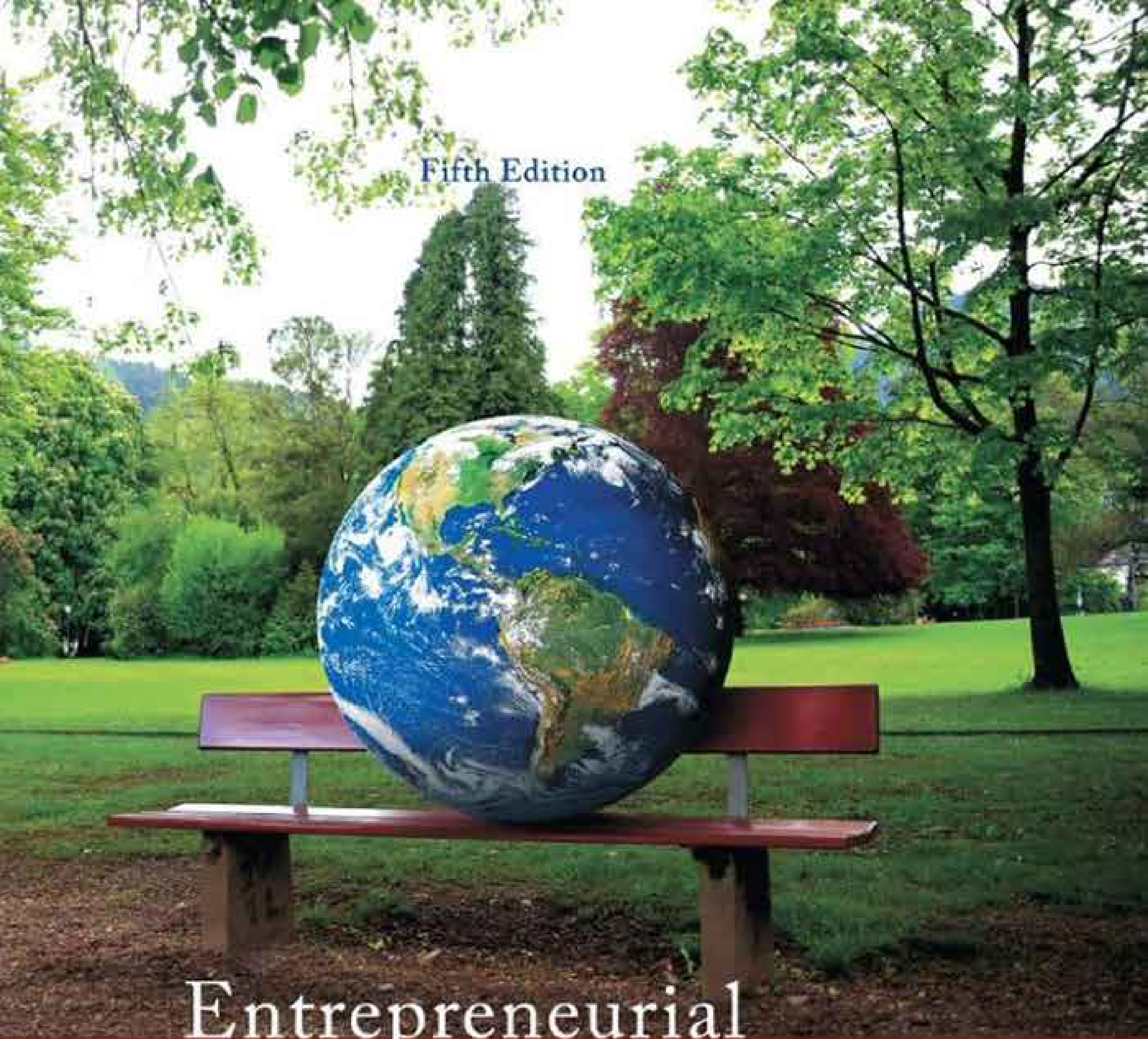

Fifth Edition

Entrepreneurial FINANCE

Leach / Melicher

Entrepreneurial Finance

FIFTH EDITION

J. CHRIS LEACH
The University of Colorado at Boulder

RONALD W. MELICHER
The University of Colorado at Boulder

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To my wife Martha, our great joys Laura and John, and the Life we share

J. CHRIS LEACH

To my parents, William and Lorraine, and to my wife, Sharon, and our children, Michelle, Sean, and Thor

RONALD W. MELICHER

Brief Contents

Contents

PART 5

Preface

The life of an entrepreneur is exciting and dynamic. The challenge of envisioning a new product or service, infecting others with entrepreneurial zeal, and bringing a product to market can be one of the great learning experiences in life. All ventures require financing—taking investors' money today and expecting to return a significantly larger amount in the future. Typically the return comes from the venture's public offering, sale, or merger. In the interim, the venture must manage its financial resources, communicate effectively with investors and partners, and create the harvest value expected by investors.

Textbook Motivation

The purpose of the textbook is to introduce financial thinking, tools, and techniques adapted to the realm of entrepreneurship. We believe that, while much of traditional financial analysis may not be ideally suited to the venture context, there is great value in applying venture adaptations.

This entrepreneurial finance text introduces the theories, knowledge, and financial tools an entrepreneur needs to start, build, and harvest a successful venture. Sound financial management practices are essential to a venture's operation. The successful entrepreneur must know how and where to obtain the financing necessary to launch and develop the venture. Eventually, that same successful entrepreneur must know how and when to interact with financial institutions and regulatory agencies to take the venture to its potential and provide a return and liquidity for the venture's investors.

