

- **Self-reflection and engagement of core supporters.** Franchising is not for everyone who wants to enter into self-employment. Taking the time to reflect on individual goals and objectives, as well as lifestyle and financial considerations, is vital. The FTC provides a readiness assessment tool for franchise ownership in its *Buying a Franchise: A Consumer Guide* (<http://business.ftc.gov/documents/inv05-buying-franchise-consumer-guide>). It should take about five minutes to complete and may provide valuable insights for prospective franchisees. Also, having the genuine, enthusiastic support of a core group of friends and family is critical to achieving and maintaining desired personal factors when deciding whether to buy a franchise.



© Roberto Herrett/Alamy

**franchise agreement** contract that determines the specific parameters of the relationship between the parties in a franchise.

### ◀ Learning Objective 5

Learn how to research franchise opportunities.

**franchise broker** an individual acting as an intermediary between the franchisor and prospective franchisee.

- **Industry, type, geography, or brand selection, brand name, or business-format franchising.** If the outcomes of the reflection and analysis suggest franchising would be an excellent option for you, choosing the franchise will be the next step. Some individuals have a desire to be associated with a particular industry. Others would prefer a retail firm, a service company, a home-based organization, or the like. Still others have more interest in the geographic location of the franchise operation than the particular industry or type of business. Another set of prospective franchisees might have a franchise in mind with the geographic location more flexible, such as Insomnia Cookies. For certain people, the greater flexibility of brand-name franchising is more desirable than business-format franchising. You can weigh these and other factors (such as the start-up franchise fee) to arrive at a set of guidelines for selection.
- **Research.** The decision-making process above will require some research, but it will be more focused on internal factors. With the results of this effort in hand, you can conduct further research to narrow the list of franchise choices to a manageable level before conducting in-depth analysis. The research need not be costly or complex, but it should be thorough enough to avoid traps and missteps at this early stage. A number of resources are listed in **Exhibit 2-3**.
- **Narrow the list of options.** The research should provide enough information to narrow the list of potential franchises down to a few. Now it is time to conduct in-depth research and hone in on the individual companies.
- **Make the broker decision.** Prospective franchisees can decide at any point whether or not to use a **franchise broker**, which is a

### Exhibit 2-3 Resources for Franchise Research

Documents	
Franchise Opportunities Guide	<a href="http://www.franchise.org">http://www.franchise.org</a>
A Consumer Guide to Buying a Franchise	<a href="http://business.ftc.gov/documents/inv05-buying-franchise-consumer-guide">http://business.ftc.gov/documents/inv05-buying-franchise-consumer-guide</a>
Web Sites	
<a href="http://www.entrepreneur.com/franchises.html">http://www.entrepreneur.com/franchises.html</a>	<i>Entrepreneur</i> magazine
<a href="http://www.franchisetimes.com">http://www.franchisetimes.com</a>	<i>Franchise Times</i> magazine
<a href="http://www.inc.com">http://www.inc.com</a>	<i>Inc.</i> magazine
<a href="http://www.money.cnn.com">http://www.money.cnn.com</a>	<i>Money</i> and <i>Fortune</i> magazines
<a href="http://www.worldfranchising.com">http://www.worldfranchising.com</a>	<i>World Franchising</i> magazine
<a href="http://www.internationalfranchisedirectory.net/">http://www.internationalfranchisedirectory.net/</a>	International franchising opportunities
<a href="http://www.franchising.com">http://www.franchising.com</a>	Franchising opportunities
<a href="http://www.franchisehandbook.com">http://www.franchisehandbook.com</a>	Franchise database
<a href="http://www.bison.com">http://www.bison.com</a>	Franchise information
<a href="http://www.FRANdata.com">http://www.FRANdata.com</a>	Franchise information services
<a href="http://www.ifa-university.com">http://www.ifa-university.com</a>	IFA University
Trade Associations	
International Franchise Association	<a href="http://www.franchise.org">http://www.franchise.org</a>
American Association of Franchisees and Dealers	<a href="http://www.aafd.org">http://www.aafd.org</a>
Trade Shows	
International Franchise Expo	<a href="http://www.mfvexpo.com">http://www.mfvexpo.com</a>
National Franchise and Business Opportunities	<a href="http://www.franchiseshowinfo.com">http://www.franchiseshowinfo.com</a>

third-party consulting company that prescreens prospective franchisees and matches them with franchisors. Broker and consultant fees are generally paid by the franchisors.