The Life Cycle Approach

We incorporate a life cycle approach to the material in this text. Successful ventures typically begin with an initial **development stage** where the entrepreneurial team generates ideas and assesses the associated business opportunities. Most entrepreneurs realize that a business plan can greatly improve the chance that an idea will become a commercially viable product or service. **Startup stage** ventures focus on the formulation of a business model and plan. As marketing and selling products and services begins, **survival stage** ventures often refocus or restructure. **Rapid growth stage** ventures increase their momentum, and begin to demonstrate value creation. **Maturity stage** ventures typically look for ways to harvest the value created and provide a return to their investors.

Each stage in the life cycle requires a specific understanding of the financial management tools and techniques, potential investors and their mindset, and the financial institutions supporting that venture stage. During the early stages of a venture's life, cash management tools and survival planning are the dominant forms of financial analysis. Cash burn rates are very high and additional sources of financing are usually limited, making it critical for the successful venture to project and accommodate necessary operating costs. The need to measure and adjust investment in working capital and property, plant, and equipment is evident. The process of anticipating and accommodating costs and asset investments begins with the analysis of historical financial experience and then projects future financial positions using projected financial statements or their proxies. Successful ventures emerging from their survival stages can concentrate more on value creation and calibration. Consequently, our financial management emphases for this stage are valuation tools and techniques.

Equally important as sound financial management practices is the need for the entrepreneur to understand the types and sources of financial capital and the related investment processes. During the development stage, seed financing usually comes from the entrepreneur's personal assets and possibly from family and friends. Business angels and venture capitalists are important financing sources during the startup stage. First-round financing from business operations, venture capitalists, suppliers, customers, and commercial banks may be initiated during the survival stage. The rapid growth stage involves second-round, mezzanine, and liquidity stage financing from business operations, suppliers, customers, commercial banks, and investment bankers. Once a venture enters its maturity stage, seasoned financing replaces venture financing. Seasoned financing takes the form of cash flow from business operations, bank loans, and stocks and bonds issued with the assistance of investment bankers or others. Our approach is to introduce the types and sources of financial capital that become available as we progress through a successful venture's life cycle.

The successful entrepreneur must understand the legal environment regulating financial relationships between the venture, investors, and financial institutions including venture capital funds and investment banks. We cover the basic securities laws and regulatory agencies, particularly the Securities and Exchange Commission (SEC), relevant to the entrepreneur when considering how to obtain financial capital at each stage.

To summarize, we take a comprehensive three-pronged stage-sensitive approach to entrepreneurial finance. Our coverage of entrepreneurship-adapted financial analysis and relevant institutional details provides a relevant financial analysis base for the entrepreneur in each of the various stages as he or she develops the idea, brings it to market, grows the venture's value, and ultimately provides an exit for venture investors. We identify and explain the types and sources of financing available during the various stages and introduce the relevant legal and regulatory environment the entrepreneur must consider when seeking financing throughout the venture's life cycle.

Distinctive Features

This text considers a successful firm as it progresses through various maturity stages. Specific examples of stage-relevant skills and techniques we introduce include:

- **Brainstorming and Screening:** Chapter 2 (Developing the Business Idea) introduces qualitative and quantitative venture screening devices. Chapter 3's (Organizing and Financing a New Venture) treatment of intellectual property issues demonstrates important issues and concepts for the earliest stage ventures.
- **Projecting Financial Statements:** Chapter 6 (Managing Cash Flow) focuses on the importance of maintaining adequate cash flow in the short run. Cash is "King." Chapter 9 (Projecting Financial Statements) focuses

on long-term projections incorporating future financing needs and establishing a basis for creating value over time.

- **Raising External Funds:** Chapter 8's (Securities Law Considerations When Obtaining Venture Financing) treatment of securities law introduces readers to the restrictions and warnings for the growing venture seeking external financing.
- **Venture Diagnostics and Valuation:** Chapter 10 (Valuing Early-Stage Ventures) presents our versions of traditional valuation techniques important to internal and external perceptions of a venture's financial health. While the material is traditional, our treatment provides a unifying approach to projecting financial statements, extracting pseudo-dividends, and assessing a venture's value.
- **Venture Capital Valuation Methods:** Chapter 11 (Venture Capital Valuation Methods) introduces representative multi-stage venture capital valuation methods and interprets them relative to more traditional procedures. It provides a unified example of traditional pre-money and post-money valuations and the shortcuts employed by many venture capitalists.
- **Professional VCs:** Chapter 12 (Professional Venture Capital) explores the historical development of venture capital and describes the professional venture investing cycle from determining the next fund objectives and policies to distributing cash and securities proceeds to investors.
- **Harvest:** Chapter 15 (Harvesting the Business Venture Investment) considers a wide range of venture harvest strategies including private sales (to outsiders, insiders, and family), transfers of assets, buyouts, and initial public offerings.
- **Turnaround Opportunities:** Chapter 16 (Financially Troubled Ventures: Turnaround Opportunities?) introduces important aspects of financial distress and alternative restructuring approaches (operations, asset, and financial) to rescue a struggling venture.

Intended Audience and Use

The material contained in this text has been used successfully at the upper division (junior/senior) undergraduate, MBA, and executive MBA levels. For MBAs, the course can easily be conducted in two ways. In the first, what we term the life cycle approach, we recommend the addition of illustrative cases, each at different life cycle stages. Recently, entrepreneurial finance cases have been available individually from the usual providers and in collected form in entrepreneurial case books. The second, or what we term the venture capital approach, emphasizes the money management aspects of financing entrepreneurial ventures. For this approach, we recommend supplementing the text treatments with venture capital cases (available individually or in collected case books) and journal articles covering private equity (venture capital) and initial public offerings (investment banking). For an abbreviated mini-semester course or compressed executive MBA, we recommend concentrating on the text and using our capstone cases as focal points for integrating the venture financing perspective.

We have also used this text for semester-long upper division (junior/senior-level) undergraduate courses involving finance and non-finance business majors. Most academic business programs require students to take basic background courses in both accounting and finance prior to upper division courses such as entrepreneurial finance. Chapters 10, 11, and 14 present a rigorous and conceptually advanced approach to financial valuation. Our experience is that these chapters provide the greatest intellectual challenge and require relatively sophisticated spreadsheet skills. The fifth edition of this textbook has been written to support two different approaches to the undergraduate entrepreneurial finance course. The more rigorous approach challenges undergraduate students by covering all 16 chapters including all valuation materials and has a decision-making focus. An alternative approach is to teach a more descriptive or conceptual course. For those preferring this latter approach, we recommend that Chapters 10 and 11 from Part 4 and Chapter 14 from Part 5 be omitted or covered in a descriptive (no modeling or calculations) manner. For application, while the included capstone cases synthesize a great deal of the text's material, some instructors find it useful to have students prepare short cases in lieu of, or prior to, these capstones.

Regarding the accounting and basic finance background material in Chapters 4 and 5, we provide it for student and instructor convenience when the material has not been covered in prerequisite courses or in instances when a review of the materials is warranted. The remainder of the text can be used without explicit coverage of this review material. Additionally, for some adopters, it may be advantageous to alter the sequencing and coverage of the securities law and investment banking material, depending on student backgrounds and other course offerings.

Pedagogical Enhancements in the Fifth Edition

Overall changes to content and organization include:

- At the beginning of each chapter of which there are now 16, we continue to add a "From the Headlines" story relating to an entrepreneurial venture. A discussion question related to the "From the Headlines" feature is provided in the end of chapter material.
- We continue to provide pedagogical guidance for: each exercise/problem at the end of each chapter by providing a brief italicized description of the content or focus of the exercise or problem.
- Chapter 3 (Organizing and Financing a New Venture) includes updated personal and corporate income tax information and includes recent changes in how the patent system operates.
- Chapter 6 (Managing Cash Flow) now focuses only on short-term financial statement projections and recognizes the need to generate, or plan for obtaining, sufficient cash flow to survive. In this edition, we have separate chapters on short-term and long-term financial planning.
- Chapter 8 (Securities Law Considerations When Obtaining Venture Funding) has been updated to reflect the significant impact the Jumpstart Our Business Startups (JOBS) Act of 2012 has on raising venture financing.
- Chapter 9 (Projecting Financial Statements) focuses on long-term financial statement projections in order to anticipate additional financing needs and to provide insights into possible value creation.

- Chapter 10 (Valuing Early-Stage Ventures) maintains the reorganization provided in the previous edition with an emphasis on simplifying the extended examples.
- Chapter 15 (Harvesting the Business Venture Investment) reflects current listing standards for the Nasdaq. We have added a current event reference for the Facebook-Nasdaq IPO trading issues.

Supplements

INSTRUCTOR'S MANUAL WITH TEST BANK

Written by the text authors, the Instructor's Manual includes short answers to end-of-chapter questions and answers to end-of-chapter problems. The Test Bank includes true/false and multiple choice questions, as well as short test problems. Both Instructor's Manual and Test Bank are available on the text Web site for instructors only.

POWERPOINT LECTURE SLIDES

Created by the text authors, the PowerPoint slides present a point-by-point lecture outline, including graphics and equations, for instructors to use in the classroom. They are available on the text Web site for instructors only.

EXCEL SOLUTIONS

Excel Solutions to end-of-chapter problems requiring Excel are provided for instructors on the text Web site.

TEXT WEB SITE

The text Web site at www.cengagebrain.com provides access to these supplements.

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During the several years we spent developing and delivering this material, we benefited from interactions with colleagues, students, entrepreneurs, and venture capitalists. We thank the numerous sections of students who became the sounding board for our presentation of this material. We also thank the members of the Venture Capital Association of Colorado who opened their professional lives and venture capital conferences to our students. Additionally, we have benefited from detailed valuable comments and input by Craig Wright and Michael Meresman. Clinton Talmo and Robert Donchez contributed to the preparation of the Instructor's Manual for earlier editions.

We recognize the moral support of the Deming Center for Entrepreneurship (Bob Deming, and directors Dale Meyer, Denis Nock, Kathy Simon, Steve Lawrence and Paul Jerde). We thank the Coleman Foundation for research support for the Coral Systems, Inc. and Spatial Technology, Inc. cases and the Educational Legacy Fund for research support for the Eco-Products, Inc. case.

We recognize the valuable contributions of our editorial staff at Cengage Learning, including Michael Mercier, our original acquisitions editor who believed in our book enough to publish it; Mike Reynolds, Senior Product Manager, and Adele Scholtz our developmental editor. Also, we'd like to thank our Senior Project Manager, Sangeetha Vijay. We also thank Martha Leach for research assistance behind the

"From the Headlines" stories and for proofreading a complete version of this fifth edition. We thank Andre Gygax, Hardjo Koerniadi, and Cody Engle who provided several important corrections to previous materials.