- **Visit franchise operator(s).** Before contacting the short list of franchise companies directly, those who are considering franchises with physical sites open to the public can strategically visit one or more units to observe them. Such visits are for information gathering and to observe such aspects as traffic flow, environment, quality of franchise décor and materials, management, and so forth. This is more akin to acting as a secret shopper than a formal visit. Try not to visit locations in your neighborhood or in the immediate area where you would be operating.
- **Contact the franchisor.** You should request basic preliminary information from each franchise company. Typically, this information is available through a Web site or franchise development staff. The basic information will permit the screening of the small pool of franchise possibilities and narrowing it to one or two finalists. The steps from this point on will become intense and time consuming.
- **Perform due diligence on a specific franchise.** A franchise company will probably require completion of a qualification questionnaire, which will enumerate your experience and financial qualifications. Once this is accepted, the franchise company will share its FDD, and you should analyze and understand it completely before moving forward. Calls to existing franchisees, possibly including a visit to the franchise company headquarters, will be important next steps. Internet research and Web buzz about a franchisor can also be taken into consideration, although these are best considered with a healthy dose of skepticism. Have people who are familiar with FDDs review them and other documents to check what you are looking at before agreeing to anything.
- **Explore financing options.** Each prospective franchisee will have a different personal financial situation. It is essential to know what your personal resources will be—from friends and family, financial institutions, private investors, and the franchisor. Identifying financial capacity can and should begin in the early-research phase.
- **Make a decision, negotiate the franchise agreement, and engage professional counsel.** The timing of this will depend upon the individual franchisee but is an essential step. The FDD and franchise agreement will be sufficiently complex that even the most sophisticated franchisee should engage legal and financial advisors.
- **Make it work!** The franchisor can provide the brand, the products, and even the system, but the franchisee has to make the business work. Astute franchisees will take advantage of all the training and assistance they have received and will reap the benefits of being part of a successful franchise.

## Exploring Global Franchising Opportunities

Franchising is a global phenomenon and opportunities abound in all areas of the world. It is common for franchisors to strategically identify countries or regions in which they plan to expand and to seek out franchisees in those areas. Some franchisors require the franchisees to be citizens of the countries in which they are developing franchises. Most franchisors prefer to expand through master franchises or area franchises rather than single units, selling franchise rights to large geographic areas or to entire countries. It is also common for franchisors to create joint ventures with existing firms in the markets they are entering.

### ◀ Learning Objective 6

Explore international franchising.



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Franchisors such as McDonald's and Intercontinental Hotels have been selling international franchises for decades. As of 2013, they have 15,365 and 1,408 international franchises, respectively.<sup>10</sup> Subway has 13,549 foreign franchises, and The UPS Store has 331 Canadian units, according to *Entrepreneur.com*. Other franchisors have just begun to reach out beyond the borders of the United States. At the same time, franchisors from overseas have extended their reach beyond national borders to span the globe.

The decision to franchise globally is far more complex than addressing local and regional variations. Ethnic, cultural, and religious diversity compels variations in the business format and operations. For example, menus must be adjusted for dietary preferences and restrictions, uniforms may have to vary, advertising and promotion will be different, as will hours and cost structures. In addition, human resources issues and policies must be altered for governing law and custom. However, there are many lucrative and rewarding franchising opportunities around the world.