For their patience and insights offered during the process, we thank our colleagues who reviewed materials for this fifth edition or earlier editions of the text:

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Miranda Lam, Salem State College

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Srinivasan Sundaram, Ball State University

Michael Williams, University of Denver

Finally, to our families for their patience through five editions, we offer our sincere thanks.

J. Chris Leach

Ronald W. Melicher

About the Authors

J. Chris Leach is Professor of Finance and the Robert H. and Beverly A. Deming Professor in Entrepreneurship at the Leeds School of Business, University of Colorado at Boulder, where he currently serves as the Senior Associate Dean for Faculty and Research. He received a finance Ph.D. from Cornell University, began his teaching career at the Wharton School and has been a visiting professor at Carnegie Mellon, the Indian School of Business, and the Stockholm Institute for Financial Research (at the Stockholm School of Economics). His teaching experience includes courses for undergraduates, MBAs, Ph.D. students, and executives. He has been recognized as Graduate Professor of the Year and has received an award for MBA Teaching Excellence. His research on a variety of topics has been published in *The Review of Financial Studies*, *Journal of Financial and Quantitative Analysis*, *Journal of Business*, and *Journal of Money, Credit and Banking*, among other journals.

Chris's business background includes various startups dating back to his early teens in the 1970s. During his transition to the University of Colorado, he was the chairman of a New Mexico startup and later, as an investor and advisor, participated in a late 1990s Silicon Valley startup that subsequently merged into a public company. His consulting activities include business and strategic planning advising, valuation, and deal structure for early stage and small businesses. He is a faculty advisor for the Deming Center Venture Fund and a member of the Deming Center Board of Directors. MBA teams Chris has advised have qualified for nine international championships of the Venture Capital Investment Competition.

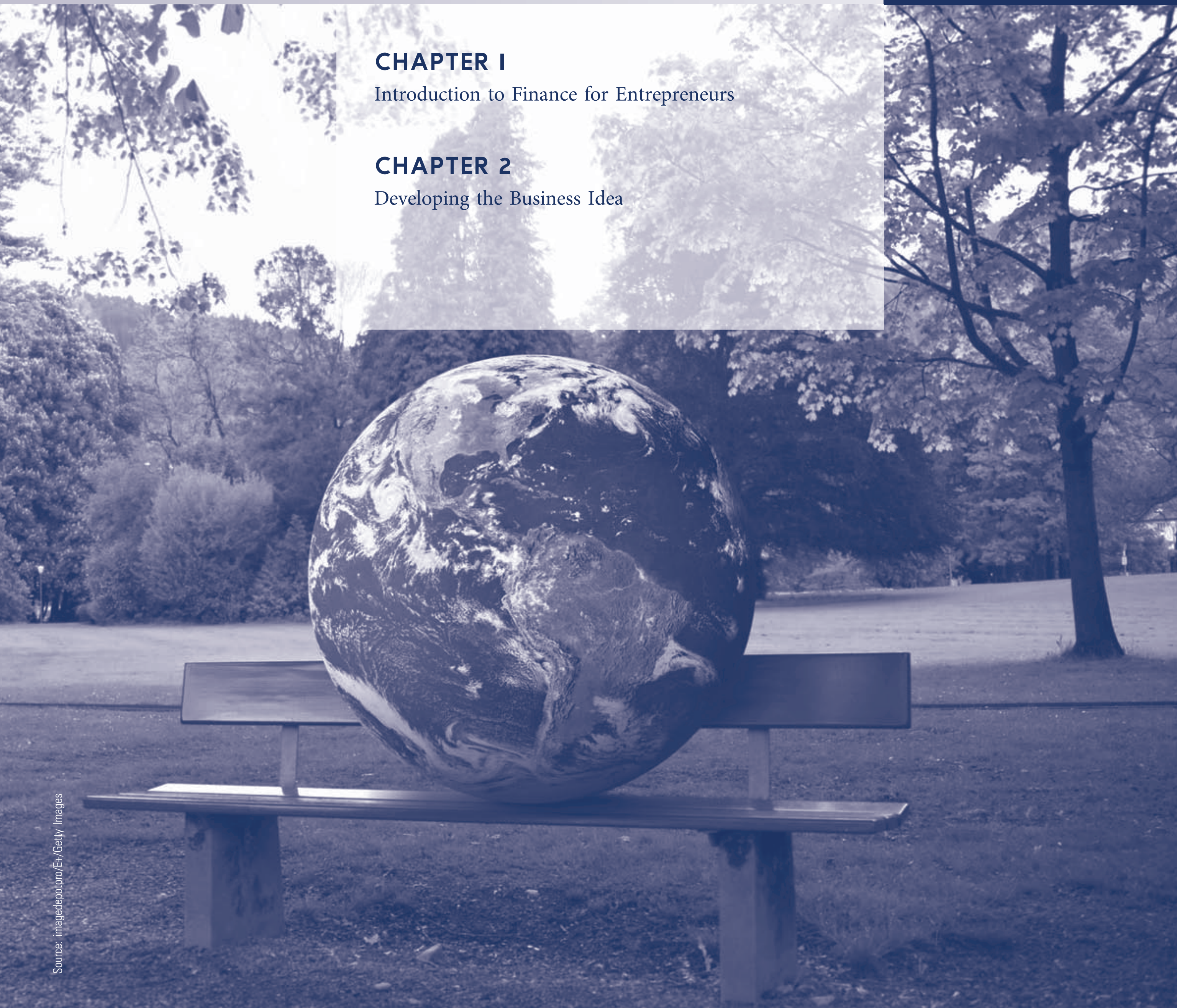
Ronald W. Melicher is Professor of Finance in the Leeds School of Business at the University of Colorado at Boulder. He earned his undergraduate, MBA, and doctoral degrees from Washington University in St. Louis, Missouri. While at the University of Colorado, he has received several distinguished teaching awards and was designated as a university-wide President's Teaching Scholar. He also has held the William H. Baugh Distinguished Scholar faculty position, served three multi-year terms as Chair of the Finance Division, served as the Faculty Director of the Boulder Campus MBA Program, and twice was the Academic Chair of the three-campus Executive MBA Programs. Ron is a former president of the Financial Management Association.

Ron has taught entrepreneurial finance at both the MBA and undergraduate levels. He also teaches corporate finance and financial strategy in the MBA and Executive MBA programs and investment banking to undergraduate students. While on sabbatical leave from the University of Colorado, Ron has taught at the INSEAD Graduate School of Business in Fontainebleau, France and at the University of Zurich in Zurich, Switzerland. He has delivered numerous university-offered executive education non-credit courses and has taught in-house finance education materials for IBM and other firms. He has given expert witness testimony on cost of capital in regulatory proceedings and has provided consulting expertise in the areas of financial management and firm valuation.

Ron's research interests focus on mergers and acquisitions, corporate restructurings, and the financing and valuation of early-stage firms. His previous research has been published in major finance journals including the *Journal of Finance*, *Journal of Financial and Quantitative Analysis*, and *Financial Management*. He is the co-author of *Introduction to Finance: Markets, Investments, and Financial Management*, Fifteenth Edition (John Wiley & Sons, 2014).

The Entrepreneurial Environment

1 PART



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Introduction to Finance for Entrepreneurs

CHAPTER 1

FIRST THOUGHTS

Only those individuals with entrepreneurial experience can say, "Been there, done that!" With aspiring entrepreneurs in mind, we start at the beginning and consider how entrepreneurial finance relates to the other aspects and challenges of launching a new venture. Our goal is to equip you with the terms, tools, and techniques that can help turn a business idea into a successful venture.

LOOKING AHEAD

Chapter 2 focuses on the transformation of an idea into a business opportunity and the more formal representation of that opportunity as a business plan. Most successful ideas are grounded in sound business models. We present qualitative and quantitative screening exercises that can help determine an idea's commercial viability. We provide a brief discussion of a business plan's key elements.

CHAPTER LEARNING OBJECTIVES

This chapter presents an overview of entrepreneurial finance. We hope to convey the potential benefit of embracing standard entrepreneurial finance methods and techniques. We consider an entrepreneur's operating and financial decisions at each stage, as the venture progresses from idea to harvest. After completing this chapter, you will be able to:

1. Characterize the entrepreneurial process.
2. Describe entrepreneurship and some characteristics of entrepreneurs.
3. Indicate three megatrends providing waves of entrepreneurial opportunities.
4. List and describe the seven principles of entrepreneurial finance.
5. Discuss entrepreneurial finance and the role of the financial manager.
6. Describe the various stages of a successful venture's life cycle.
7. Identify, by life cycle stage, the relevant types of financing and investors.
8. Understand the life cycle approach used in this book.

FROM THE HEADLINES

Small Wind Gets a Gust from CLEANtricity Power

According to a recent poll, 89% of U.S. voters, including 84% of Republicans, 88% of Independents, and 93% of Democrats, believe that increasing the amount of energy their nation gets from wind is a good idea.[1] While these voters and their parties find plenty of issues on which they vehemently disagree, there is little doubt that the United States and the world will continue to increase its efforts to harvest energy from the wind. In 2008, 42% of all new generating capacity in the United States came from wind, up from only 2% in 2004.[2]

Much of the public's attention has been focused on large-scale wind farming, complete with landscape photos of rows of towering wind turbines sporting massive propellers. Less in the limelight, but every bit as much in the game, are ventures targeting small-scale wind turbine electricity generation. Like their cousins in other renewable energy categories, including those working with micro biofuel and solar energy production, small-scale wind energy generation ventures are contributing to the debate on viable paths forward in the renewable energy markets.

CLEANtricity Power, located in Broomfield, Colorado, is one of the new players in the "small wind market." The American Wind Energy Association characterizes that market by the target customers and the rated capacity of the generating technology:

> *Small wind turbines are electric generators that utilize wind energy to produce clean, emissions-free power for individual homes, farms, and small businesses. With this simple and increasingly popular technology, individuals can generate their own power and cut their energy bills while helping to protect the environment. The United States leads the world in the production of small wind turbines, which are defined as having rated capacities of 100 kilowatts and less, and the market is expected to continue strong growth through the next decade.*[3]

CLEANtricity's intent is to manufacture small-scale wind turbines that "enable individuals, businesses, and communities to generate reliable, affordable clean energy where they use it." Their current product offering, known as the SHAPEshifter, is a vertical-axis self-adjusting wind turbine capable of electricity generation at lower wind speeds than the usual 30 miles per hour targeted by competing technology. It accomplishes this versatility by morphing into a more efficient shape depending on the speed of the wind. Co-founder and chief executive officer Daniel Sullivan summarizes this capability as "it's large in low winds and small in high winds…the blades move naturally to their optimum position."[4] Given that North American wind speeds at 60 feet above ground only average 7.3 miles per hour, SHAPEshifter's functionality at lower speeds and its ability to adapt to higher speeds offer a potentially important advantage in the small-scale wind generation market.