## Chapter Summary

Now that you have studied this chapter you can do the following:

1. Define and describe franchising.
  - A franchise is a business that markets a product or service developed by the franchisor, typically in the manner specified by the franchisor.
  - Product and trade-name franchising is the licensing of a product or the production of a product, and the use of the trademark, logo, or other identifying feature of the franchise.
  - Business-format franchising takes place when the franchisee secures the product and trade-name benefits, and the operating, quality assurance, accounting, marketing methods, and support of the franchisor.

<sup>10</sup>Entrepreneur 2013 Franchise 500, *Entrepreneur* magazine. Accessed July 1, 2013, <http://www.entrepreneur.com/franchises/mcdonalds/282570-0.html> and <http://www.entrepreneur.com/franchises/subway/282839-0.html>.

2. Identify the positive and negative aspects of franchising.
  - Start-up assistance (+)
  - Advertising and promotional support (+)
  - Operating guidelines and assistance (+)
  - Record of success (+)
  - Constraints on creativity and freedom (–)
  - Costs (–)
  - Standards and termination (–)
3. Understand the structure of the franchise industry.
  - Large franchisors control most of the industry.
  - Types include Internet franchises, conversion franchising, and co-branding.
4. Recognize the legal aspects of franchising.
  - Franchise Disclosure Document (FDD) is essential.
  - State and federal regulations govern franchising.
  - A franchise agreement and other legal documents will be involved.
  - Use good legal counsel.
5. Learn how to research franchise opportunities.
  - Self-reflect and engage core support people.
  - Explore industry, type, geography, or brand selection and brand name, or business-format choice.
  - Research using available resources.
  - Narrow the list of options.
  - Make the broker decision.
  - Visit franchise operator(s).
  - Contact the franchisor.
  - Perform due diligence on the specific franchise.
  - Explore financing options.
  - Make a decision and negotiate the franchise agreement, engaging professional counsel.
  - Make it work!
6. Explore international franchising.
  - Opportunities are available worldwide.
  - Decision is more complex than domestic franchising.

## Key Terms

area franchise, 58	franchisee, 57
business-format franchising, 58	franchising, 57
co-branding, 65	franchisor, 57
conversion franchising, 65	Internet franchise, 65
cooperative advertising fee, 60	master franchise, 58
franchise, 57	multiple-unit franchise, 58
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franchise broker, 68	product and trade-name
Franchise Disclosure Document (FDD), 66	franchising, 58

## Entrepreneurship Portfolio

### *Critical Thinking Exercises*

- 2-1. Does franchising limit an entrepreneur's freedom and creativity? Illustrate your arguments with examples.
- 2-2. What factors should one consider before taking up a franchise?
- 2-3. Would you like to become the franchisee of an international organization? Why or why not?
- 2-4. If one wants to be successful, not only does one have to be in the right place at the right time but also do something about it. Describe and discuss two instances that illustrate this.

### *Key Concept Questions*

- 2-5. Define franchise. What are the different types of franchises? Choose any franchise and discuss its type.
- 2-6. Which franchising format do you think is more prone to legal complications?
- 2-7. What, if any, trends in franchising suggest continued expansion of the industry? Contraction? Cite your sources.

### *Application Exercise*

- 2-8. Identify an industry or type of business that interests you. Select a community where you would like to locate such an organization (select a business that would have a physical presence). Find two competitors already in that market space and one franchisor that is not. Would it or would it not make sense to open a franchise in the community?

### *Exploring Online*

- 2-9. Visit the Wahoo Fish Taco Web site at <http://www.wahoos.com>. What are the advantages of a Wahoo Fish Taco franchise according to the site? What franchise opportunities are available?
- 2-10. Visit the International Franchise Association Web site at <http://www.franchise.org>. Find a franchise organization that is unfamiliar to you. Find the following information about the franchisor:
  - a. When did it begin offering franchises?
  - b. How many company-owned units does it have?
  - c. What are its initial financial requirements (start-up fee, net worth, liquid resources)?
  - d. What type of franchisor is it (product or trade-name or business-format)?

If the information is not available on the International Franchise Association (IFA) Web site, try others from the list in **Exhibit 2-3**.

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