CLEANtricity is a self-funded 2009 startup and was one of twelve semifinalists at the 2009 Rocky Mountain Region Clean Tech Open. At the time we met with them with prototype, provisional patent, and field tests in hand, they were seeking $2 million in external financing.

1 American Wind Energy Association press release, April 22, 2010, citing poll conducted by Neil Newhouse of Public Opinion Strategies and Anna Bennett of Bennett, Petts & Normington; press release available at http://www.awea.org/newsroom/releases/04-22-10_Poll_Shows_Wind_Works_for_Americans.html visited on 4/25/2010.
2 American Wind Energy Association, "Wind, A Leading Source of New Electricity Generation," http://www.awea.org/pubs/documents/Outlook_2009.pdf., visited on 4/25/2010.
3 http://www.awea.org/smallwind/ visited on 4/25/2010.
4 *Coloradobiz*, December 2009, Tech Startup of the Month, pg. 58. This article is also available at http://www.cobizmag.com/articles/tech-startup1/.

Small Business Administration (SBA)
established by the federal government to provide financial assistance to small businesses

It is estimated that more than one million new businesses are started in the United States each year. The Office of Advocacy of the United States **Small Business Administration (SBA)** documents that "employer firm births" have exceeded 700,000 annually in recent years.[1] Reasonable estimates place non-employer (e.g., single person or small family) businesses started each year at a similar number. In addition to these formally organized startups, countless commercial ideas are entertained and abandoned without the benefit of a formal organization. The incredible magnitude of potential entrepreneurial opportunities is a clear reflection of the commercial energy fostered by a market economy. We believe that the time spent on this book's treatment of financial tools and techniques may be one of the more important investments you make.

1 The Office of Advocacy of the Small Business Administration (SBA) was created in 1976 by Congress to be an independent voice for small business within the federal government. Small business statistics are available at http://www.sba.gov/sites/default/files/Startup%20Rates.pdf.

SECTION **1.1**

The Entrepreneurial Process

The **entrepreneurial process** comprises: developing opportunities, gathering resources, and managing and building operations, all with the goal of creating value. Figure 1.1 provides a graphical depiction of this process. Many entrepreneurship students have formulated ideas for possible new products and services. However, prior to committing significant time and resources to launching a new venture, it can really pay to take the time and effort to examine the feasibility of an idea, screen it as a possible venture opportunity, analyze the related competitive environment, develop a sound business model, and prepare a convincing business plan.

entrepreneurial process

developing opportunities, gathering resources, and managing and building operations with the goal of creating value

The second aspect of a successful entrepreneurial process involves gathering the physical assets, intellectual property, human resources, and financial capital necessary to move from opportunity to entrepreneurial venture. The venture should organize formally and legally, the process of which also provides an opportunity for founders to build consensus for the new venture's boundaries of authority and basic ethical framework. Every startup needs "seed" financing and must have a strategy for acquiring it.

The third piece of the entrepreneurial process is managing and building the venture's operations. An effective business model must generate revenues to cover operating costs in the foreseeable future. Eventually, a growing venture will also need to provide enough cash flow to cover planned expansion and reinvestment. Additional financing rounds, possibly including those available through public securities offerings, may be necessary for growth in later years.

Figure 1.1 The Entrepreneurial Process

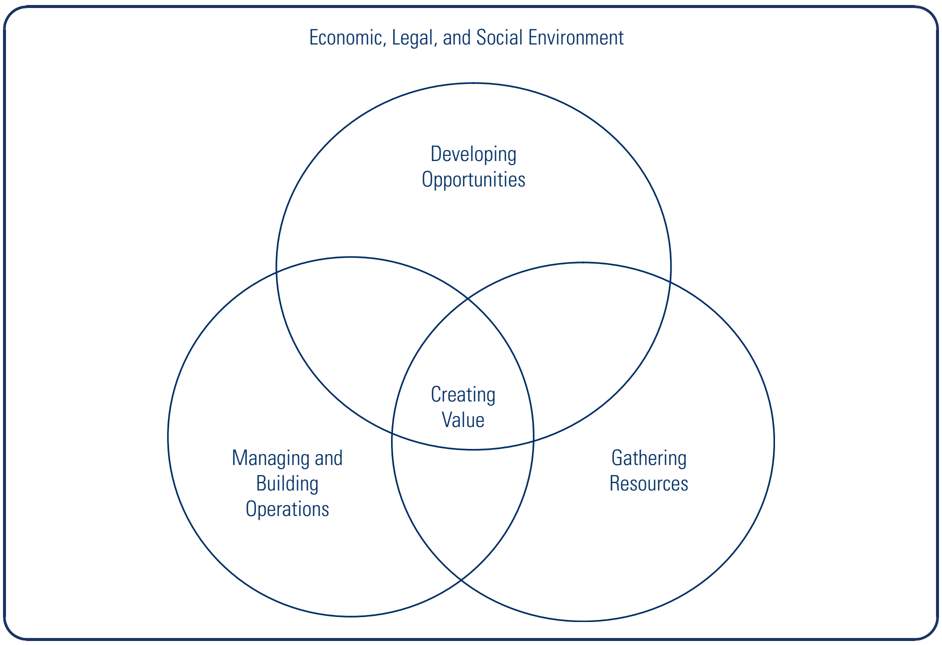

Figure 1.1 depicts an intersection of all three components—creating value. Each of the components contributes to the overall value. As a reminder of the wider context, we place the components and their intersection in the context of the venture's economic, legal, and social environment.

CONCEPT CHECK ► What are the components of the entrepreneurial process?

SECTION **1.2**

Entrepreneurship Fundamentals

Successful entrepreneurs recognize and develop viable business opportunities, have confidence in the market potential for their new products and services, and are committed to "running the race." They keep success in sight even when others may have difficulty focusing.

WHO IS AN ENTREPRENEUR?

After working for a large corporation for nearly five years, you are considering launching a Web-based business. Product development and testing require financing that exceeds your limited personal resources. How much external financing do you need to make a credible attempt with the new venture? How much of the venture's ownership will you have to surrender to attract this initial financing?

A friend of yours, who graduated from college three years ago, started a new business on the conviction that pumpkin stencils and special carving knives could foster an unprecedented commercial exploration of the market for Halloween crafts. Her firm has experienced phenomenal growth and is seeking financing for this season's inventory stockpiling. Do her options differ from yours? Do the possible investors for your startup and her later-stage venture move in the same circles?

Your neighbor is the chief executive officer (CEO) of a large firm founded twenty years ago. He has accumulated enormous paper wealth and, before retirement, wishes to diversify his investments. How do your neighbor's investment goals and your financial needs relate to one another? Is your neighbor a reasonable prospect for startup funding, or is he more likely to spend the money he has allocated for earlier-stage investing on his own idea for a new product? Does he see himself as an entrepreneur or as one who wants to enable and profit from other entrepreneurs?

Who will succeed? Who will fail? Who is an entrepreneur? Your pumpkin-carving friend? Your CEO neighbor? You? All of you or none of you? We offer no infallible formula or process for entrepreneurial success. None exists. We cannot tell you if you should drop a Fortune 500 career track and take up drinking from the entrepreneurial fire hose. We have no blueprint for the ideal entrepreneur and no screening device to test for the entrepreneurial gene. Even if we had such a test, rest assured that for many who test positive, the news might not be welcome, particularly to friends and family. The ups and downs of the entrepreneurial lifestyle are difficult for those supporting the entrepreneur financially and emotionally. Nonetheless, we believe that the tools and techniques we introduce can help entrepreneurs and others anticipate venture challenges, navigate through shortfalls, and achieve important milestones. Fortunately for the entrepreneur, employees, backers, and their families, these tools and techniques can help smooth out an inevitably bumpy ride.

BASIC DEFINITIONS

While the academic definition of "entrepreneurship" has evolved, it is useful to formalize our context for the term. Jeffry Timmons and Stephen Spinelli suggest that "entrepreneurship is a way of thinking, reasoning, and acting that is opportunity obsessed, holistic in approach, and leadership balanced for the purpose of value creation and capture."[2] We adopt a somewhat shorter definition: **Entrepreneurship** is the process of changing ideas into commercial opportunities and creating value. An **entrepreneur** is an individual who thinks, reasons, and acts to convert ideas into commercial opportunities and to create value. Whether entrepreneurial efforts succeed or fail, an entrepreneur's mission is to find economic opportunities, convert them into valuable products and services, and have their worth recognized in the marketplace.

entrepreneurship
process of changing ideas into commercial opportunities and creating value

entrepreneur
individual who thinks, reasons, and acts to convert ideas into commercial opportunities and to create value

CONCEPT CHECK
- What is the meaning of entrepreneurship?
- Who is an entrepreneur?

ENTREPRENEURIAL TRAITS OR CHARACTERISTICS

While we want to avoid most generalizations about entrepreneurial traits or characteristics, there are three we consider important. First, successful entrepreneurs recognize and seize commercial opportunities, frequently before others even have an inkling of their potential. Mark Twain once said, "I was seldom able to see an opportunity, until it ceased to be one." Second, successful entrepreneurs tend to be doggedly optimistic. The glass is never "half empty" and usually not even "half full." It is "full," and they are ready to call for more glasses. Third, successful entrepreneurs are not consumed entirely with the present. Their optimism is conditional. They know that certain events need to take place for this optimism to be justified. They do not treat venture planning as the enemy. Seeing a (conditionally) bright future, successful entrepreneurs plan a way to get there and begin to construct paths to obtain the required physical, financial, and human resources.

While there are caricatures, there is no prototypical entrepreneur. Many authors have tried to identify specific characteristics of successful entrepreneurs, but accurate generalizations have eluded them. There are numerous myths about entrepreneurs.[3] One hears that "entrepreneurs are born, not made." Yet many successful entrepreneurs have been, or will be, failing entrepreneurs if observed at different times in their lives. While identifying the fear of failure as a personal motivation propelling them forward, successful entrepreneurs are not paralyzed by this fear. If you see venture bumps as opportunities rather than obstacles, perhaps the entrepreneurial lifestyle is right for you.

2 Jeffry A. Timmons and Stephen Spinelli, *New Venture Creation*, 8th ed. (New York: McGraw-Hill/Irwin, 2009), p. 101. See also: Stephen Spiunelli and Rob Adams, *New Venture Creation*, 9th ed. (New York: McGraw-Hill/Irwin, 2012).

3 Timmons and Spinelli address seventeen myths and realities about entrepreneurs and summarize prior efforts to identify characteristics of successful entrepreneurs. Ibid., pp. 59–60.

CONCEPT CHECK ► What are some general traits or characteristics of entrepreneurs?

OPPORTUNITIES EXIST BUT NOT WITHOUT RISKS

If you feel the entrepreneurship bug biting, you are not alone. Remember, the annual number of new U.S. business formations runs in the millions. Small and growing enterprises are critical to the U.S. economy; small firms provide over 80 percent of net new jobs.[4]

Firms with fewer than 500 employees represent more than 99 percent of all employers and employ approximately one-half of the private workforce. During the past century, entrepreneurial firms' innovations included personal computers, heart pacemakers, optical scanners, soft contact lenses, and double-knit fabric. Entrepreneurial firms have long been major players in high-technology industries, where small businesses account for over one-fourth of all jobs and over one-half of U.S. innovations and new technologies. Small high-technology firms are responsible for twice as many product innovations per employee, and obtain more patents per sales dollar, than large high-technology firms. One government study suggests that some of the fastest growing opportunities for small businesses are in the restaurant industry, medical and dental laboratories, residential care industries (housing for the elderly, group homes, etc.), credit reporting, child daycare services, and equipment leasing.[5]

As much as we would like to encourage your entrepreneurial inclinations, it would be irresponsible for us to imply that starting and successfully operating a business is easy. As a basic financial principle, risk and return go together—the expectation of higher returns is accompanied by higher risks. According to the SBA's Office of Advocacy, around two-thirds of new employer businesses survive at least two years and only about one half survive for at least five years.[6]

For additional perspective, Headd studied the U.S. Census Bureau's Characteristics of Business Owners database, which surveyed owners of closed firms on whether the owners felt their firms were successful or unsuccessful at the time of closure. The evidence suggests that about one-third of closed businesses were successful at closure. Thus, instead of closing due to bankruptcy, many owners may have exited their businesses by retiring or selling.[7]

Nearly half of business failures are due to economic factors such as inadequate sales, insufficient profits, or industry weakness. Of the remainder, almost 40 percent cite financial causes, such as excessive debt and insufficient financial capital. Other reasons include insufficient managerial experience, business conflicts, family problems, fraud, and disasters.[8]

Although the risks associated with starting a new entrepreneurial venture are large, there is always room for one more success. Successful entrepreneurs are able

4 *Small Business Profile* (Washington, DC: U.S. Small Business Administration, Office of Advocacy, 2012). See http://www.sba.gov/sites/default/files/us11_0.pdf.

5 "Small Business Answer Card" and "The Facts about Small Business" (Washington, DC: U.S. Small Business Administration, Office of Advocacy, 2000).

6 *Small Business Facts*, http://www.sba.gov/sites/default/files/Business-Survival.pdf.

7 Brian Headd, "Redefining Business Success: Distinguishing Between Closure and Failure," *Small Business Economics* 21 (2003): pp. 51–61.

8 "Small Business Answer Card" and "The Facts About Small Business."

to anticipate and overcome the business risks that cause others to fail. While hard work and a little luck will help, an entrepreneur must be able to finance and manage the venture. Commercial vision, an unrelenting drive to succeed, the ability to build and engage a management team, a grasp of the risks involved, and a willingness to plan for the future are some of the ingredients for success.

CONCEPT CHECK

- What percentage of new businesses survive four years of operation?
- What are some of the major reasons why small businesses fail?

SECTION **1.3**

Sources of Entrepreneurial Opportunities

Entrepreneurs are the primary engine of commercial change in the global economy. **Entrepreneurial opportunities** are ideas that have the potential to create value through new, repackaged, or repositioned products, markets, processes, or services. One study of *Inc*. magazine's 500 high-growth firms suggests that about 12 percent of founders feel their firms' successes are due to extraordinary ideas, whereas the remaining 88 percent feel their firms' successes are due to exceptional execution of ordinary ideas.[9] In a separate survey, Amar Bhide found that *Inc*. 500 founders often make use of existing ideas originating in their prior work experiences. Only 6 percent of his responding founders indicate that "no substitutes were available" for their products or services. In contrast, 58 percent say they succeeded even though competitors offer "identical or close substitutes."[10]

entrepreneurial opportunities
ideas with potential to create value through different or new, repackaged, or repositioned products, markets, processes, or services

Megatrends are large societal, demographic, or technological trends or changes that are slow in forming but, once in place, continue for many years. In contrast, *fads* are not predictable, have short lives, and do not involve macro changes. Of course, there are many degrees between fads and megatrends that provide entrepreneurs with business opportunities. However, while entrepreneurial opportunities can come from an almost unlimited number of sources, we give special focus to Figure 1.2's five megatrend categories.

SOCIETAL CHANGES

Many entrepreneurial endeavors are commercial reflections of broader societal changes. In 1982, John Naisbitt identified several major or megatrends shaping U.S. society and the world.[11] Naisbitt recognized that the U.S. economy, by the early

9 J. Case, "The Origins of Entrepreneurship," *Inc.*, June 1989, p. 51.

10 Amar V. Bhide, *The Origin and Evolution of New Businesses* (New York: Oxford University Press, 2000).

11 John Naisbitt, *Megatrends* (New York: Warner Books, 1982). Although only two are presented here, Naisbitt identified six additional megatrends. For a follow-up look at the megatrends shaping our society, see John Naisbitt and Patricia Aburdene, *Megatrends 2000* (New York: Morrow, 1990). In a 2007 article in *Entrepreneur* magazine, five forces that shaped the face of entrepreneurship over the past three decades were identified as technology (the computer), the Internet (a network to link computers), globalization (everyone can sell worldwide), baby boomers (question-authority attitudes), and individualism (corporate restructurings forced individuals to look out for themselves). See Carol Tice, "Change Agents," *Entrepreneur* (May 2007), pp. 65–67.